



Are Fairness Opinions...Fair?

Jeffrey B. Bede
Managing Director, Private Placements
Chessiecap, Inc.

Commonly used to justify transactions, fairness opinions have come under heavy regulatory and public scrutiny. **Investment banks often issue supposedly “objective” opinions when there are substantial potential conflicts of interest that could have affected their objectivity.** In some cases, the bank was actually advising the company on the transaction and had a large success fee at stake. Quite often, a bank is looking for future business from a company or wants to preserve a good relationship. In either case, the client’s desired outcome is usually clear, and investment banks have been all too eager to be “fair”.

We at Chessiecap Securities believe it is in the best interest of companies to hire an independent investment bank with deep transaction expertise, industry experience, and business judgment to make the opinion as objective as possible. **Independence, expertise and judgment** are the keys to creating an objective, high integrity fairness opinion.

Who Needs a Fairness Opinion?

A fairness opinion is a formal review, typically by an investment bank, that assesses whether a transaction is fair to shareholders from a financial point of view. It is most often used in a corporate merger or acquisition to opine on the suitability of the acquisition price, but opinions are used in a variety of other situations where an outside financial opinion is necessary. Fairness opinions are particularly important when the transaction is not arms length, or market, such as an insider-led financing or a management buy-out.

Transactions Where a Fairness Opinion is Important

- ◆ Corporate acquisitions and divestitures
- ◆ Leveraged buyouts
- ◆ Recapitalizations and restructurings
- ◆ Employee Stock Ownership Plan (ESOPs) transactions
- ◆ Exchange offers/minority buy-outs
- ◆ Transactions involving “insiders” and related parties
- ◆ Court appointed valuations in hostile takeovers
- ◆ Liquidations
- ◆ Bankruptcy reorganizations
- ◆ Dissenting Shareholder disputes

Why All the Attention Now?

In theory, fairness opinions are designed to protect the interests of shareholders or other parties who do not have a voice in the transaction. In practice, they can become expensive insurance policies for companies. We are not lawyers and will leave the legal nuances to the experts, but fairness opinions grew in importance out of the

“business judgment rule”. Boards of directors and management have a fiduciary responsibility to act on behalf of shareholders. The business judgment rule protects directors from liability in transactions where they exercise due care, meaning that they have made an informed judgment, acted in good faith and do not have a conflict of interest.

“In general, courts will not review business decisions or second guess the decisions of a Board of Directors or find liability for honest mistakes of business judgment. A party attacking a transaction bears the burden of proving that it was unfair, provided the board had taken the proper steps.”

- The Business Judgment Rule

It is clear that fairness opinions help establish that directors and management exercised due care. Companies should get these opinions to protect shareholders and arm themselves in case of a shareholder lawsuit. The biggest risks, though, are if the opinions are found to have significant conflicts of interest or are not appropriately thorough or complete.



Both Art and Science

The key to a fairness opinion - and the reason an investment bank is typically used -- is valuation. Is the consideration given or received fair to the shareholders? Anyone familiar with company valuation knows that valuation is both art and science. In the absence of a thorough auction, we cannot rely on valuation as the clearing price the market is willing to pay. Thus, valuation methodologies, such as discounted cash flow models or comparable company or transaction multiples, provide some of the science. These methodologies are grounded in financial theory and have at least some empirical basis. Basing a valuation on future cash flows or using comparable valuations in the marketplace makes a lot of sense.

Science

- Valuation - future cash flow, discounted cash flow
- Comparable company or transaction multiples

Art

- Creating the financial projections
- Choice of market comparables
- Choice of financial metrics
- Market dynamics
- Less mature companies and industries

The art comes in when applying these methodologies. For the discounted cash flow, financial projections and the discount rate take on enormous importance. In practice, the financial projections are prepared by management and can be overly optimistic or pessimistic to get the desired result. Most investment banks explicitly state in their opinion letters that they have not reviewed or made a judgment about the projections in order to sidestep the inherent subjectivity of financial projections. The discount rate depends on an analysis of comparable companies and consequently depends on the choice of these comparables. The rate becomes even more problematic for small or private companies where a premium is often added to the discount rate to account for additional risk.

Comparable valuation methods use averages of the multiples of comparable public companies or comparable M&A transactions. Obviously, the choice of companies used in this average can have a strong impact on the resulting valuation. Even choosing the mean or median makes a difference. Furthermore, bankers have discretion in their choice of financial metrics to multiply (revenues, EBITDA, net income, book value) and can use forward multiples that bring in the uncertainty of projections. Even actual financial results for the company or comparables may need to be modified to make them comparable due to accounting differences, discontinued operations, one-time gains or losses, and other financial factors.

Finally, every industry, every company and every transaction is different, and it is important for investment banks to use sophisticated analysis to consider those factors. Valuation issues become compounded when analyzing fast growing, less mature companies. Valuation is often most difficult for earlier stage technology companies that do not have profits and are in rapidly changing industries, where future financial performance is even harder to predict. The net result is that valuations depend on key variables and can have wide swings. Investment bankers have a lot of discretion - and independence - and, as a result, expertise and judgment are essential.

