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Focus On

Transactions

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About Mercer Capital

Mercer Capital is one of the largest independent business valuation and financial advisory firms in the nation serving both private and public companies, financial institutions, and high net-worth families. We offer a broad range of services including gift and estate tax valuation, corporate valuation, financial reporting valuation, M&A advisory, fairness opinions, ESOP and ERISA valuation services, and litigation and expert testimony consulting.

Our valuation opinions are well-reasoned and thoroughly documented, providing critical support for any potential engagement.

Our work has been reviewed and accepted by the major agencies of the federal government charged with regulating business transactions, as well as the largest accounting and law firms in the nation in connection with engagements involving their clients.

Mercer Capital's Core Services

Business Valuation	Financial Institution Valuation
Litigation & Expert Testimony Consulting	Financial Statement Reporting Valuation
Employee Stock Ownership Plan Valuation	Fairness Opinions
Estate & Gift Valuation	M&A Representation & Consulting

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Fairness Opinions in ESOP Transactions

Q: Why are fairness opinions important?

Prepared by an independent financial advisor, a fairness opinion is just that – an opinion that a proposed transaction is fair (or not) from a financial point of view, to shareholders of a company (either all or a certain specific group of shareholders). A fairness opinion can assist corporate directors and/or ESOP trustees in making or approving decisions concerning strategic and financial events. A fairness opinion can also instill confidence among stakeholders that an action has been thoroughly vetted for its effects on the ESOP and/or the sponsoring company. These opinions can aid in substantiating that decision makers have adhered to the business judgment rule.

Q: Does a transaction involving or affecting an ESOP require a fairness opinion?

The prudent answer is yes. Despite out belief that transactions affecting or potentially affecting an ESOP should include a fairness opinion, such opinions are rare. Some business owners and trustees believe that fairness opinions are time-consuming, costly, uncommon, unnecessary, or excessive for many transactions. Perhaps, in some circumstances, a fairness opinion could be viewed as nonessential. However, every ESOP installation and every ESOP termination, and virtually every significant corporate (or strategic) event in an ESOP sponsoring company would be better served to include a fairness opinion rendered from the financial perspective of the ESOP and its trustee.

That an ESOP transaction or significant corporate event that affects the shareholders or participants of an ESOP company requires a fairness opinion is not specifically codified. Nonetheless, obtaining the service can be a vital, virtually obligatory exercise for any prudent decision-maker, particularly one carrying the burden of a fiduciary obligation to ESOP participants.

Q: If a "valuation" is already part of the process, isn't a fairness opinion the same thing?

No. A valuation of the transacting interests may be an essential underpinning for a fairness opinion but it is not the only substance of a fairness opinion. Fairness opinions frequently contain additional disclosures, observations, and assessments concerning the circumstances of, alternatives to, and other key factors surrounding a transaction.

In many cases a fairness opinion reaches beyond the instant economics of a transaction to examine the specific terms and context of a transaction. Valuations are often based on the standard of "fair market value" and are constructed using reasonable assumptions and reflections of a hypothetical and rational universe. When an actual transaction arises between specific parties, the situation often includes attributes specific to the parties and the circumstances – in other words, the real world versus the hypothetical world. A well-crafted fairness opinion reaches beyond the hypothetical to examine and document these real world considerations.

Q: What events give rise to the need for a fairness opinion?

The following is a list (non-comprehensive) of the types of events that could give rise to the need for a fairness opinion. A good rule for decision makers concerning the assessment of need for a fairness opinion is if you suspect that any aspect of a transaction is potentially controversial, then an assessment of fairness to the party in question should be considered. The responsibilities and obligations inherent in the ESOP trustee role is serious business.

» The sale and/or issuance of stock to a newly forming ESOP

» The sale of a significant portion or substantially all of the assets or stock of an ESOP company

» The incurrence of significant debt or the financial restructuring (recapitalization) of an ESOP company

» The sale of a significant asset or business segment which is beyond the normal scope of business or corporate activity

» The purchase of a significant asset or business segment which is beyond the normal scope of business or corporate activity

» The liquidation of the ESOP company

» The termination of the ESOP

» The redemption of stock by the company from non-ESOP shareholders

» The changing of corporate entity organization of the ESOP company (“S” election)

» Significant changes to the ESOP plan document

» The commitment of the company to shareholder agreements that place future obligations on the company

» Significant changes in compensation or other financial practices, particularly if such changes are different or contrary to the financial construct upon which a transaction value or ongoing plan valuation is based

Q: Are there specific circumstances that should be considered in the decision to obtain a fairness opinion?

