



Sprint Nextel and Nextel Partners

What Is Fair Market Value?

Z. Christopher Mercer, ASA, CFA

The merger of Sprint and Nextel, creating Sprint Nextel (S), closed on August 12, 2005. Shortly thereafter, Nextel Partners, Inc. (NXTP), a publicly traded joint venture partner of Nextel and the operator of a significant portion of the Nextel Digital Wireless Network, recommended that its shareholders begin a process to exercise a right to put ("the Put") their shares in Nextel Partners to Nextel, now Sprint Nextel.

Nextel Partners' Put is a form of a buy-sell agreement, even though it does not have that name. While buy-sell agreements often have mutual buy and/or sell obligations, the Put in question is a one-way deal. The shareholders of Nextel Partners have the right to put their shares to Sprint Nextel according to the mechanism created by the Put agreement.

Nextel Partners' shares closed on Friday, September 9, 2005 at \$25.28 per share, so the price should be easily determinable, right? Wrong!

The issues related to the Put are detailed and complex. This article discusses the first two of the defining elements of the Put, the *standard of value* and the *level of value*.

What Is a Buy-Sell Agreement?

I wrote about such agreements in a recent article, "Your Corporate Buy Sell Agreement: Ticking Time Bomb or Reasonable Resolution?"¹ In that article, I identified six defining elements in a corporate buy-sell agreement from a valuation viewpoint.

Defining Elements of Buy-Sell Agreements

1. Standard of value
2. Level of Value
3. The "As Of" of Valuation Date
4. Qualifications of Appraisers
5. Appraisal Standards to Be Followed
6. Funding Mechanism/Consideration

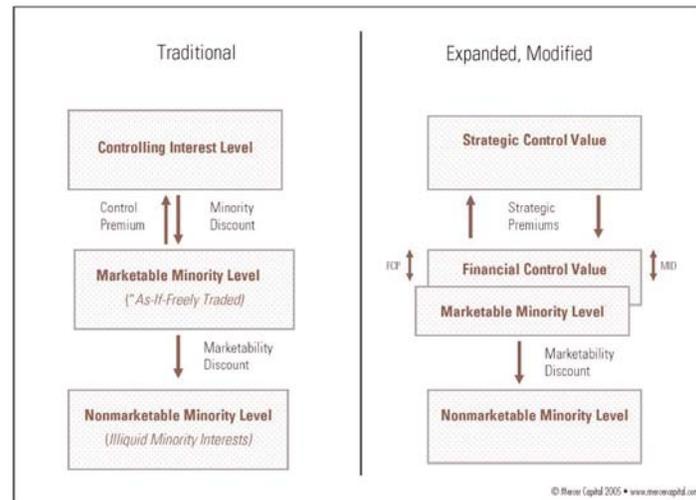
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¹ "Your Corporate Buy Sell Agreement: Ticking Time Bomb or Reasonable Resolution?" *VALUE MATTERS™*, Vol. 2005-08, September 2, 2005.

Levels of Value

We will discuss the standard of value known as fair market value below. Before doing so, however, it will be helpful to get a brief overview of the concept of "levels of value." We have been writing and speaking about levels of value since the late 1980s, and in my latest book, The Integrated Theory of Business Valuation, a good deal of attention is paid to the concept. Figure 3-4 of the book provides two levels of value charts for perspective:



The left side of the chart reflects three levels of value. Only the top two are relevant for the Put, since we know (and you will soon see) that there can be no discount for lack of marketability relative to Nextel Partners' shares.

The right side of the chart shows four levels. Similar to the left side, the relevant levels are the top three. But which level is the appropriate premise, or level of value, for the Nextel Partners Put? The language in the Certificate provides guidance for appraisers.

The Nextel Partners Put

The Put is defined in the Certificate of Incorporation of Nextel Partners in the Schedule 14A filed September 6, 2005. The standard of value is defined in Section 5.7(a). According to the Business Valuation Standards of the American Society of Appraisers ("ASA"), a standard of value is "the identification of the type of value being used in a specific engagement, e.g., fair market value, fair value, investment value."

The Nextel Partners Certificate of Incorporation establishes Fair Market Value (as specifically defined) as the appropriate standard of value for determinations of value under the Put. The beginning point for the defined standard was the fairly typical definition of fair market value.

Fair market value is defined in the cited *ASA Business Valuation Standards* as:

The price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical and able seller, acting at arm's length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts.