Conflicts of Interest

Discretion becomes especially problematic if the bank is not truly independent. The imperfect nature of valuation means that a fairness opinion is always a candidate for intense scrutiny. Some investment banks can be strongly influenced by their desire to position for future business, preserve a good relationship with directors or management or earn large success fees based upon closing of the transaction.

The argument for using the investment bank that is advising on the transaction (and with success fees at stake) is that the investment bank knows the company, industry and nuances of the transaction. The already engaged investment bank is in the most informed position to issue a fairness opinion. The deal expenses to the Company may be less as the opinion fees can be tied to the overall fees coming out of the transaction. Are these reasons compelling enough to risk a clear conflict of interest?



There Must Be A Better Way

In our opinion, there is a better way. Increased disclosure that explains potential conflicts of interest helps, but we believe this does not go far enough. In a perfect world, shareholders should do their own investigation and not rely on a fairness opinion; however, the fairness opinion serves an important role in providing useful information to shareholders as well as a needed validation of pricing in the absence of a market transaction. In this post-Enron era of increased shareholder and regulatory vigilance, an unassailable fairness opinion will serve a company well in any potential dispute. We believe the keys to an effective fairness opinion are independence, expertise and judgment.

Independence. Receiving a fairness opinion from an independent bank avoids many of the obvious conflicts of interest. Its compensation is not specifically tied to providing a favorable opinion, it is in the best position to determine fairness, and it may be more likely to take its responsibilities seriously and objectively.

Expertise. Industry and financial expertise allow a bank to come up to speed quickly on a transaction and offer a valuable outside voice on behalf of shareholders. The investment bank can provide expert analysis and decipher industry nuances, providing a counter to the subjective nature of valuation. Investment banks that do not have the subject matter expertise to ask the right fundamental industry and company specific questions expose their valuations and opinions to an unnecessary level of uncertainty.

Judgment. Look for bankers who have the years of transaction experience and business acumen to manage the fairness opinion process effectively. Sensitivity to timing is crucial. On one hand, the banker must represent fairness and be willing to imperil a deal to drive fairness. On the other, the banker needs the discrimination to attain fairness while not unnecessarily jeopardizing the timing or viability of the transaction.

Complete Package. Hiring an independent bank that has both deep industry and financial expertise and years of transaction experience is the best course of action. From a short-sighted point of view, this type of fairness opinion may not be in the best interests of management or directors who have incentives to get a deal done or who want to control the fairness opinion process. In our opinion, true independence from a competent firm is the long-term solution that avoids major challenges from regulators and shareholders.

Change is needed in the investment banking industry to maintain the role of the fairness opinion. The skeptic will say that fairness opinions were never designed to be objective and are mainly used to create legal cover for directors. We make the point that the two are tied together. If fairness opinions are discredited due to conflicts of interest, then they will lose all their legal potency. ***Independence*** of the advisory investment bank will create trust among parties. ***Expertise*** and ***judgment*** will ensure the opinion's credibility.

On the Regulation Horizon

The NASD is taking a close look at the issue of independence and is expected to, at the very least, issue new disclosure guidelines. We believe that company directors should take action now and ensure that any fairness opinion is provided by an independent investment bank with the appropriate expertise and judgment.



Chessiecap

About Jeff Bede

Mr. Bede is an experienced investment banker and has spent much of his career raising private equity for growth and middle-market companies. He has executed over 30 successful transactions raising more than \$1.5 billion - the majority of which were in information technology. Prior to joining Chessiecap, Mr. Bede was a co-founder and Principal at Capital Run LLC, a Seattle-based boutique investment bank that specializes in providing private equity, debt, and M&A advisory services. Mr. Bede has also worked for a number of investment banks, including Prudential Securities, Volpe, Brown & Whelan, Dain Rauscher Wessels and Donaldson, Lufkin & Jenrette, executing private equity, M&A, and public offering transactions.

Mr. Bede holds Bachelors and Masters Degrees from Stanford University and an MBA, with honors, from the University of Chicago.

Contact: jeff@chessiecap.com or 301.469.3186.

About Chessiecap

Chessiecap, Inc. is a team of transaction professionals that leverages exceptional investment banking, strategy and technology expertise to drive premium value transactions. Our **Prepare, Deliver, & Transact** methodology strengthens growth and middle market companies and accelerates their access to capital markets. For more information, visit www.chessiecap.com.

Contact Us

Doug Schmidt
CEO and Managing Director
301.469.3181
doug@chessiecap.com

Alden Hart
CTO and Managing Director
301.469.3182
alden@chessiecap.com

Peter Buchanan
Managing Director,
Strategy Services
301.469.3184
peter@chessiecap.com

Jeff Bede
Managing Director,
Private Placements
301.469.3186
jeff@chessiecap.com

Rick Garvin
Managing Director,
Technology Consulting Services
301.469.3183
rgarvin@chessiecap.com

Ann Quinn
Director, Strategy Services
301.469.3197
ann@chessiecap.com