MERCER CAPITAL

MERCER CAPITAL'S

Value Matters™

Volume 2008-09 » September 24, 2008
www.mercercapital.com
mcm@mercercapital.com

Fairness Opinions
Q&A from an ESOP Perspective

Excerpted from Mercer Capital's forthcoming book,
"***Is It Fair? A Guide to Understanding Fairness Opinions from a Valuation Perspective***."

The following question and answer format allows readers to focus on material of specific interest. Additional must-read materials related to your questions about fairness opinions and other ESOP oriented topics are included in the forthcoming book, "*Is it Fair? A Guide to Understanding Fairness Opinions from a Valuation Perspective*," and on the Mercer Capital website (www.mercercapital.com) where an ongoing dialog of ESOP questions and answers can be found in our quarterly valuation periodicals and archived articles. In our experience as financial advisors to ESOP trustees, 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.

Q: WHY ARE FAIRNESS OPINIONS IMPORTANT?

A: 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. A fairness opinion can assist corporate directors and executives in making 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, which requires that a board exercise due care in the process of reaching a corporate decision, that the board acts independently and objectively in reaching such decisions, that decisions are made in good faith, and that there was no abuse of discretion in making the decision.

Q: DOES A TRANSACTION INVOLVING OR AFFECTING AN ESOP REQUIRE A FAIRNESS OPINION?

A: The prudent, albeit self-serving, answer is yes. Despite this author's professional convictions 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.

INSIDE

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 future, present, and past ESOP participants.

Q: IF A “VALUATION” IS ALREADY PART OF THE PROCESS, ISN’T A FAIRNESS OPINION THE SAME THING?

A: 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.

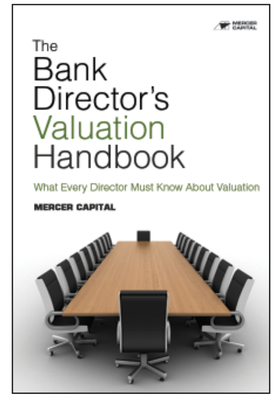
In many cases a fairness opinion reaches beyond the instant economics of a transaction to examine the specific terms and context of a transaction. Valuations are often based on the standard of “fair market value” and are constructed using reasonable assumptions and reflections of a hypothetical and rational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

Q: WHAT EVENTS GIVE RISE TO THE NEED FOR A FAIRNESS OPINION?

A: The following is a list (non-comprehensive) of the types of events that 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 that board directors have to their ESOP trustees and in turn the trustee’s obligations to their plan participants are 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 changing of corporate entity organization of the ESOP company (“S” election)
- Significant changes to the ESOP plan document
- The purchase of a significant asset or business segment which is beyond the normal scope of business or corporate activity
- The sale of a significant asset or business segment which is beyond the normal scope of business or corporate activity
- The redemption of stock by the company from non-ESOP shareholders
- 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
- The liquidation of the ESOP company
- The termination of the ESOP

COMING SOON



The Bank Director’s Valuation Handbook

What Every Director Needs to Know About Valuation

To be released Fall 2008

Q: ARE THERE OTHER CIRCUMSTANCES THAT MAY REQUIRE DECISION MAKERS AND FIDUCIARIES TO OBTAIN FAIRNESS OPINIONS?

A: 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 other stock transactions have occurred or is different than the valuation expected in a potential sale of the company

» 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 at a valuation different than the ESOP appraisal or for consideration that is different than anticipated
- 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 is not represented by a qualified investment banker or other intermediary whose purpose is to maximize value and deal structure for the company and the ESOP
- 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?

A: 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 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 (or the party that requisitioned the opinion).