Absolutely. Based on Mercer Capital’s experience, events that are potentially controversial, involve a conflict of interest, or involve decisions and actions other than in the ordinary course and timing of business may require a fairness opinion. As with the previous list of events, the following is not all-inclusive. Additionally, most of the following conditions relate to the sale of an ESOP company or the installation of an ESOP.

» The proposed ESOP transaction includes a stock valuation that is different than the valuation at which actual offers for the stock or the company have occurred

» The proposed ESOP transaction includes a valuation that is different than reflected in recent stock appraisals

» The proposed ESOP transaction includes a valuation that is different than stock valuations called for in shareholder agreements (buy-sell, etc.)

» The proposed ESOP transaction requires high levels of debt financing

» The proposed ESOP transaction includes a valuation that relies on changes to historical compensation and other business practices

» The proposed ESOP transaction and its associated debt may compromise the ability of the company to secure operating and growth capital, such factors which may be a predicate to the proposed transaction valuation

» The cost of financing does not appear to reflect market rates and/or the ESOP transaction is otherwise unable to achieve third-party (independent) financing

- The proposed ESOP transaction entails financing that potentially dilutes shareholders (such as warrants)
- The proposed transaction valuation is not thorough, methodologically complete, and standards-compliant
- The seller of stock to an ESOP is also the ESOP trustee
- The issuance of stock to an ESOP involves the use of sale proceeds for non-recurring payments to non-ESOP shareholders and/or executives of the company
- The company conducts significant business with parties that are owned or controlled by sellers of stock to a proposed ESOP
- A proposed ESOP transaction is occurring at a time of significant change in company performance (declining revenue and/or profitability)
- A proposed ESOP transaction is occurring at a time of significant change regarding senior management, product and service offerings, closure or discontinuation of certain lines of business or locations, etc.
- Alternative transaction bids have been received that are different in price or structure, thereby leading to an interpretation as to whether the exact terms being offered reconcile to the proposed ESOP transaction valuation
- There is concern that the shareholders, trustees and directors fully understand that considerable efforts were expended to assure fairness to all parties
- The board desires additional information about the potential impact of the ESOP transaction and ongoing plan requirements on the company
- An ESOP company is issuing stock options or other equity-based compensation that could adversely dilute the ESOP's ownership position
- An ESOP company is being sold to a related party or buyer with a current or prior relationship to the company
- An ESOP company is being sold for consideration that is above and beyond that which directly benefits shareholders (including the ESOP) on a pro rata basis (management contracts, non-competes, etc.)
- An ESOP company is being sold to a buyer that intends to employ company executives, trustees, and/or board members subsequent to the closing of the transaction
- An ESOP company is being sold where the company, its board, and/or its executives have not obtained competing bids or assessed alternative strategies for maximizing value and/or achieving liquidity
- An ESOP company has elected not to respond to or to negotiate an offer submitted by a bona fide purchaser of the company

Despite the breadth of the above events circumstances, there are many other situations which likely accompany ESOP transactions and transactions of ESOP owned companies. Your transactions should be thoroughly reviewed from the financial perspective of the ESOP. The transaction process, evolution, negotiations, and other factors that comprise the event (and any circumstances) should be systematically analyzed and documented within the fairness opinion.

Q: What does the deliverable fairness opinion work product look like? What does it contain?

The fairness opinion is a brief document, typically in letter form. However, the supporting work behind the fairness opinion letter can be substantial. This supporting work is often reported and documented in the form of a fairness memorandum that incorporates all material factors, conditions, circumstances, and other considerations which were analyzed, assessed, and disclosed in the development of the opinion. The fairness opinion letter typically makes the affirmative statement that the proposed transaction is fair from the financial perspective of the ESOP.

In the case of a new ESOP or the sale of an ESOP owned company, the fairness exercise virtually always includes a valuation to determine if the ESOP is paying or receiving adequate consideration for the interests it is buying or selling. Generally, the purpose of the valuation is to develop the fair market value of the ownership interest to be transacted. The fairness memorandum also includes all relevant disclosures concerning the transaction, alternatives and potential consequences related to action or inaction regarding the pending transaction, and other assessments that may be specifically requested by the trustee.

In our experience as financial advisors to ESOP trustee, and as an ESOP-owned company, every ESOP situation usually has unique circumstances that require specific assessment. For a confidential discussion about your specific ESOP situation, please contact a Mercer Capital valuation professional.

