

Pitfalls in Fairness Opinion Valuations

By Gilbert E. Matthews, CFA

A fairness opinion is a document that states whether a transaction, or the consideration payable in a transaction, is fair, from a financial point of view, to a particular group of investors. Fairness opinions are most often issued by investment banking firms, but also by commercial banks, accounting firms, and entities specializing in valuation.

The opinions are normally addressed to equity investors, sometimes to all common shareholders or limited partners, and sometimes to a specific subgroup, for example, public shareholders, or shareholders other than an interested party.

Fairness opinions serve two purposes: 1. they provide key decision makers with information that may affect their decisions; and 2. they can serve as evidence in litigation that the decision makers used reasonable business judgment in approving a transaction.

Importance in Litigation

An important role of a firm giving a fairness opinion is defending the opinion in the event of litigation. In selecting a firm, it behooves the retaining party to understand the qualifications and skills of the firm it engages and of the senior people who will be responsible for the assignment.

Boards of directors of corporations and general partners of limited partnerships are required to act with informed business judgment when considering a proposed transaction. Whether informed business judgment was used is often a central issue in litigation.

In *Smith v. Van Gorkom*,¹ the Delaware Supreme Court ruled that the directors of Trans Union Corp. were grossly negligent in not obtaining adequate information as to the value of the company when they approved a cash acquisition of Trans Union. The court criticized the directors for not seeking “any valuation study or documentation of the \$55 price per share as a measure of the fair value of the Company in a cash-out context.” They relied primarily on information provided by officers of the company and failed to request any advice from independent advisors.

¹ 488 A.2d 858 (Del. 1985).

Although the merger price was at a substantial premium over the market price of Trans Union's stock, and although the experienced and reputable directors were not charged with acting with malice, the directors were adjudged liable to the plaintiff stockholders for damages. While the court did not hold that, as a legal matter, directors must always obtain an outside valuation study, a fairness opinion would have helped the Trans Union directors to demonstrate that they had made an informed business decision.

Pitfalls in Valuation

Numerous courts have ruled that directors are entitled to rely on the opinion of an independent investment bank in fulfilling their fiduciary obligations.² However, directors have a duty to inquire as to the basis of an opinion, and are not entitled to rely on an opinion given in conclusory terms without supporting documentation.³

Accordingly, litigators, experts, and directors may be called upon to critique fairness opinions. Some of the author's *bêtes noires* are discussed below.

1. Selection of Comparable Companies

It is important that comparable companies have characteristics that do not make them dissimilar in the eyes of investors. The fact that companies are in the same general industry category does not necessarily make them comparable. Companies in the electronics, computer, and semiconductor sectors include innovative, fast-growing companies with strong patent and market positions, but also mundane manufacturers of commodity-type products, such as memory chips and electrical connectors.

On the other hand, companies making dissimilar products but using similar manufacturing processes or supplying the same end markets could be deemed comparable to the extent that they are subject to similar market forces. There are marked similarities, for example, between manufacturers of different kinds of components for automobiles, all of which are dependent on the success of automobile companies and the state of the auto industry.

2. Overstated Averages

Arithmetic means of ratios with price in the numerator, such as AMV/EBITDA and P/E, give greater weight to higher multiples and less weight to lower multiples. The median, the midpoint of the group, is a better measure of central value, but it effectively eliminates information contained in the remaining multiples.

In any event, the median can be unreliable with small samples. The harmonic mean, which is calculated by taking the arithmetic mean of the reciprocals of the market multiples, is statistically a better measure of central value. The harmonic mean gives equal weight to equal dollar investments, while the arithmetic mean gives greater weight to stocks with higher price/earnings ratios.

As an example, take two hypothetical companies selling at \$40 per share: Company X has earnings per share of \$4.00, and Company Y has earnings of \$1.00 per share. The P/Es of the two companies are

² E.g., *Samjens Partners I v. Burlington Indus., Inc.*, 663 F. Supp 614 (S.D.N.Y. 1987); *Horwitz v. Southwest Forest Indus. Inc.*, 604 F. Supp. 1130 (D. Nev. 1985); *Nebenzahl v. Miller*, C.A. No. 13206, 1993 Del. Ch. LEXIS 249 (Del. Ch. Nov. 8, 1993). See also 8 Del C. §141(e).

³ *Hanson Trust PLC v. ML SCM Acquisition Inc.*, 781 F.2d 264 (2d Cir. 1986).

10x and 40x, respectively, and the arithmetic mean is 25x. The harmonic mean is calculated by taking the reciprocals of 10x and 40x (0.10 and 0.025), averaging the reciprocals (0.0625), and then taking the reciprocal of 0.0625 to get a harmonic mean P/E of 16x.

If a person invests an equal amount in each stock, what is the P/E of the portfolio? Investing \$4,000 in 100 shares of Company X buys underlying earnings of \$400; \$4,000 invested in 100 shares of Company Y purchases underlying earnings of \$100. With \$8,000 invested in a portfolio earning a total of \$500, the portfolio's P/E is 16x, *i.e.*, the harmonic mean.

