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Issue No. 3, 2014

# Fairness Opinions

## Evaluating a Buyer's Shares from the Seller's Perspective

M&A activity in the U.S. (and globally) has accelerated in 2014 after years of gradual improvement following the financial crisis. According to Dealogic, M&A volume where the target was a U.S. company totaled \$1.4 trillion YTD through November 10, the highest YTD volume on record and up 43% from the same period last year. Excluding cross-border acquisitions, domestic-only M&A was \$1.1 trillion, which represented the second highest YTD volume since 1999 and up 27% from last year. Healthcare and telecommunications were the first and second most targeted sectors.

The improvement has taken a long time even though corporate cash is high, financing costs are very low and organic revenue growth in most industries has been sluggish. Aside from improving confidence, another key foundation for increased M&A activity fell into place in 2013 when equity markets staged a strong rally as the S&P 500 rose 30% (32% with dividends) and the Russell 2000 increased 37% (39%). The absence of a meaningful pullback in 2014 and a 12% advance in the S&P 500 and 2% in the Russell 2000 have further supported activity.

The rally in equities, like low borrowing rates, has reduced the cost to finance acquisitions because the majority of stocks experienced multiple expansion rather than material growth in EPS. It is easier for a buyer to issue shares to finance an acquisition if the shares trade at rich valuation than issuing "cheap" shares. As of November 24, the S&P 500's P/E based upon trailing earnings (as reported) was 20.0x compared to 18.2x at year-end 2013, 17.0x at year-end 2012 and 14.9x at year-end 2011. The long-term average P/E since 1871 is 15.5x (Source: <http://www.multpl.com>).

High multiple stocks can be viewed as strong acquisition currencies for acquisitive companies because fewer shares have to be issued

to achieve a targeted dollar value. As such, it is no surprise that the extended rally in equities has supported deal activity this year. However, high multiple stocks may represent an under-appreciated risk to sellers who receive the shares as consideration. Accepting the buyer's stock raises a number of questions, most which fall into the genre of: what are the investment merits of the buyer's shares? The answer may not be as obvious as it seems, even when the buyer's shares are actively traded.

Our experience is that some, if not most, members of a board weighing an acquisition proposal do not have the background to thoroughly evaluate the buyer's shares. Even when financial advisors are involved there still may not be a thorough vetting of the buyer's shares because there is too much focus on "price" instead of, or in addition to, "value."

A fairness opinion is more than a three or four page letter that opines as to the fairness from a financial point of a contemplated transaction; it should be backed by a robust analysis of all of the relevant factors considered in rendering the opinion, including an evaluation of the shares to be issued to the selling company's shareholders. The intent is not to express an opinion about where the shares may trade in the future, but rather to evaluate the investment merits of the shares before and after a transaction is consummated.

Key questions to ask about the buyer's shares include the following:

- **Liquidity of the Shares.** What is the capacity to sell the shares issued in the merger? SEC registration and even NASDAQ and NYSE listings do not guarantee that large blocks can be liquidated efficiently. Generally, the higher the institutional ownership, the better the liquidity. Also, liquidity may improve

with an acquisition if the number of shares outstanding and shareholders increase sufficiently.

