



Organismo Italiano di Valutazione

# Fairness opinions (FO) and Italian Valuation Standards (PIV)

Mauro Bini –  
Chair of OIV Management Board

1. A poll on Fairness Opinions
2. The elusive definition of Fairness Opinion and the main issues
3. An example and evidences from academic literature
4. PIV and Fairness Opinion (what has been done)
5. Next step: Illustrative examples of PIV (what will be done)
6. Conclusion

### 1. A poll on **Fairness Opinions**

2. The elusive definition of Fairness Opinion and the main issues

3. An example and evidences from academic literature

4. PIV and Fairness Opinion (what has been done)

5. Next step: Illustrative examples of PIV (what will be done)

6. Conclusion

## First question of the poll

1) FROM YOUR PERSPECTIVE OF PROFESSIONAL VALUER WHAT IS THE RIGHT SENTENCE ?

A) A FAIRNESS OPINION IS **MORE** THAN A TYPICAL VALUATION

B) A FAIRNESS OPINION IS **LESS** THAN A TYPICAL VALUATION

C) A FAIRNESS OPINION AND A TYPICAL VALUATION ARE TOTALLY DIFFERENT. **NO COMPARISON** IS POSSIBLE.

## I prefer answer A

- Fairness opinions require an in-depth assessment of the confidence level of conclusions from the various approaches used within the context of facts and circumstances of the transaction.
- The hypothetical willing buyer and willing seller in the transitional definition of «fair market value» are actually known in the fairness opinion context. The opinion is developed in response to a specific deal.
- The particular facts and circumstances of the transaction pose specific valuation problems that must be weighted in the fairness determination.
- For these reasons from my point of view a fairness opinion is not a valuation, but it should be more than a typical valuation. Unfortunately many times it is far less.

**2) FROM YOUR PERSPECTIVE OF PROFESSIONAL VALUER, FAIRNESS OPINION IS:**

- A) A LEGAL PROTECTION, IN AND OF ITSELF**
- B) A LEGAL PROTECTION ONLY WHEN WELL-SUPPORTED, ROBUST AND CREDIBLE**
- C) ALWAYS A LIMITED LEGAL PROTECTION, BECAUSE ULTIMATELY THE FIDUCIARIES HAVE THE RESPONSABILITY OF THE TRANSACTION**

## I prefer answer B

- Fairness opinion is an expert's judgment: it is not a statement of fact. As any opinion it must be well supported, robust and credible
- The challenges of serving as an effective fiduciary have never been greater. When transactions enter the picture, the fiduciary's role gets even more challenging. Board members are responsible for evaluating and ultimately approving or rejecting a proposed transaction.
- Fairness opinions assist board members and other fiduciaries in their evaluations, but Fairness opinions don't constitute, in and of themselves, a legal protection

## Third question of the poll

3) WHAT SHOULD THE MAIN FUNCTION OF A FAIRNESS OPINION BE ?

- A) A PROTECTION FOR FIDUCIARIES (**RUBBER STAMP**)
- B) A MEAN FOR TRANSACTION'S TERMS IMPROVEMENT (**TRANSACTION IMPROVEMENT**)
- C) A MEAN FOR SIGNALLING HIGHER QUALITY TRANSACTIONS. THE FAIRNESS OPINION PROVIDER UNWILL TO RISK ITS REPUTATION ON LOWER-QUALITY DEALS (**SIGNALLING**)



## I prefer answer C

- Ultimately, the value of Fairness Opinion is for investors.
- Fairness Opinion providers use private information. The asymmetry in information between the firm and the shareholders is source of agency costs.
- When we think how many acquisitions or other forms of external growth have destroyed shareholders wealth, we understand that the main function of Fairness Opinion is signalling.
- Unfortunately, empirical evidence tells us that the majority of Fairness Opinion doesn't have any signal value. So the motto of this conference could be: we have a problem here. Not necessarily a legal problem: because the courts for the most part are satisfied as long as there is evidence of the process of a Fairness Opinion having been undertaken (they place less emphasis on the quality of that opinion). But even if there are no legal problems, there could be a significant economic problem.

