

# **Dual Fairness Opinions** *and the Role of the Valuation Firm*

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**Jeff K. Davis, CFA**

Mercer Capital

615-345-0350 / [jeffdavis@mercercapital.com](mailto:jeffdavis@mercercapital.com)

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# Controversy

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## What is Fair? Fairness?

- » Fair – adjective ... just, equitable, legitimate in accordance with the rules or standards
- » What rules and standards?
- » Fairness, like valuation, is a range concept
- » Process is important
- » Deals may be not fair, close calls, fair or very fair
- » Does a second fairness opinion matter?

# Controversy

*“Fairness Opinions are not worth the \$3.00 (€2.70) stationary they are written on”*

*“A fairness opinion, you know—it’s the Lucy sitting in the box: FO, 5 cents”*

A large investor and a M&A attorney expressing their views



# Board Duties

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## Duty of Loyalty

Act in the best interests of all shareholders

- » No personal gain at the expense of shareholders
- » No preference for class of shares
- » Disclose conflicts

## Duty of Care

Good faith effort to make a fully informed decision

- » Commit time
- » Hire experts
- » Understand the analysis and the impact on the company
- » Does not require accepting short-term gain vs a reasonable long-term plan

# Corporate Shield

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**No breach  
of duties**

Directors are generally shielded by Business Judgement Rule – courts usually defer from second guessing decisions made in good faith

**Duties  
breached**

Burden of proof that actions taken were in the best interest of shareholders shifts to the directors – Entire Fairness Standard re: price and process

# US Fairness Opinion Evolution

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## Trans Union Case

Benchmark Delaware (DE) case  
Smith v. Van Gorkom (1985)

Focused on directors' duty of care

Bad process - board did not hire  
advisors to review deal price,  
relied upon executives' analysis

Board "grossly negligent"

Fairness opinions became  
standard part of board  
deliberation, but never formally  
mandated

## Evolution

Second fairness opinions never  
mandated either

Litigious society – majority of M&A  
has some form of challenge

Retention of a second advisor and  
issuance of a second opinion  
spurred by FINRA Rule 5150 in  
2007

Rule requires conflicts and firm's  
work processes to be disclosed

# Rural Metro Corp.

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## Looks Bad

RBC ran a 2011 auction to sell RMC – Warburg winner @ \$438M

RBC sought share of \$55M of financing fees for Warburg, 11x its advisory fee

Plaintiff's argued RBC: (a) pushed directors into a fast sale; (b) lowered its valuation to align with Warburg offer; (c) did not disclose the financing angle; and (d) did not disclose efforts to finance the buyer of RMC's main competitor

## Outcome

Court found price for RMC \$91M too low and ordered RBC to pay \$76M for “aiding and abetting” directors' fiduciary breach

Ruling for RBC's appeal to DE Supreme Court is pending

Second opinion no help - Moelis settled before trial for \$5M

Price too low? RMC filed for bankruptcy protection in 2013

# Why a Second Opinion?





# Second Opinions

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## Legal Protection?

FO is not a legal pass

Board exercising “duty of care” –  
to be informed of all relevant facts  
by obtaining

That the second advisor is conflict  
free supports a “safe harbor”  
decision

May reduce conflicts with first  
advisor (e.g., stapled financing)

Will not make-up for any deal  
short-comings

## Deal Improvement?

If the second advisor is brought in  
early improvement is possible

If the advisor’s objections can be  
addressed, a board may seek to:

- » Change price or terms
- » Nix a bad deal

# Second Opinion

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## Auction (Revlon Duties)

Board as auctioneer seeking the highest price in a sale

Triggered if cash deal, break-up or transfer of control to a private company or public company with a majority shareholder

Second opinion?

- » Procedural—why not
- » But—robust auction is the ultimate market check

## Everything Else

Business judgement rule re: making an informed decision

Second opinion?

