MERCER CAPITAL
Business Valuation & Financial Advisory Services

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Value Matters™

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Fairness Opinions and Down Markets

by Jeff K. Davis, CFA

August has become the new October for markets in terms of increased volatility and downward pressure on equities and high yield credit. This year has seen similar volatility as was the case in some memorable years such as 1998 (Russian default; Long-Term Capital Management implosion), 2007 (tremors in credit markets), 2008 (earthquakes in credit and equity markets) and 2011 (European debt crisis; S&P's downgrade of the U.S.). Declining commodity markets, exchange rate volatility and a pronounced widening of credit spreads finally began to reverberate in global equity markets this year.

So far the downdraft in equities and widening high yield credit spreads has not slowed M&A activity. Preliminary data from Thomson Reuters for the third quarter indicates global M&A exceeded $1 trillion, which represents the third highest quarter on record and an increase of 11% over the year ago quarter. Activity is less broad-based though as 8,989 deals were announced compared to 10,614 a year ago.

Immediately prior to intensified pressure on risk-assets, Thomson Reuters estimated that as of August 13 global M&A was on pace for a record year with $2.9 trillion of announced transactions globally (+40% vs. LYTD) and $1.4 trillion in the U.S. (+62%). Within the U.S., strategic buyer activity rose 53% to $1.1 trillion while Private Equity M&A rose 101% to $326 billion.

Leveraged buy-out ("LBO") multiples have been trending higher since 2009. The median LBO EBITDA multiple for broadly syndicated large deals was 10.1x through September, while middle market multiples expanded to 10.3x. Debt to EBITDA multiples for LBOs were 6.0x for large deals YTD and 5.5x for middle market transactions.

No one knows what the future holds for markets. Deal activity could slow somewhat; however, a weak environment for organic revenue growth will keep many strategic buyers engaged, while lower prices for sellers if sustained will make more targets affordable for private equity provided debt financing costs do not rise too much. As of October 14, the option-adjusted-spread (OAS) on Bank of America Merrill Lynch's High Yield Index was 6.31%, up from 5.04% at year-end and 4.83% a year ago.

The role of the financial advisor becomes tougher too when markets are declining sharply. Obviously, sellers who do not have to sell may prefer to wait to see how market turmoil will play out while buyers may push to strike at a lower valuation. Questions of value and even fair dealing may be subjected to more scrutiny.

Fairness opinions seek to answer the question whether a proposed transaction is fair to a company's shareholders from a financial point of view. Process and especially value are at the core of the opinion. A fairness opinion does not predict where a security—e.g. an acquirer's shares—may trade in the future. Nor does a fairness opinion approve or disapprove a board's course of action. The opinion, backed by a rigorous valuation analysis and review of the process that led to the transaction, is just that: an opinion of fairness from a financial point of view. Nevertheless, declining markets in the context of negotiating and opining on a transaction will raise the question: How do current market conditions impact fairness?

There is no short answer; however, the advisor's role of reviewing the process, valuation, facts and circumstances of the transaction in a declining market should provide the board with confidence about its decision and the merits of the opinion. Some of the issues that may weigh on the decision process and the rendering of a fairness opinion in a falling market include the following:

» **Process vs. Timing.** Process can always be tricky in a transaction. A review of fair dealing procedures when markets have fallen sharply should be sensitive to actions that may favor a particular shareholder or other party. A management-led LBO after the market has fallen or a board that agrees to buyback a significant shareholder's interest when prices were higher are examples. Even an auction of a company may be subject to second guessing if the auction occurred in a weak environment.