1. A poll on Fairness Opinions

**2. The elusive definition of Fairness Opinion and the main issues**

3. An example and evidences from academic literature

4. PIV and Fairness Opinion (what has been done)

5. Next step: Illustrative examples of PIV (what will be done)

6. Conclusion

## Fairness opinions' paradoxes

1. Fairness Opinions [FO] are more characterized by what they are not than by what they actually are.
2. FO are the most widespread opinions (of value) in the developed countries, although they lack of established standards.
3. Laws and regulations govern when a fairness opinion is required, who may provide the opinion and matters that the opinion has to address, but almost never they discipline how the fairness must be performed
4. Most providers of FO are in potential conflict of interests because their compensation is dependent on the success of the deal (on average median total advisory fees are 10 times higher the median fee for a Fairness Opinion)

## The alternative views about FO

- **Critics** of FO complain that the valuation analyses are overly subjective, methodologically flawed and tainted by conflicts of interest
- **Supporters** of FO assert that they provide useful inputs to the transaction process either because opinion providers enjoy access to higher quality information or because they have superior ability to process this information.

## The OIV's point of view

- OIV is of the view that it is in the public interest to promote understanding of the purpose of a fairness opinion, and to identify principles of best practice in the development and provision of fairness opinions.
- OIV thinks that whether fairness opinions add value or are a «legal tax» on corporate transactions is an empirical question.
- This is the reason why we have invited such a prestigious panel of speakers with a great expertise in the field, in explaining us their point of view.

## What a Fairness Opinion is

**A Fairness Opinion [FO]** is an opinion on whether the terms of a proposed corporate transaction (a merger, a partial or total sale, a takeover, going private transaction, related party transaction, etc.) are fair from a financial point of view.....

**..... even though the terms «fair» and «from a financial point of view» are never formally defined.**

So FO is the opinion of the advisor that the consideration is within a range of values that would be deemed «financially» fair .....

**.....even though the opinion doesn't provide an explanation as to what would constitute fairness in the considered context .....**

**.....nor does it detail the extent of investigation and verification**

## What a Fairness Opinion is not

### **A fairness opinion is not:**

- i. an opinion or any form of assurance that the highest and best possible price is to be received or obtained in a given transaction;
- ii. an assessment or evaluation of the negotiation process leading to the pending transaction;
- iii. an affirmation of the strategic merit of the pending transaction;
- iv. an analysis or opinion on other (contractual, ..) aspects of a given transaction, such as termination fees, lockup;
- v. a recommendation to security holders on how to vote;
- vi. a confirmation of, or any form of an opinion, or audit on historic or prospective financial information provided by or on behalf of the client or obtained publicly.

1. “Fair” is not a term univocally stated: what constitutes (financial) fairness ?
2. Fairness can be stated in terms of a range of values, which in some cases can be very wide;
3. Lack of established standards (i.e. performance standards) in preparing opinions;
4. Lack of established minimum contents;
5. To whom are fairness opinions of service (helpful)?
6. Conflicts of interest are associated with the provision of fairness opinion by investment bankers (by large, the main provider);
7. The quality of fairness opinion brings everyone back to a sense of business integrity.



1. A poll on Fairness Opinions
2. The elusive definition of Fairness Opinion and the main issues
- 3. An example and evidences from academic literature**
4. PIV and Fairness Opinion (what has been done)
5. Next step: Illustrative examples of PIV (what will be done)
6. Conclusion

# Acquirer-side vs. target-side Fairness Opinion (exchange ratio in a merger of two Italian listed banks)

## Rapporto di Concambio

### Metodologia di valutazione

#### Metodi Stand-Alone (Media Semplice)

Analisi delle quotazioni di mercato

Multipli di Mercato (P/E)

Analisi di Regressione

Dividend Discount Model

#### Metodi Stand-Alone di Controllo

Analisi dei prezzi obiettivo degli analisti

Analisi del Concambio Massimo

Metodo delle transazioni comparabili

Metodo della creazione di valore

Minimo

Massimo

0,91

1,12

0,81x

1,12x

1,04x

1,17x

1,01x

1,14x

0,80x

1,06x

0,82x

1,00x

1,04x

1,46

1,27x

1,53x

Acquirer-side investment bank

Range = 65% of offer price

Offer price = exchange ratio 1,12

## Rapporto di Cambio

### Metodologia di valutazione

Dividend Discount Model

Multipli di Mercato

Analisi delle Quotazioni di Mercato

Intervallo di riferimento individuato

Bank A

Bank B

Bank C

[0,86 - 0,95]