- **Profitability and Revenue Trends.** The analysis should consider the buyer's historical growth and projected growth in revenues, and operating earnings, (usually EBITDA or EBITDA less capital expenditures) in addition to EPS. Issues to be vetted include customer concentrations, the source of growth, the source of any margin pressure and the like. The quality of earnings and a comparison of core vs. reported earnings over a multi-year period should be evaluated.
- **Pro Forma Impact.** The analysis should consider the impact of a proposed transaction on revenues, EBITDA, margins, EPS and capital structure. The per share accretion and dilution analysis of such metrics as earnings, EBITDA and dividends should consider both the buyer's and seller's perspectives.
- **Dividends.** In a yield starved world, dividend paying stocks have greater attraction than in past years. Sellers should not be overly swayed by the pick-up in dividends from swapping into the buyer's shares; however, multiple studies have demonstrated that a sizable portion of an investor's return comes from dividends over long periods of time. If the dividend yield is notably above the peer average, the seller should ask why? Is it payout related, or are the shares depressed? Worse would be if the market expected a dividend cut. These same questions should also be asked in the context of the prospects for further increases.
- **Capital Structure.** Does the acquirer operate with an appropriate capital structure given industry norms, cyclicity of the business and investment needs to sustain operations? Will the proposed acquisition result in an over-leveraged company, which in turn may lead to pressure on the buyer's shares and/or a rating downgrade if the buyer has rated debt?
- **Balance Sheet Flexibility.** Related to the capital structure should be a detailed review of the buyer's balance sheet that examines such areas as liquidity, access to bank credit, and the carrying value of assets such as deferred tax assets.
- **Ability to Raise Cash to Close.** What is the source of funds for the buyer to fund the cash portion of consideration? If the buyer has to go to market to issue equity and/or debt, what is the contingency plan if unfavorable market conditions preclude floating an issue?
- **Consensus Analyst Estimates.** If the buyer is publicly traded and has analyst coverage, consideration should be given to Street expectations vs. what the diligence process determines. If Street expectations are too high, then the shares may be vulnerable once investors reassess their earnings and growth expectations.
- **Valuation.** Like profitability, valuation of the buyer's shares should be judged relative to its history and a peer group presently as well as relative to a peer group through time to examine how investors' views of the shares may have evolved through market and profit cycles.
- **Share Performance.** Sellers should understand the source of the buyer's shares performance over several multi-year holding periods. For example, if the shares have significantly outperformed an index over a given holding period, is it because earnings growth accelerated? Or, is it because the shares were depressed at the beginning of the measurement period? Likewise, underperformance may signal disappointing earnings, or it may reflect a starting point valuation that was unusually high.
- **Strategic Position.** Assuming an acquisition is material for the buyer, directors of the selling board should consider the strategic position of the buyer, asking such questions about the attractiveness of the pro forma company to other acquirers.
- **Contingent Liabilities.** Contingent liabilities are a standard item on the due diligence punch list for a buyer. Sellers should evaluate contingent liabilities too.

The list does not encompass every question that should be asked as part of the fairness analysis, but it does illustrate that a liquid market for a buyer's shares does not necessarily answer questions about value, growth potential and risk profile.

We at Mercer Capital have extensive experience in valuing and evaluating the shares (and debt) of financial and non-financial service companies garnered from over three decades of business. Feel free to contact us to discuss your situation in confidence.



**Jeff K. Davis, CFA**  
jeffdavis@mercercapital.com

# Mercer Capital News

## Harms and Rajbhandary Author Article in *ABF Journal*

Mercer Capital's Travis W. Harms, CFA, CPA/ABV and Sujan Rajbhandary, CFA authored an article in the October 2014 issue of *ABF Journal*, titled "Valuation Expertise: Necessary Chapter 11 Process Navigation."

View the article at <http://mer.cr/1vD0w75>.

## New Additions to Mercer Capital's Staff

Mercer Capital welcomes Mr. Atticus L. Frank, Mr. Demetri E. Jerow, and Mr. Robert T. Richardson to our professional staff as Financial Analysts.

Mr. Frank is a graduate of Sewanee: The University of the South with a double major in Economics and Political Science. Mr. Jerow holds a Bachelor of Arts in Economics/Commerce and Business from Rhodes College. Mr. Richardson is a graduate of Vanderbilt University holding a Bachelor of Arts degree in Economics & History.

In their capacity as Financial Analysts at Mercer Capital, Mr. Frank, Mr. Jerow, and Mr. Richardson will provide business valuation and financial consulting services to public and private companies and financial institutions across the nation.