- **Corporate Forecasts.** Like the market, no one knows how the economy will perform over the next several years; however, consideration should be given to whether declining equity markets and widening credit spreads point to a coming economic slowdown. A baseline forecast that projects rising sales and earnings or even stable trends may be suspect if the target's sales and earnings typically fall when the economy enters recession. A board should consider the implications of any sustained economic slowdown on the subject's expected financial performance with follow-through implications for valuation.
- **Valuation.** Unless markets experience a sharp drop from a valuation level that reflects a widely held view that multiples were excessive, a sharp pullback in the market will cause uncertainty about what's "fair" in terms of value. DCF valuations and guideline M&A transaction data may derive indications that are above what is obtainable in the current market. Transactions that were negotiated in mid-2007 and closed during 2008 may have felt wildly generous to the seller as conditions deteriorated. Likewise, deals negotiated in mid-2012 that closed in 2013 when markets were appreciating may have felt like sellers left money on the table. There is no right or wrong, only the perspective provided from the market's "bloodless verdict" of obtaining a robust market check if a company or significant asset is being sold. It is up to the board to decide what course of action to take, which is something a fairness opinion does not address.
- **Exchange Ratios.** Acquisitions structured as share exchanges can be especially challenging when markets are falling. Sellers will tend to focus on a fixed price, while buyers will want to limit the number of shares to be issued. The exchange ratio can be (a) fixed when the agreement is signed; (b) fixed immediately prior to closing (usually based upon a 10 day volume-weighted average price of the buyer); or (c) a hybrid such as when the ratio floats based upon an agreed upon value for the seller provided the buyer's shares remain within a specified band. Floating exchange ratios can be seen as straightjackets for buyers and lifejackets for sellers in falling markets; rising markets entail opposite viewpoints.
- **Buyer's Shares.** An evaluation of the buyer's shares in transactions that are structured as a share exchange is an important part of the fairness analysis. Like profitability, valuation of the buyer's shares should be judged relative to its history and a peer group presently and relative to a peer group through time to examine how investors' views of the shares may have evolved through market and profit cycles. The historical perspective can then be compared with the current down market to make inferences about relative performance and valuation that is or is not consistent with comparable periods from the past.
- **Financing.** If consummation of a transaction is dependent upon the buyer raising cash via selling shares or issuing debt, a sharp drop in the market may limit financing availability. If so, the board and the financial advisor may want to make sure the buyer has back-up financing lined-up from a bank. The absence of back-stop financing, no matter how remote, is an out-of-no-where potential that a board and an advisor should think through. Down markets make the highly unlikely possible if capital market conditions deteriorate unabated. While markets periodically become unhinged, a board entering into an agreement without a backstop plan may open itself to ill-informed deal making if events go awry.

A market saw states that bull markets take the escalator up and bear markets take the elevator down. Maybe the August sell-off will be the pause that refreshes, leading to new highs, tighter credit spreads, and more M&A. Maybe the October rebound in equities (but not credit, so far) will fade and the downtrend will resume. It is unknowable.

What is known is that boards that rely upon fairness opinions as one element of a decision process to evaluate a significant transaction are taking a step to create a safe harbor. Under U.S. case law, the concept of the "business judgment rule" presumes directors will make informed decisions that reflect good faith, care and loyalty to shareholders. The evaluation process is trickier when markets have or are falling sharply, but it is not unmanageable. We at Mercer Capital have extensive experience in valuing and evaluating the shares (and debt) of financial and non-financial service companies engaged in transactions during bull, bear and sideways markets garnered from over three decades of business.

Jeff K. Davis

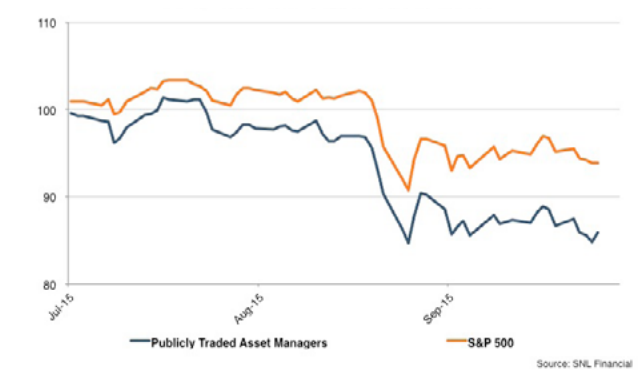
Jeff K. Davis, CFA
jeffdavis@mercercapital.com | 615.345.0350