[0,85 - 0,92]

[0,86 - 0,93]

[0,83 - 0,97]

[0,92 - 1,00]

[0,92 - 1,01]

[0,94 - 1,00]

[0,96 - 0,98]

[0,96 - 0,98]

[0,87 - 0,97]

[0,91 - 0,97]

[0,91 - 0,97]

### Metodi di Controllo

Analisi dei Prezzi Obiettivo degli Analisti

Analisi di Contribuzione

[0,77 - 1,01]

[0,77 - 1,01]

[0,77 - 1,01]

[0,67 - 1,02]

[0,67 - 1,02]

[0,67 - 1,02]

Target-side investment banks

Range = 31% of offer price

Results of a survey conducted by Cain and Denis on a sample of 582 mergers negotiated between 1998 and 2005 in the US show that:

- in acquirer-side fairness opinions: the mean (median) range amounts to 76% (48%) of the offer price;
- in target-side fairness opinion: the mean (median) range amounts to 60% (36%) of the offer price.

It means that for a hypothetical offer price of \$20 per share:

- in acquirer-side fairness opinion the mean (median) difference between min and max price is \$15,2 (\$9,6);
  - in target-side fairness opinion the mean (median) difference is \$ 12 (\$7,2).
- 
- Are they reasonable ranges ?

\* Matthews D. Cain, David J. Denis, Do fairness Opinion valuations contain Useful Information?, Purdue University, July 2010

- The study on 1.509 M&A deals, of which 80% with target-side FO and 37% with acquirer- side FO, over the period 1994-2003, shows that:
- The FO do not affect deal outcome when used by targets, but they affect deal outcomes when used by acquirers
- The deal premium is lower if the acquirer obtains a fairness opinion, and it is further reduced if multiple advisors provide an opinion;
- However the acquirer's announcement-period return is 2.3% lower if the acquirer has a FO, especially if the acquirer pays a high premium, indicating that investors are skeptical about the quality of the FO.

\* Darren J. Kisgen, Jun «QJ» Qian, Weihong Song, «Are Fairness Opinions fair ? The case of mergers and acquisitions, Journal of Financial Economics 91 (2009)

1. A poll on Fairness Opinions
2. The elusive definition of Fairness Opinion and the main issues
3. An example and evidences from academic literature
- 4. PIV and Fairness Opinion (what has been done)**
5. Next step: Illustrative examples of PIV (what will be done)
6. Conclusion

**PIV. III.1.4. [....] The professional valuer should specify whether the analysis performed has the features of a full valuation or those of a limited valuation.**

PIV III.1.2 Comment:

[In a full valuation] the professional valuer can review and/or supplement forecast data via management interviews, provided that he goes over the entire planning process, by examining:

- 1) the quality of the process completed and the company's plan management experience;
- 2) the robustness of the plan in terms of the endorsement received, its sharing and its operability (i.e. the ability to effectively guide management's action at the different levels);
- 3) the reasonableness of management's assumptions and estimates;
- 4) the plausibility of expected future results and their actual sustainability, in light of the internal and external evidence available;
- 5) the magnitude of implicit risks and their possible effects.

## PIV. III.1.3 Comment:

[A limited valuation], according to the general standards may be:

- 1) a technical opinion on specific elements, which are necessary to carry out an estimation;
- 2) Analysis of certain aspects or phases of the valuation process: the most frequent examples of such analysis are estimates based on inputs adopted without adequate controls, especially future streams of economic benefits not subjected to suitable fundamental analysis;
- 3) An estimate without the accuracy required for full valuation

**Minimum contents** are as follows PIV.II.4.5:

- limitations in the construction and assessment of the information base;
- description of the transaction, its relevant main characteristics and the price in relation to which the fairness opinion is required (e.g. share exchange ratio, acquisition price, etc.);
- details of main information relied on to prepare the valuation;
- indications of the valuation approaches used and the relative importance attributed to each, as well as indication to whether – due to limitation of the information base or specific situations related to the subject assets – one or more approaches might be adopted;
- indications of any key assumptions adopted and any limitation that might entail significant impacts on the results of the valuation;
- conclusion on the fairness of the price.