## Grabowicz Earns Accredited in Business Valuation Designation

Mercer Capital is pleased to announce that Karolina Grabowicz, CPA has been awarded the Accredited in Business Valuation (ABV)

credential from the American Institute of Certified Public Accountants (AICPA). The ABV credential is granted exclusively to CPAs who elect to demonstrate their business expertise and experience by earning the credential.

Ms. Grabowicz met the requirements to earn the credential, including holding a valid CPA

certificate, providing evidence of experience and continuing education in business valuation, and passing the ABV examination covering the business valuation common body of knowledge, including the areas of professional and regulatory standards, valuation analysis and report writing. Ms. Grabowicz is a financial analyst at Mercer Capital.

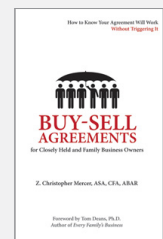
## Mercer Capital's Books of Interest

**Unlocking Private Company Wealth: Proven Strategies and Tools for Managing Wealth in Your Private Business**



This book will help business owners turn their business into the liquidity-creating vehicle it needs to be for them to become independent of the business and truly free to sell it, stay with it, or transition it to others of their choice.

**Buy-Sell Agreements for Closely Held and Family Business Owners: How to Know Your Agreement Will Work Without Triggering It**



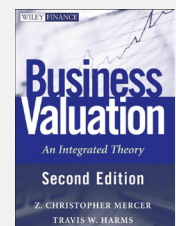
Designed for business owners and business advisers, this book provides a road map for business owners to develop or improve their buy-sell agreements.

**An Estate Planner's Guide to Revenue Ruling 59-60: Understand How Valuation Experts Utilize the Ruling in Income and Estate & Gift Tax Valuation Engagements**



Mercer Capital  
This book is a non-technical resource that clearly explains how business appraisers attempt to translate the guidance found in Revenue Ruling 59-60 into actual valuation engagements.

**Business Valuation: An Integrated Theory Second Edition**  
Z. Christopher Mercer, ASA, CFA, ABAR  
Travis W. Harms, CFA, CPA/ABV



Whether you are an accountant, auditor, financial planner, or attorney, *Business Valuation: An Integrated Theory, Second Edition* enables you to understand and correctly apply fundamental valuation concepts.

**Each book is available at [www.mercercapital.com](http://www.mercercapital.com)**

## Industry Events

The senior staff of Mercer Capital attends and presents at numerous industry and professional conferences. If you are attending as well, please let us know so we can connect with you.

### Heckerling Institute on Estate Planning

January 12-16, 2015 // Orlando, FL

**Chris Mercer**, CEO, **Tim Lee**, Managing Director, **Nick Heinz**, Senior Vice President, and **Barbara Price**, Senior Vice President of Marketing, will be attending this event. Visit them in Booth No. D-2.

Chris Mercer » [mercerc@mercercapital.com](mailto:mercerc@mercercapital.com)  
Tim Lee » [leet@mercercapital.com](mailto:leet@mercercapital.com)

Nick Heinz » [heinzn@mercercapital.com](mailto:heinzn@mercercapital.com)  
Barbara Price » [priceb@mercercapital.com](mailto:priceb@mercercapital.com)

### Unlocking Private Company Wealth: A Tutorial for Business Advisers

Webinar sponsored by Valuation Products and Services  
November 18, 2014

**Chris Mercer**, CEO, presented the webinar "Unlocking Private Company Wealth: A Tutorial for Business Advisers."

Chris Mercer » [mercerc@mercercapital.com](mailto:mercerc@mercercapital.com)

### Louisiana CPA Business Valuation Conference

October 23, 2014  
Lafayette, LA

**Tim Lee**, Managing Director, spoke at this event on October 23, on the topic of "Unlocking Private Company Wealth."

Tim Lee » [leet@mercercapital.com](mailto:leet@mercercapital.com)

### Young Presidents' Organization

October 14, 2014  
Memphis, TN

**Chris Mercer**, CEO, spoke on "Unlocking Private Company Wealth."

Chris Mercer » [mercerc@mercercapital.com](mailto:mercerc@mercercapital.com)

### Las Vegas ESOP Conference & Trade Show

November 13-14, 2014  
Las Vegas, NV

**Tim Lee**, Managing Director, **Nick Heinz**, Senior Vice President, and **Lisa Doble**, Senior Vice President, attended this conference. On November 13, Tim moderated the panel "Repurchase Obligation: I Have A Study, Now What Do I Do With It?"