- » Yes—why rely upon a conflicted banker
- » Merger (share exchange)
- » Selling a major asset
- » Significant acquisition
- » Dilutive capital raise

# Why?

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Board recognizes advisor conflict and takes action to minimize

Legal counsel requested it Vet valuation and process

Non-Revlon (i.e. other than an auction) situation may entail a difficult or nuanced deal where the board wants/needs another perspective

Minimal cost vs. deal cost



# Second Opinion Objectives

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## Clean Opinion – No Conflicts

## Insight to the Board

- » Industry expertise (ideally)
- » Confidence in the second opinion provider

## Own the Numbers and Valuation

- » Transaction structure and implications
- » Transaction valuation relative to an expected range
- » Articulate “why” if value indications differ by a sizable amount
- » Acquirer’s shares and other forms of consideration
- » Preparation of supporting “fairness memorandum”

# Second Opinion Objectives

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## Vet the Transaction Process

- » Who initiated the transaction and why?
- » Who negotiated the transaction?
- » What market checks occurred—full or limited auction? If none is the value pre-emptive? Go shop provisions?
- » Were there any efforts to improve the transaction price?
- » Was the board fully apprised of the process as it occurred?
- » Any insider conflicts and what processes employed to manage?
- » Any agreements that could be construed as shifting value to insiders?

# Banker vs. Valuation Firm

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## Banker

Hired for execution and connections

Connectedness and conflicts are inherent

Most connected are most sought after bankers

Providing a fairness opinion may be a given, but contingent fee creates apparent conflict with opinion objectivity

## Valuation Firm

Financial analysis

Valuation analysis

Transaction analysis

Process review

No contingent fee conflict re: issuing a fairness opinion

Important that the firm be experienced in the industry and transactions

# Less Conflicted

## Advisory Fee

## Fairness Opinion Fee

**Lead  
Banker**

**Contingent**

**Contingent or Fixed Fee**

**Valuation  
Firm**

**None**

**Fixed Fee**

# Second Opinion Fees

	U.S. Commercial Banks	U.S. Specialty Finance	U.S. Financial Tech	U.S. Insurance Underwriters
<b><u>Seller M&amp;A Fees (Median)</u></b>				
Advisor Success Fee (%)	1.20%	1.11%	1.18%	0.65%
Advisor Fairness Opinion (%)	0.17%	0.22%	0.20%	0.12%
Second Fairness Opinion (%)	0.10%	0.21%	0.07%	0.06%
Second FO vs Lead Advisor	-0.06%	-0.01%	-0.13%	-0.05%
<b><u>Buyer M&amp;A Fees (Median)</u></b>				
Buyer Success Fee (%)	0.76%	0.41%	0.55%	1.01%
Buyer Fairness Opinion (%)	0.13%	0.14%	0.08%	0.03%
Transactions *	591	158	255	196
% with Sell-Side Advisor	83%	42%	47%	52%
% with 2nd Sell-Side Advisor	7%	9%	9%	7%

*\* Source: SNL Financial - Data reflects only those deals in which the value was disclosed from Jan 1, 2012 - Oct 23, 2015; however, not all deals with an announced value had banking fees disclosed. Fees are expressed as a % of the announced deal value.*



# Second Opinions

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## Second opinion has greater significance when

- » The facts of a transaction can lead reasonable (or unreasonable) shareholders to believe an alternative transaction is preferable
- » When there is the reality or perception that insiders could take advantage of their positions to enrich themselves
- » There is lack of unanimity among directors over the appropriateness of the transaction and/or adequacy of consideration

# Second Opinions

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## Second opinion has greater significance when

- » Limited market checks for a company being sold and value falls toward the lower end of an expected range
- » Questions about the value of the consideration
  - Buyer's shares are private or thinly traded
  - Valuation multiples for the buyer's shares are high compared to peers
  - Contingent consideration, buyer notes, preferred shares