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For Sale By Owner

Should You or Shouldn't You?

by Z. Christopher Mercer, ASA, CFA, ABAR

Imagine this common scenario for many business owners today...You have spent the better part of your life building your business through hard work, determination, and a little luck. Now, your company has grown into a well-known, highly respected business and a formidable competitor in the industry. You have made a pretty good living for yourself and your family through the success of the business. Now, you are starting to think about the prospects of selling it so that you can spend more time with your grandchildren and just generally have a chance to have fun. You are not sure what the business is worth, but you have an idea at what price you would sell. Then, the call comes. A company in a similar industry calls to inform you that they have been watching your company over the last few years and are impressed with its product mix and brand name recognition. They are interested in buying your business. You think to yourself: "I built this business by myself. I know the industry. I have negotiated with vendors and customers all my life. I should certainly be able to negotiate the sale of my business by myself. It can't be that hard."

The above scenario (or some version of it) often occurs with companies considered to be in the lower-tier of the middle-market ($5 million – $200 million revenues). It is common for business owners to get serious about exit strategies only after a potential buyer comes knocking on the door.

At Mercer Capital, we see this frequently, because often times the first thing a business owner does after he gets an offer is call us to obtain an appraisal. Business owners usually tell us that they have an idea what the business is worth or even what they would take for it, but want a professional appraiser to "verify" their assumptions.

Fear is the underlying motivation bringing the business owner into our office — fear of leaving money on the table, or never knowing, with some degree of certainty, if he got the best deal possible. After investing a life's work growing this valuable asset, which probably comprises the majority of his (and his family's) net worth, it would be a shame not to realize its maximum value.

Unfortunately for the business owner who takes this route, an appraisal is not the appropriate tool to prevent his fears from becoming a reality. He needs a professional M&A intermediary to help him sell his business. We have seen business owners shortchange themselves by taking the "For Sale by Owner" (FSBO) approach. Sure, they managed to sell their business, but did they get the best price and terms? It's hard to say without entertaining multiple competing offers. Even if the offer is, in the owner's mind, a good one; is it the best one?

Objections to using an intermediary usually relate to the fee associated with hiring an investment banker. But is the fee that onerous?

Consider the following analogy:

You are trying to sell your car for $10,000. Someone offers to wash it and tune it up and then do all the work to sell it for you and the only up front cost is to purchase the soap. The individual only wants to be paid after the car is sold and for a percentage of sales price above $10,000.

You don't have to be a seasoned entrepreneur to know that's a pretty good deal.

An M&A intermediary is compensated in the same manner. The cost for soap in our scenario is essentially the intermediary's retainer fee. The intermediary "cleans up" the company by presenting the business in the most favorable way, making necessary adjustments to uncover value. The intermediary will work to convince prospective buyers to pay for that value. The incremental increase in deal price that an intermediary can create is often many times that of the fee charged. It is essentially a "zero-cost" service to the client.

Because Mercer Capital has served both as an intermediary for clients or provided appraisals for clients who chose to go it alone, we have witnessed the outcomes of both strategies. Accordingly, we have compiled a list of warnings for those who venture down the FSBO road:

» **Negotiating with only one potential buyer = lower price.** A fundamental economic truth: the more buyers sitting at the bargaining table, the higher the price. If the buyer believes that he is the only one at the table, the seller is in a position of weakness. However, with multiple offers in a competitive bidding situation, the seller will know what the market will truly pay for the business. As a FSBO, it is extremely difficult to allocate the time to seek other offers. In our experience, once a FSBO owner has an interested buyer, he pours all his time into closing the deal with that party. If it doesn't work out, he looks for the next potential buyer. One of the critical roles of an intermediary is to create competition that will drive up deal price. Often, even the introduction of an intermediary into the negotiation process creates a sense of competition. Facilitating a competitive bidding process is a full-time task that is best left to the professionals.

» **The buyer wants to harvest the "low-hanging fruit".** In a recent post on the *Buyout Blog*, author Tom O'Neill calls the profit enhancements made after a middle market business is acquired "low-hanging fruit". He speaks directly to how often owners of lower-tier middle-market businesses leave this money on the table when they sell their business. Professional acquirers, like private equity funds or other corporations, are routinely able to add 10 to 25% to the bottom line the first year of ownership just by harvesting this "low-hanging fruit". An intermediary should be able to recognize that low-hanging fruit and demand that his client be compensated for it. Through a clear and concise presentation of the business and its financial data, the intermediary can create a sound argument to the buyer for any profit enhancement the buyer should expect to capture. As a FSBO, it may be difficult to identify, or at least present, a strong argument for being compensated for that value.