Rough Quarter for the RIA Industry

First appeared on Mercer Capital's ***RIA Valuation Insights*** *blog on October 5, 2015. Subscribe to receive blog posts* ***here****.*

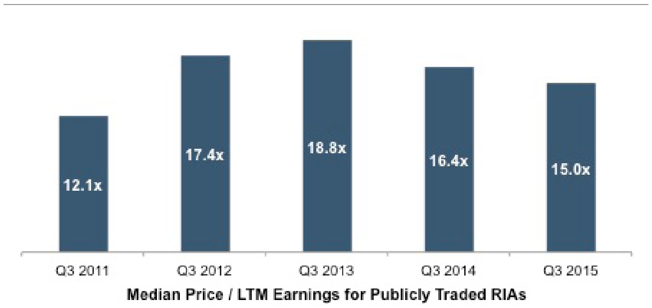
by Brooks K. Hamner, CFA

Publicly Traded Asset Managers Versus the S&P 500



Q3 was an especially bad quarter for asset managers, with the group losing over $40 billion in market capitalization during a six week skid. Given the sector's run since the last financial crisis, many suggest this was overdue and only pulls RIA valuation levels closer to their historic norms. The multiple contraction reflects lower AUM balances and the anticipation of reduced fees on a more modest asset base.

Asset Manager Valuations since 2011



Source: SNL Financial

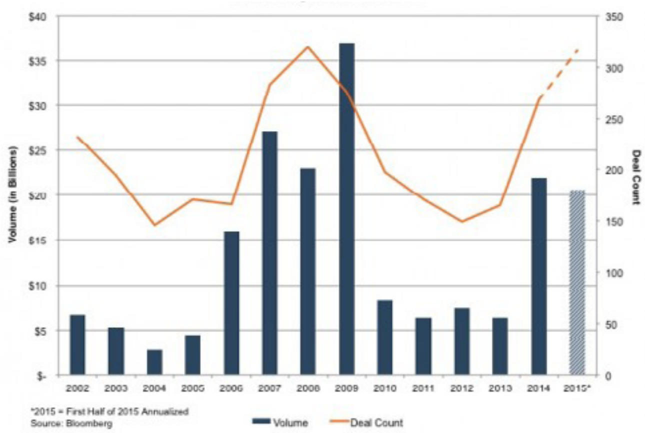
The most recent sell-off brings the industry to the brink of a bear market despite the S&P being down only 10% or so over the last few months. Such underperformance is not surprising for a business tethered to market conditions and investor sentiment. The market is acknowledging that revenue for equity managers is directly tied to index movements and earnings often vary more than management fees due to the presence of fixed costs (as demonstrated in the example below). Combining these dynamics with some multiple contraction reveals the market's rationale for discounting these businesses in recent weeks.

Asset Manager Operating Leverage

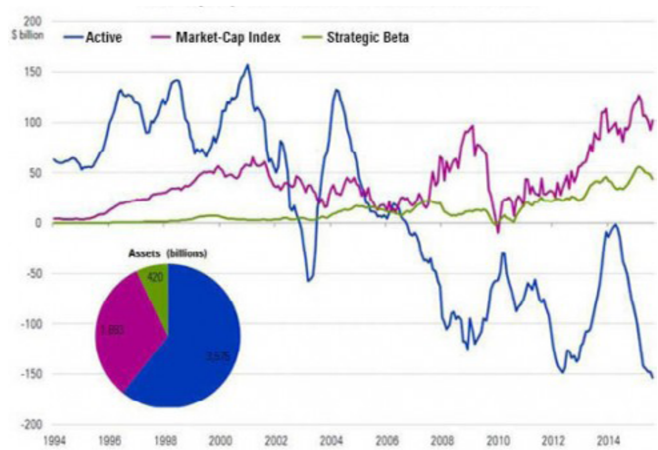
	Initial	10% AUM Decline
AUM	$1,000,000,000	$900,000,000
x Realized Fee %	0.60%	0.60%
= Management Fees	$6,000,000	$5,400,000
- Variable Expenses	3,300,000	2,970,000
- Fixed Costs	1,200,000	1,200,000
= Operating Income	$1,500,000	$1,230,000
% Δ in Operating Income	*-18.0%*	