If, instead, one wished to purchase \$400 of the underlying earnings in each company, one would still buy 400 shares of Company X for \$4,000, but would have to spend \$16,000 to buy 1,600 shares of Company Y. The total cost of the portfolio would be \$20,000 for \$800 in earnings. The price/earnings ratio of this portfolio is 25x, the same as the arithmetic mean. This demonstrates the greater weight to stocks with higher price/earnings ratios by the arithmetic mean. In fact, the arithmetic mean gives a multiple of 40x, four times the weight of a multiple of 10x.

3. Weaknesses in the DCF Approach

The discounted cash flow method has been overpraised and often misused. The methodology has significant limitations. It is of necessity highly dependent on discount rate assumptions, as well as on the methodology used for determining the terminal value. It is dependent on the quality of the projections used. It is overly dependent on longer-term projections, which are, by their nature, less reliable than shorter-term forecasts. Because terminal value is a major portion of the calculated DCF value, the final year of the forecast is by far the dominant factor in the result.

Problems with Projections

In a majority of industries, it is questionable whether management reasonably can be expected to project future performance several years into the future. Many public companies have trouble projecting next year's earnings accurately. How far ahead can one project a high-tech industry, where management often does not know what its products will be in two years? Changes in competitive conditions have made forecasts in retailing more speculative than they were a generation ago. Many cyclical industries show highly volatile earnings, but it is rare to see a projection that includes periods of significant downturns.

The number of years in a projection is an element that affects reliability. The outer years are obviously more difficult to project than the near term. If the growth rate in a forecast is higher than the discount rate, each added projection year increases the DCF value.

It is frequent practice, unfortunately, for a management to prepare only a single projection. Consideration should be given to developing several scenarios, particularly more conservative ones. The analyst could then compute a DCF value for each scenario, consider the relative probability of each alternative, and arrive at a weighted result.

Problems with Discount Rates

A discounted cash flow valuation is significantly influenced by the choice of discount rate. Although the capital asset pricing model (CAPM) has been widely accepted for portfolio applications, its reliability

for calculating discount rates applicable to individual companies is subject to question. Certain elements in the determination of a discount rate can be quite judgmental.

Volatility of a given company relative to the market (Beta) can be difficult to determine and is not infrequently a matter of contention. For any given publicly traded stock, several sources can be used, and they rarely agree. Moreover, since Beta is based on historical market prices, it can fluctuate depending on when it is calculated and it can be quite different at different dates. Moreover, there is disagreement in the academic community over the relevance of Beta.⁴

Company-specific risk is an arbitrary matter of judgment in any given situation. Because it does not lend itself to mathematical calculation, it is often questionably omitted from the determination of equity discount rates.

There is also disagreement as to how the small company premium is determined and even as to whether it should be applied.

In academic theory, the small company premium is based solely upon the equity value of a company, with no regard to the size of other companies in its industry. It *should* be based, at least in part, on size in relation to other entities in the company's industry.

Another factor that is often overlooked is the effect on discount rates of leveraging a capital structure. As a company's leverage increases, its cost of equity rises because the equity risk increases, and the interest rate payable on its increased debt increases because the quality of the debt declines.

Problems with Terminal Value

The final year of a forecast is used for determining terminal value. The final year is necessarily subject to a higher margin of error than earlier periods. A small variation in the final year forecast can have a major impact on the DCF value, far greater than the effect of a variation in any earlier year.

Calculation of terminal value using the Gordon growth model is highly sensitive both to the assumed growth rate and to the discount rate used. The analyst should be aware that a distorted result could be obtained using the Gordon growth model when the growth rate is close to the cost of capital. If the discount rate equals the expected growth rate, use of the model results in an infinite terminal value. If the expected growth rate is 2% lower than the discount rate, it values a company at 50x free cash flow. The value obtained using the model can be checked for reasonableness by computing the implied multiples of EBITDA, EBIT, and earnings, which it yields for the final year of the forecast.

In applying a growth model to projected free cash flow, it is necessary to consider the relationship between depreciation and capital expenditures. If projected capital expenditures substantially exceed depreciation, the calculated terminal value will be understated. If, on the other hand, depreciation exceeds capital expenditures (an impossibility over any extended period), the result is an overstatement of terminal value.

Often the current multiple for comparable companies is used, but the analyst should consider whether an adjustment is necessary, for example, because the current multiple is based on a current growth rate, which may decline as an industry matures.

⁴ See e.g., Fama, Eugene F., and French, Kenneth R., *Industry Cost of Equity*, 43 J. Fin. Econ. 153 (1997).