Timothy R. Lee, ASA
leet@mercercapital.com

MERCER CAPITAL'S E-BOOK LIBRARY

TITLE	DESCRIPTION	INVESTMENT	RELEASE DATE
UPDATED **The QMDM Companion, Version 4.0 (2008)**	The Quantitative Marketability Discount Model (QMDM) presents a practical model to assist business appraisers in developing, quantifying and defending marketability discounts under the income approach. The very latest version of the QMDM now includes a revised and expanded explanatory manual. The model and manual are delivered as a .zip file electronically via email.	**$125.00**	*Currently Available*
Valuing Financial Institutions	We are responding to requests to put this 1992 book back into print and we are doing so as an E-Book	**$65.00**	*Currently Available*
Are S Corporations Worth More Than C Corporations?	An e-booklet that adds to the S Corp vs. C Corp debate.	**$19.95**	*Currently Available*
Embedded Capital Gains	A closer look at the Embedded Capital Gains issue.	**$19.95**	*Currently Available*
Rate & Flow: An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions	In this e-book, we present an alternative model for determining active / passive appreciation in a marital dissolution.	**Complimentary**	*Currently Available*
QMDM Fact Sheet	The latest information about the QMDM in a pdf format	**Complimentary**	*Currently Available*

Visit our website at www.mercercapital.com for more information or to download an e-book.

NEW WHITEPAPER SERIES: "UNDERSTAND THE VALUE OF ..."

TITLE	DESCRIPTION	INVESTMENT	RELEASE DATE
Understand the Value of Your Local Exchange Carrier	Over the past decade, the telecommunications industry has been characterized both by rapid innovation and obsolescence. Whether through selling, acquiring, divesting, or any other major strategic change, it is important to realize the value of your telecommunications company as it stands today.	**Complimentary**	*Currently Available*
Understand the Value of Your Electrical Distributorship	Electrical equipment wholesalers operate in a highly fragmented industry, consisting largely of family-owned business with a few locations within a relatively close proximity. This article provides insight into the situational (when and why) and analytical (how) aspects of valuing electrical distributors.	**Complimentary**	*Currently Available*
Understand the Value of Your Start-Up Business	Valuation for start-up enterprises can be a tricky proposition. Regardless of industry, start-ups generally share a common set of operational characteristics and valuation needs that are distinct from mature firms. This article discusses specific valuation considerations relevant to start-up companies.	**Complimentary**	*Currently Available*
Understand the Value of Your Independent Trust Company	Due to their variance in size, there is no one-size-fits-all definition of an independent trust company, and recognition of the particular attributes of independent trust companies is significant to understanding their value.	**Complimentary**	*Currently Available*
Understand the Value of Your Brick Business	This article provides an informative overview regarding the valuation of businesses operating in the brick industry, including a discussion of value as it relates generally to both manufacturers and wholesalers, as understanding how brick businesses are valued may help you understand how to grow the value of your business.	**Complimentary**	*Currently Available*
Understand the Value of Your Insurance Brokerage	For the past several years, insurance brokerages have been in a period of consolidation, and the current soft market is expected to persist for at least the near term. As such, it is an opportune time for business owners to have an idea of what their brokerage business is worth.	**Complimentary**	*Currently Available*
Understand the Value of Your Physician Practice	The event that triggers ownership transfer can be categorized as either voluntary or involuntary. It is important for physicians to consider the universe of ownership transfer possibilities, because sooner or later, you will be involved.	**Complimentary**	*Currently Available*
Understand the Value of Your Auto Dealership	Because your dealership will change hands, it is important for you to understand the key concepts of business value and how value is determined for your dealership.	**Complimentary**	*Currently Available*
Understand the Value of Your Wholesale Distributorship of Malt Beverage Products	The financial landscape is littered with rules of thumb pertaining to the value of privately owned businesses. Perhaps in no other industry is the rule of thumb concept more prevalent than in beer distribution. It is critical that value be determined and articulated in a credible fashion.	**Complimentary**	*Currently Available*

Visit our website at www.mercercapital.com for more information or to download a whitepaper.

A GENTLE PLUG FOR OUR FIRM

MERCER CAPITAL is a business valuation and investment banking firm serving a national and international clientele. Our reputation for excellence is based on an ability to solve complex financial problems expeditiously. We convert over 20 years of experience, including thousands of assignments, into solutions for the issues of today.

Corporate Valuation. Mercer Capital provides a broad range of independent valuation and financial advisory services, including:

- Dispute Analysis Services and Expert Testimony
- Valuation for Corporate Tax Matters
- Valuation for Corporate Income Tax Issues
- Valuation for ESOPs
- Purchase Price Allocations
- Valuation of Employee Options
- Goodwill Impairment Testing
- Valuation of Intangible Assets
- Fairness Opinions

Mercer Capital's investment banking professionals specialize in providing merger and acquisition services to sellers or buyers of private businesses or public companies divesting divisions and subsidiaries. In addition, we assist clients in industry consolidations, roll ups, and refinancings.