The impact on sector M&A is more nuanced. On the one hand, the lower price tag might entice prospective buyers fearful of overpaying. Yet for others the market's recent variability could spook potential investors, and sellers may be less inclined to part with their businesses at a lower valuation. Though the third quarter figures aren't out yet, the recent slide could curtail the deal making momentum we've witnessed over the last year-and-a-half.

Asset Manager M&A Since 2002



U.S. Equity Fund Flows and Current Assets



Source: Morningstar

The outlook also remains uncertain and will ultimately be determined by market movements and asset flows. We're neither smart enough nor dumb enough to predict future market movements and will defer that to the experts.

As for asset flows, fee-richer active funds are losing ground to indexes and alternative products despite typically outperforming more passive strategies during market downturns. Overall, asset flows to riskier products (active or passive) are unlikely to improve until the recent volatility declines to more normal levels.

Brooks K. Hamner, CFA
hamnerb@mercercapital.com
901.685.2120

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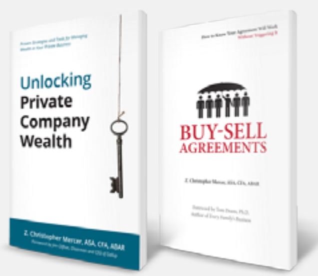

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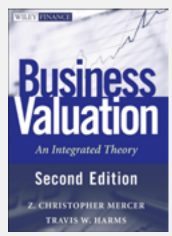

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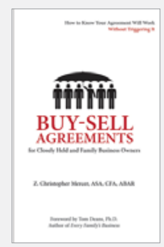

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Contact Us

Timothy R. Lee, ASA
901.322.9740
leet@mercercapital.com

Bryce Erickson, ASA, MRICS
214.468.8400
ericksonb@mercercapital.com

Matthew R. Crow, CFA, ASA
901.685.2120
crowm@mercercapital.com

Nicholas J. Heinz, ASA
901.685.2120
heinzn@mercercapital.com

Z. Christopher Mercer, CFA, ASA, ABAR
901.685.2120
mercerc@mercercapital.com

Travis W. Harms, CFA, CPA/ABV
901.322.9760
harmst@mercercapital.com

MERCER CAPITAL

Memphis
5100 Poplar Avenue, Suite 2600
Memphis, Tennessee 38137
901.685.2120

Nashville
102 Woodmont Blvd., Suite 231
Nashville, Tennessee 37205
615.345.0350

Dallas
12201 Merit Drive, Suite 480
Dallas, Texas 75251
214.468.8400

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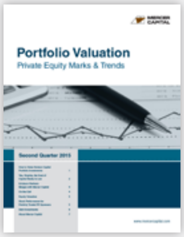
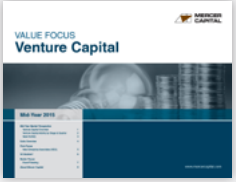


Portfolio Valuation: Private Equity Marks & Trends



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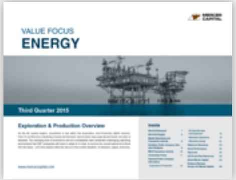

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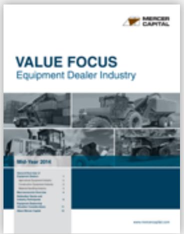

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