Frequently, more than 80% of a calculated DCF value is attributable to the present value of the terminal value. Because terminal value dominates most DCF valuations, it is clearly inaccurate to describe the methodology as capitalizing the future cash flows of a business. In effect, what is misnamed as a discounted cash flow value is, in fact, no more or less than the present value of capitalized earnings five to 10 years in the future using a comparable company or acquisition approach and, most often, aggressive projections.

4. The problem With Acquisition Premiums

An approach sometimes used in considering fairness is to compute the average historical premium in similar acquisitions and compare that to the premium over market in the subject transaction. This methodology is of little value, because the average premium in other transactions is not a relevant standard for determining fairness. The average premium over market paid in acquisitions is biased upward by the fact that it includes purchases of companies that are perceived as undervalued and therefore are attractive targets for acquirers, but any average necessarily excludes companies which acquirers consider overpriced.

Market prices fluctuate regularly. A company's shares may increase in reaction to an acquisition of a competitor. The premium that a buyer would pay in an acquisition results from the buyer's valuation. The premium is not the cause, but the effect. Acquisition premiums depend on the specific factors of each transaction. For example, assume that there are two identical companies trading in the market at \$30. Assume that one is acquired at \$45, a premium of 50%. In reaction, the stock price of the second company then rises to \$40 per share. It defies logic to argue that an acquirer would therefore pay \$60 per share for the second company.

5. Structural Fairness

Most fairness opinions address the fairness of the consideration to be paid in a given transaction. Consideration is not the sole standard of fairness from a financial point of view. There are situations in which the consideration itself is fair to outside shareholders, but the transaction is structurally unfair for other financial reasons, for example, in situations where certain inside shareholders are receiving materially different consideration.

The advisor should weigh the relative consideration received by various parties, other financial terms of the transaction, and any financial alternatives that might be available to shareholders. A financial advisor should not render an opinion that the consideration is fair if he or she has reason to believe that the transaction taken as a whole is not fair.

A recent Delaware Supreme Court decision⁵ even questioned the fairness of a transaction in which the majority shareholder and the minority public shareholders received identical cash consideration per share. The plaintiff asserted that directors permitted the 80% shareholder to restrict bidders to an all-cash deal and failed to determine the value of the company as a going concern.

⁵ *McMullin v. Beran*, 765 A.2d 910 (Del. 2000).

6. Updates

A fairness opinion is usually dated on the date it is verbally rendered to the boards of directors. If a proxy statement or similar document is sent to shareholders, the mailing date is often several weeks or more after the opinion was originally given. Changes in market conditions, changes in the company's recent operations or prospects, changes in industry conditions, and other factors could cause a transaction that had been fair to become unfair by the mailing date. However, the inclusion of a fairness opinion in a mailing to shareholders implies, unless otherwise stated, that the opinion is still valid at that later date.

No published decision has yet established that an investment banker has a legal obligation to update a fairness opinion. The Delaware Court of Chancery declined to rule that a board's failure to obtain an update was a breach of its duty,⁶ but it did so in a case where it determined that the transaction was fair. What a court would decide if a transaction becomes unfair with the passage of time prior to mailing remains to be seen. The author worked on a merger in which a now-defunct investment banking firm did not update its opinion but had a memo in its file indicating that the transaction had become unfair; that firm settled the class action to avoid trial.

A fairness opinion should serve not only to protect directors but should also serve the interests of shareholders. To this end, it would be helpful both to directors and to shareholders if an opinion letter were updated prior to mailing. In the absence of such an updated letter, directors would be well advised to ascertain whether the firm that rendered the opinion continues to believe that the transaction would be fair.

7. Responsibility of Investment Bankers

There is no case in which an investment banker has been deemed a fiduciary to the shareholders who rely on a fairness opinion. However, a New York appellate court rejected an investment banker's claim that it owed no duty to shareholders in rendering a fairness opinion because it was not in privity to them.⁷

To the extent that shareholders rely on a fairness opinion sent to them by a company in deciding how to vote (and whether to seek appraisal), it is difficult to argue that the opinion-giver has no duty to them. After all, shareholders are the ultimate beneficiaries of fairness opinions. Some opinion letters contain disclaimers in an effort to limit the persons who may rely on the opinion. These disclaimers have not yet been expressly addressed by any court.

Opinion-givers can best limit their liability, protect boards, and serve shareholders by performing their work thoroughly and conscientiously, by using appropriate methodologies properly applied, and by keeping open minds until they have considered all relevant data.

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⁶ *In re Unocal Exploration Corp. Shareholders Litig.*, C.A. No. 12453, 2000 Del. Ch. LEXIS 92 (Del Ch. June 13, 2000), reprinted in 24 Bank & Corp. Gov. L. Rptr. 1161.

⁷ *Wells v. Shearson Lehman/American Express*, 127 A.D. 2d 200, 514 N.Y.S.2d 1 (N.Y. App. Div. 1987), rev'd. on other grounds, 526 N.E.2d 8, 72 N.Y.2d 11, 530 N.Y.S.2d 517 (N.Y. 1988).