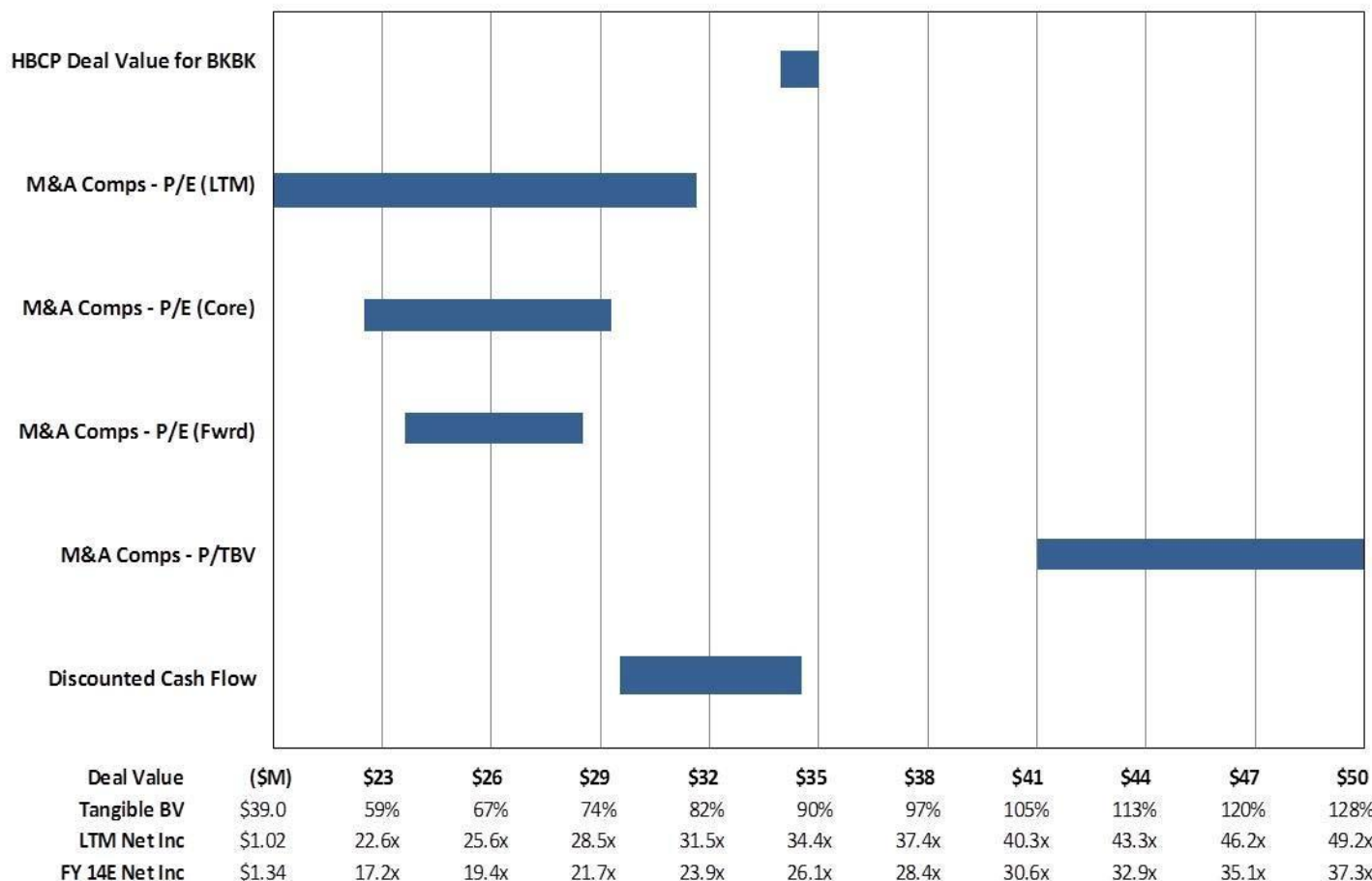
# Second Opinions

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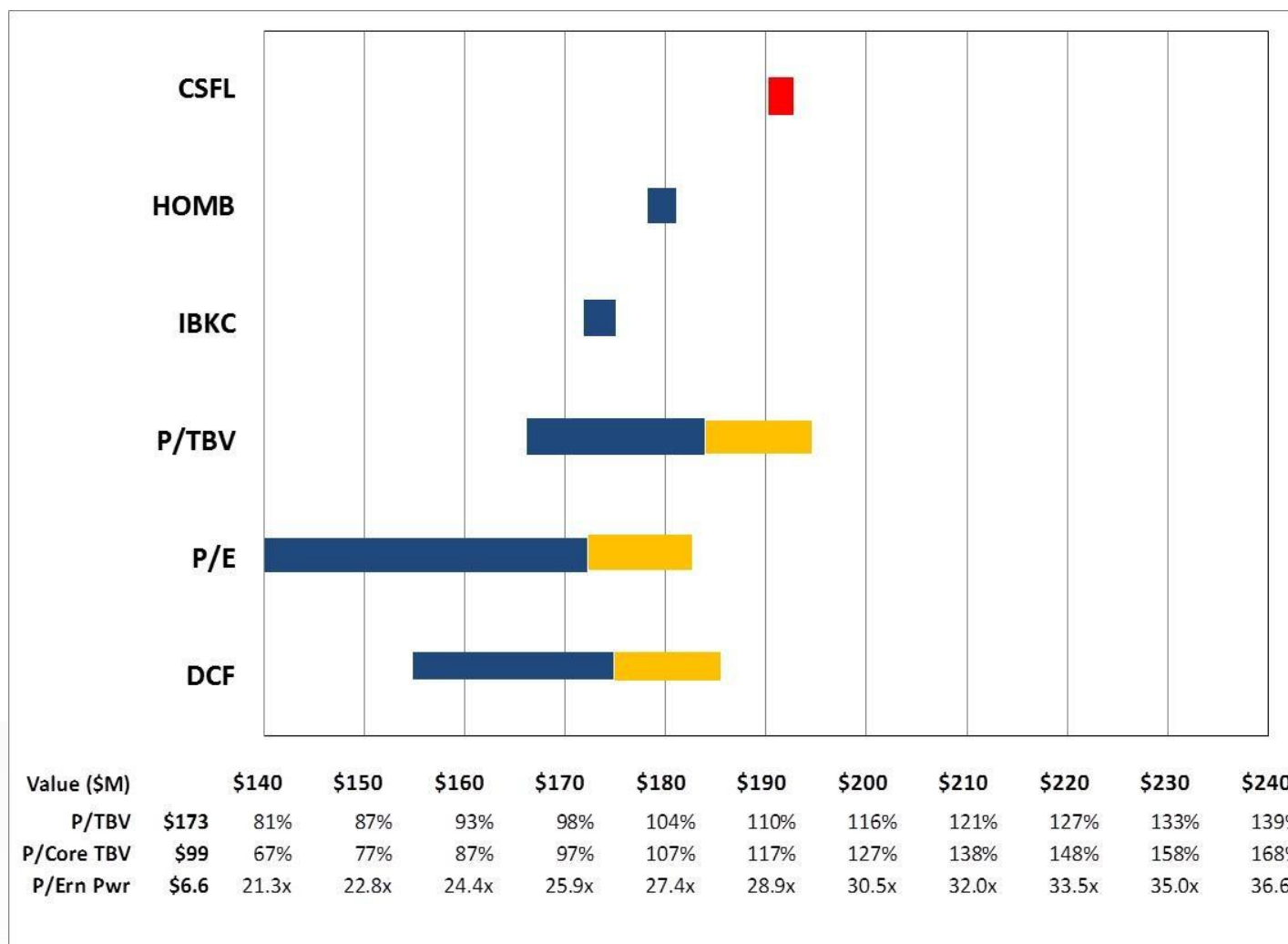
## Second opinion has greater significance when

- » EPS and EBITDA per share accretion appears to be rich from the seller's perspective (or too dilutive with too long of an earn back period from the buyer's view)
- » Questions about the pro forma capital structure
  - Appears to be too levered
  - Unclear ability to raise cash to close
  - Regulatory and market constraints on leveraged deals

# Explaining a Divergence



# Value is not always Clear



# Where from here?

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Gradual trend toward more second advisors providing a fairness opinion for a fixed fee seems likely

Possible that the legal and regulatory environment results in the contingent fee lead bankers passing on issuing opinions

Rural/Metro remains problematic to the extent banker is deemed to have “aided and abetted” board in breach of its duty of care

Key remains full upfront disclosure so that a board selects and evaluates a transaction on a fully-informed basis

And pushing for a role by valuation firms as the (largely) disinterested secondary advisor

# Jeff K. Davis, CFA

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[Jeffdavis@mercercapital.com](mailto:Jeffdavis@mercercapital.com)

[jeffkdavis@comcast.net](mailto:jeffkdavis@comcast.net)

Twitter@JeffKDavis1

615-345-0350 (O)

Managing Director – Financial Institutions Group  
(FIG) @ Mercer Capital

Provides financial advisory services primarily related to the valuation of privately-held equity and debt issued by financial services companies and advisory related to capital structures and M&A

SNL Financial contributor “Nashville Notes”

Previously a sell-side analyst covering commercial banks and specialty finance companies for Guggenheim Partners, FTN Financial and J.C. Bradford & Co.

Rhodes College (BA); Vanderbilt University (MBA)