Business appraisers are highly familiar with this definition and with the standard known as *fair market value*. It is the standard of value employed in by far the greatest portion of all formal appraisals actually rendered by business appraisers.

Fair Market Value, Per Section 5.7(a)

I will quote the entire definition in pieces in order to facilitate reading. After each of the quotes, I'll comment from the viewpoint of an objective, "nationally recognized investment banker or appraiser" (as noted in the document) and businessman.

This is important, because the Section 5.7(a) of the Certificate is a portion of a legal document. Lawyers and courts interpret the law. Business appraisers value businesses. But appraisers sometimes have to make valuation interpretations of words on pages in legal documents.

The Certificate defines Fair Market Value.

(a) "Fair Market Value" of the Corporation means the price that would be paid for all of the Corporation Capital Stock (excluding the Series B Preferred Stock and any mandatorily redeemable pay-in-kind non-convertible securities)

[This kind of value is an "enterprise value" based on 100% of the cash flows to common equity holders and includes 100% of the common stock of Nextel Partners -- i.e., the 269.5 million shares currently outstanding, together with any options or other contingent shares that will become common stock equivalents upon the closing of the Put transaction.]

by a willing buyer to a willing seller, in an arm's-length transaction,

[This is standard in the usual definitions of fair market value, it being an "arm's length" standard.]

as if the Corporation were a publicly traded and non-controlled corporation and the buyer was acquiring all of such Corporation Capital Stock of the Corporation,

[This language, "as if...publicly traded," sounds almost like the marketable minority level of value, or the middle level on the levels of value charts.]

and assuming that the Corporation was being sold in a manner designed to attract all possible participants to the sales process (including Nextel and its Competitors, subject to the provisions below) and to maximize stockholder value (including, if necessary, through a public or private market sale or other disposition (including tax-free spin-offs, if possible) of businesses prohibited by legal restrictions to be owned by a particular buyer or class of buyer),

[This language limits the "as if publicly traded" language, because it now clarifies that the public company is to be valued as if it were marketed in an active sales process. Such sales processes are known as auctions. Auctions are designed to elicit the highest possible price for a company subject to relevant constraints (like cash only for consideration) placed on the process by the sellers.]

with both buyer and seller in possession of all material facts concerning the Corporation and its business.

[Again, fairly standard language for fair market value.]

In all cases, Fair Market Value for the Corporation will include a control premium and there will be no minority or illiquidity discount.

[At this point, readers who first saw a "levels of value" chart in this article can begin to see the kind of value the Certificate is describing. The "illiquidity discount" referred to above is also called a marketability discount. And no minority interest discounts will be applied. Looking again at the chart on the left, this language would describe a control value, and rule out the nonmarketable minority level of value (the bottom level on both charts). On the right, the appropriate level of value might be either financial control or strategic control, or something in between.]

Fair Market Value of the Corporation shall be determined on the assumption that in a competitive acquisition market with Nextel and prospective buyers other than Nextel, the Corporation would be at least as valuable to other prospective buyers as to Nextel.

[This language is actually fairly smart from Nextel Partners' viewpoint. Absent similar language, if other prospective buyers could achieve adequate returns only by paying less than Nextel could, it could be argued that they set the market, and therefore Fair Market Value, at the lower level. This language assures that if an appraiser believes that Nextel could pay more than other bidders, the amount Nextel would have to pay is what it could pay (and still achieve an adequate return on investment).]

Fair Market Value shall be determined on the assumption that the Corporation is at least as valuable as if it were a part (although separable) of Nextel, with the valuation of the Corporation for purposes of this sentence being derived from a valuation of Nextel consistent with the first sentence of this paragraph but without taking into account a control premium for Nextel (it being understood that a control premium, however, will be applied to the Corporation).

[Again, this is smart language for Nextel Partners. It suggests to the appraisers that if the valuation multiples (price-earnings, total capital to EBITDA (earnings before interest, taxes, depreciation and amortization), total capital to revenues, or others) are significantly lower than those applicable to Nextel, then Nextel's (Sprint Nextel's if the valuation date is after their merger) multiples should be applied to Nextel Partners prior to consideration of any appropriate control premium.]

Fair Market Value of the Corporation will not include any premium solely due to the fact that a competitor of Nextel might be willing to pay a premium for the Corporation in order to hamper or impede Nextel's growth or strategy.