- **Driving a deal takes a great deal of time.** Do you have that time? If the marketing process is managed correctly, a good business will have multiple parties interested. Each potential buyer will have different questions at different times, which will consume a great deal of the business owner's attention. It is also difficult to manage the information to guarantee a high level of confidentiality. Coordinating due diligence visits and other similar meetings demands an exorbitant amount of time and energy that the seller may not be able to afford.

- **Business owners are not necessarily good negotiators.** Many find themselves getting emotionally involved and losing a degree of rationality and objectivity. If a critical eye is cast on the business by the prospective buyer, it is possible that the seller could take it personally, leading to stalled negotiations or heightened tension between both parties.

- **Do you know how to manage the information flow?** Do you know when should you get a confidentiality agreement? What about an exclusivity agreement? How much information should you share? What if the buyer is a competitor? What is a reasonable time frame for due diligence? If the seller doesn't know what is reasonable, it may send a signal to the buyer that the seller is naïve. Many experienced buyers will offer to lead the seller through the process if they feel the seller is uninformed. This puts the seller at a disadvantage, and sellers often find themselves agreeing to things that may not be in their best interest. An intermediary will know what is reasonable and will handle all of these details.

- **Financial statements and brochures are not adequate for presentation.** Typically, when a business owner begins negotiations with an interested buyer, he will provide the financial audits for the last few years and the latest marketing slicks. Often, this information can create more questions than provide answers, and answering these questions will require the business owner's time and attention. An intermediary will know what a buyer is looking for and will present the business in a format that will expedite the process and position the business in the best light possible. The intermediary will have studied the company and questioned the seller about one-time charges, excess or discretionary expenses and non-operational items that should be adjusted. He will also consider, in the case of a corporate buyer, what synergistic cost savings the buyer should see and account for.

- **Watch out for "tire-kickers."** We have seen FSBO sellers waste a ridiculous amount of time on "tire-kickers", buyers who are not serious about a transaction or may not have the financial capacity to transact. We often have clients call us out of sheer frustration, because they provided private information, spent time in due diligence, and wasted hours at the negotiating table; all to have the deal die because the buyers couldn't get the financing to transact. An intermediary will perform the necessary due diligence on any prospective buyers to prevent this situation from occurring.

- **CPAs and attorneys are not intermediaries.** While both parties play a key role in selling a business, we believe (and they would likely agree) neither professional has the experience or capacity to serve as an intermediary. Like a general contractor pulls together the skills of the electrician, plumber and painter, the intermediary works with the business's accountants and attorneys to pull together the necessary information to get the deal closed.

- **Negotiating with your "new boss" is not a good idea.** It is common for a buyer to expect the former owner to work in the business for a few months up to several years to ensure business continuity. Occasionally, there is an earn-out provision that provides the seller with an incentive to continue to successfully grow the company. In this situation, it makes life difficult if animosity was created between the buyer and the seller through the negotiation of the deal. It is possible that tension will be carried over from the negotiations into the new working relationship, causing problems for everyone involved. We have found it best when the intermediary serves as the hardball negotiator. It is helpful, should the seller stay with the business, when the seller can default to the advice of the intermediary. Most intermediaries don't mind being stern in their client's best interest.

» **Selling a business can take a great deal of time – at the expense of running the business.** FSBO sellers always underestimate the time commitment involved with selling their business. Forget about multiple buyers (which we have established is in the seller's best interest), but dealing with just one prospect requires a great deal of time and effort. Invariably, the operations of the business will be adversely affected. In a self-defeating manner, the FSBO process will only lengthen the time and increase the cost to get to closure.

The disposition of your life's work is nothing to be taken lightly. You owe it to yourself and the company's shareholders to consult a professional when considering the sale of your business. Perhaps Mark Twain put it best in his book, Following the Equator, when he remarked:

> *"There are two times in a man's life when he should not speculate: when he can't afford it, and when he can".*

If you are contemplating the sale of your business, remember these words and contact an intermediary to help you avoid the perils of FSBO. The professionals of Mercer Capital do more than provide business appraisals. We are regularly engaged to act as intermediaries. If you have been approached by a potential acquirer, give me a call at 800.769.0697 to discuss your situation in confidence. When it counts, count on the experience and expertise of Mercer Capital.

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