INTERNET COMMERCE: OBTAIN PROPOSALS TO VALUE YOUR COMPANY, BANK, FLP OR LLC VIA OUR WEBSITE

The cost of your time and delays in obtaining proposals has just gone down. Use one of the PROPOSAL REQUEST FORMS on our website.

Many of your colleagues have already used our PROPOSAL REQUEST FORMS and are impressed by the decrease in transactional overhead and the increased ease in obtaining actionable proposals for their clients. We are pleased to be doing business with them. Try it yourself! Visit our website and provide us with the pertinent information via this form, and we'll prepare a proposal and deliver it to you via e-mail, fax or USPS. Complete confidentiality is assured.

UNSUBSCRIBE

We will continue to send the newsletter as published at no cost unless you notify us that you wish to be removed from the distribution list. To REMOVE yourself from this list, send an e-mail to: newsletters@mercercapital.com and type the words "Unsubscribe – Value Matters" in the subject line (without the quotation marks).

MERCER CAPITAL

Business Valuation » Investment Banking

HEADQUARTERS:
5860 Ridgeway Center Parkway, Suite 400
Memphis, Tennessee 38120
901.685.2120 » Fax 901.685.2199

LOUISVILLE OFFICE:
455 South 4th Street, Suite 690
Louisville, Kentucky 40202
502.585.6340 » Fax 502.585.6345

www.mercercapital.com

DISCLAIMER. This publication does not constitute legal, valuation, tax, or financial consulting advice. It is offered as an information service to our clients and friends. Those interested in specific guidance for legal and accounting matters should seek competent professional advice. Inquiries to discuss specific valuation or corporate finance matters are welcomed. Permission is specifically granted to send copies of this Value Matters™ to others who might have an interest in its contents. Permission is also granted to quote portions of this newsletter with proper attribution.

Copyright © 2008 by Mercer Capital Management, Inc., all rights reserved. Text, graphics, and HTML code are protected by US and International Copyright Laws, and may not be copied, reprinted, published, translated, hosted, or otherwise distributed by any means without explicit permission.

THE BUY-SELL AGREEMENT RESOURCE KIT

MERCER CAPITAL

SPECIAL OFFER

Get your copy of the
Buy-Sell Agreement Resource Kit
for **only $79**

(Regular price - $129)

Includes the book, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?* as well as the *Buy-Sell Audit Checklist*

The Latest Tool to Help You Craft Buy-Sell Agreements

Mercer Capital's **Buy-Sell Agreement Resource Kit** includes:

- » The best-selling book, *Buy-Sell Agreements: Ticking Time Bombs or Reasonable Resolutions?*
- » Delivered as an 8.5"x11" PDF file, the *Buy-Sell Audit Checklist* is a 40-page "audit tool" that addresses the many obvious, yet overlooked, valuation issues related to buy-sell agreements.

Estate planning professionals must have this resource kit. It is an invaluable aid as you draft and review buy-sell agreements. Authored by a valuation professional, the book and the *Buy-Sell Audit Checklist* can help you avoid the problems and pitfalls of poorly worded or incomplete agreements.

Name

Firm

Address

City/State/Zip Telephone

Email

☐ Visa ☐ Mastercard ☐ American Express ☐ Check Enclosed

Card Number

Name on Card Exp. Date

Signature

	ITEM	REG. PRICE	SPECIAL PRICE	TOTAL
	Buy-Sell Agreement Resource Kit *(Includes Book & Checklist)*	~~$129~~	**$79**	

Individual Item Orders

	Buy-Sell Agreements: The Book	$79		
	Buy-Sell Audit Checklist	$50		

Sales Tax - TN Residents (9.25%)

Shipping Charge

TOTAL

SHIPPING CHARGES

	1 Kit	**2 or More**
FedEx Ground	$7.00	$12.00
2-Day	$11.00	$15.50
Overnight	$35.00	$40.00

Please call for Canadian & International rates

MERCER CAPITAL :: 5860 Ridgeway Center Parkway, Suite 400, Memphis, TN 38120 :: 901.685.2120 (P) :: 901.685.2199 (F) :: www.mercercapital.com