## PIV and Code of Ethical Principles for Professional Valuers (IVSC 2011)

- OIV considers it vital that the provider of a FO is sufficiently independent to provide, and be seen to provide, an Opinion that is objective and unbiased.
- The PIV require the compliance with *the Code of Ethical Principles for Professional Valuers* issued by IVSC in December 2011. The «Code» includes discussion and guidance on how professional valuers can identify threats to their independence, and actions that may be taken to avoid or mitigate such threats.
- The closer the relationship between the FO provider, including the FO provider's family, associates and staff, and a commissioning party or any other interested party, the greater the onuses on the FO provider to demonstrate their impartiality.

1. A poll on Fairness Opinions
2. The elusive definition of Fairness Opinion and the main issues
3. An example and evidences from academic literature
4. PIV and Fairness Opinion (what has been done)
- 5. Next step: Illustrative examples of PIV (what will be done)**
6. Conclusion

- **Content of a Fairness Opinion (Definitional problem and disclosure)**
- The definition of the term «fairness» and the criteria used to provide the opinion. The advisor should state under which definitions the price is fair, and under which definitions the price is unfair.
- For example an opinion should not be limited to state that the price is fair from a financial point of view. Rather it should state that the price is fair compared to the pre-merger announcement stock price or fair compared to the price the company would carry in an auction, etc.
- The overriding principle that should guide the exercise of the FO provider's judgment is that the FO should provide sufficient information to enable the reader to reasonably understand the factual background, the principal judgments made and the rationale used in arriving at the conclusions it contains.

Fairness largely depends on the kind of transaction at issue and the particular context of that transaction.

Imagine a company facing an acquisition offer.

The buyers might seek to acquire it through :a merger, a friendly tender offer, or a hostile tender offer. In this context fair price could refer to:

- 1) the value of the company as an independant entity;
- 2) the value shareholders would receive if their company were auctioned off to the highest bidder;
- 3) the value that a bilateral arm's-lenght transaction would yield;
- 4) the value of the company as an independant entity plus a fraction of the gains resulting from the acquisition of control (i.e. premium paid add on);
- 5) a combination of more definitions of value

- **Extent of investigations (measurement problem and valuer's performance)**
- Even financial analysis that employ the same definition of fair price can arrive at widely differing results. It depends on information:
  - The appropriate information sources;
  - The required amount of information;
  - The accuracy of any company-supplied information;
  - The necessity of independently verifying that information.

It is common for a FO provider to exclude responsibility for independently verifying some of the data relied upon in developing the FO and instead to rely on information supplied by the commissioning party or an unconnected third party. However:

- The FO provider should exercise reasonable professional skepticism in using information provided by others and request additional information or further clarification if the information provided is considered to be in any way inadequate or unusual.
- The more material the information is to the conclusions reached by the FO provider, the greater the responsibility of the FO provider to examine the information.
- The extent to which the FO provider has relied upon information provided by the commissioning party or third parties should be disclosed in the FO but if the provider considers that there are many material deficiencies in the information provided an FO should not be issued

1. A poll on Fairness Opinions
2. The elusive definition of Fairness Opinion and the main issues
3. An example and evidences from academic literature
4. PIV and Fairness Opinion (what has been done)
5. Next step: Illustrative examples of PIV (what will be done)

### **6. Conclusion**

- There is a wide scope for further improvement in FO. FO must provide value to shareholders.
- The standard setters has to protect public interest both in valuation and in fairness opinion (a silo approach that considers fairness opinion something totally different from a valuation is not acceptable).
- Remedies for potential conflict of interests are not always enough.
- The efforts of valuation standard setters has to be in increasing the obligation for FO providers to disclose the process followed in FO, specifying the different role of FO in different types of deals
- OIV is trying to cover the FO area stimulating the FO providers to declare if FO is a full valuation or a limited valuation and the extent and the contents of the FO. The valuation methods and the depth of the analysis by the FO provider are the key of high quality FO
- Co- advisor or Multi-advisor Fairness Opinion could be an efficient solution, but only if the FO providers are different in nature (for example a financial advisor and a valuation firm). Diversity is a plus in the FO world.