Tim Lee » [leet@mercercapital.com](mailto:leet@mercercapital.com)  
Nick Heinz » [heinzn@mercercapital.com](mailto:heinzn@mercercapital.com)  
Lisa Doble » [doblel@mercercapital.com](mailto:doblel@mercercapital.com)

### Southern Federal Tax Institute

October 20 - 23, 2014  
Atlanta, GA

**Matt Crow**, President, **Nick Heinz**, Senior Vice President, and **Laura Stevens**, Vice President, attended this event and Matt and Nick spoke on Thursday, October 23, on the topic "Pathways to Liquidity: Advising Your Clients in Monetizing Their Illiquid Wealth."

Matt Crow » [crowm@mercercapital.com](mailto:crowm@mercercapital.com)  
Nick Heinz » [heinzn@mercercapital.com](mailto:heinzn@mercercapital.com)  
Laura Stevens » [stevensl@mercercapital.com](mailto:stevensl@mercercapital.com)

### An Introduction to Business Development Companies

Webinar sponsored by SNL Financial  
September 23, 2014

**Travis Harms**, Senior Vice President, and **Jeff Davis**, Managing Director, presented on the topic of "An Introduction to Business Development Companies" with panelist, Cynthia Krus from Sutherland Asbill & Brennan.

Travis Harms » [harmst@mercercapital.com](mailto:harmst@mercercapital.com)  
Jeff Davis » [jeffdavis@mercercapital.com](mailto:jeffdavis@mercercapital.com)

### AICPA Business Valuation Conference

November 10, 2014  
New Orleans, LA

**Travis Harms**, Senior Vice President, presented "Digging Deeper: Exploring Nuances of Discounted Cash Flow Analysis" and **Andy Gibbs**, Senior Vice President, presented "Bank Valuation: Financial Issues, Valuation Implications."

Travis Harms » [harmst@mercercapital.com](mailto:harmst@mercercapital.com)  
Andy Gibbs » [gibbsa@mercercapital.com](mailto:gibbsa@mercercapital.com)

### The Market Participant Acquisition Premium

Webinar sponsored by Business Valuation Resources  
October 16, 2014

**Travis Harms**, Senior Vice President, presented on the topic "The Market Participant Acquisition Premium."

Travis Harms » [harmst@mercercapital.com](mailto:harmst@mercercapital.com)

### Tennessee Society of CPAs

September 9, 2014  
Memphis, TN

**Matt Crow**, President, and **Nick Heinz**, Senior Vice President, presented on the topic of "Unlocking Private Company Wealth."

Matt Crow » [crowm@mercercapital.com](mailto:crowm@mercercapital.com)  
Nick Heinz » [heinzn@mercercapital.com](mailto:heinzn@mercercapital.com)

# Mercer Capital

Mercer Capital's ability to understand and determine the value of a company has been the cornerstone of the firm's services and its core expertise since its founding.

Mercer Capital is a national business valuation and financial advisory firm founded in 1982. We offer a broad range of valuation services, including corporate valuation, gift, estate, and income tax valuation, buy-sell agreement valuation, financial reporting valuation, ESOP and ERISA valuation services, and litigation and expert testimony consulting. In addition, Mercer Capital assists with transaction-related needs, including M&A advisory, fairness opinions, and strategic alternatives assessment.

We have provided thousands of valuation opinions for corporations of all sizes in a variety of industries. 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 on behalf of their clients.

Contact a Mercer Capital professional to discuss your needs in confidence.

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