[Score one for Nextel. Suppose the appraisers believed that, say, Verizon, just for purposes of example, might overpay for Nextel Partners to cause strategic damage to Nextel. The kind of strategic premium that Verizon might pay over and above other competing bidders, would not be applicable.]

If the Corporation's stock is publicly traded, Fair Market Value will take into consideration (i) the trading activity and history of the Corporation's stock and (ii) the Corporation's most recent "unaffected" public market stock price.

[This guidance suggests that the historical pricing of the stock should be considered, but that appraisers should examine the most recent "unaffected" price. Control premiums are typically measured one week, one month, or even several months prior to the announcement of a deal, or leaking of information that suggested it might be a possibility. The existence of the Nextel Partners Put has been known for a long time. Should the appraisers go back to pricing before Sprint and Nextel announced their discussions? Or should the standard for "unaffected" come closer to the actual closing of the Sprint Nextel deal? This is important, because if an appraiser were to apply a control premium directly, the premium would logically be applied to the "unaffected" price. This point provides a very wide range of judgment within which the selected appraisers may consider control premiums (in addition to the judgment regarding the magnitude of that premium and the market evidence that might be cited to support it!).]

In making the determination of Fair Market Value of the Corporation, the Corporation will be given the benefit of the fact that it uses the Nextel brand name, business and technology pursuant to the Joint Venture Agreement,

[This provision tells the appraisers that the value may not be discounted because some potential buyers would not be able to use the Nextel brand name, etc., after an acquisition of Nextel Partners. Such consideration, if applied, would likely discount the value of Nextel Partners Put Price.]

but there will be no discount or premium included in any valuation of the Corporation relative to its business as conducted or reasonably expected to be conducted due to the facts that

(v) the Corporation will not own but Nextel will directly or indirectly lease or otherwise make available to the Corporation certain of its rights, assets and services pursuant to the Joint Venture Agreement and the other Collateral Agreements, or pursuant to any other agreements or arrangements entered into from time to time between Nextel and/or its Subsidiaries, on the one hand, and the Corporation and/or its Subsidiaries, on the other hand,

[See the comment immediately above.]

(w) in certain circumstances Nextel will have the right to acquire the Corporation's FCC licenses, and in such a case, the Corporation will not own, but Nextel and/or its Subsidiaries will directly or indirectly make available to the Corporation, the right to manage the use of the frequencies subject to such licenses,

[See the comment immediately above.]

(x) Nextel directly or indirectly has, and may exercise, certain aspects of control over the Corporation's business and the Corporation,

[See the comment immediately above.]

(y) Nextel directly or indirectly provides certain services and other benefits to the Corporation on a cost or subsidized basis

[See the comment immediately above.]

and (z) there may be few potential buyers for the Corporation due to any real or perceived control of the Corporation exercised by Nextel or due to the fact that only Nextel has an identical technology platform.

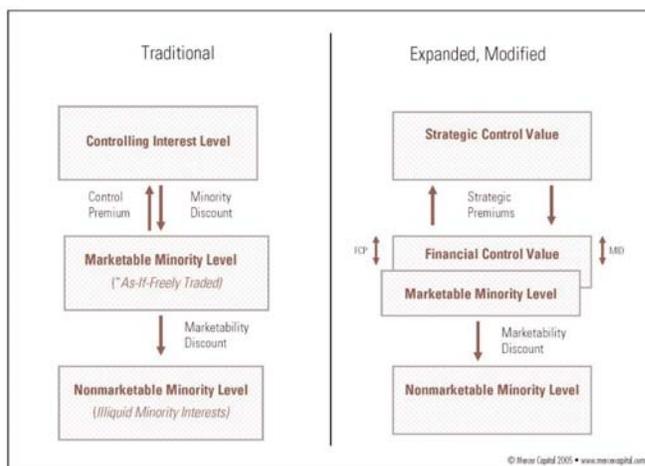
[See the comment immediately above.]

Now, Isn't All That Clear?

The purpose of defining the standard of value and the level of value is to insure that the appraisers called for in buy-sell agreements understand the kind of value to be determined.

Experience in dealing with the valuation aspects of numerous buy-sell agreements suggests that differences in the level of value used by appraisers can cause wide variations in concluded results. Clearly, the potential for such wide variations exists in this case.

It might seem that all the specificity would make things crystal clear. The standard of value is fair market value, a willing buyer, willing seller concept, and the level of value is some kind of controlling interest value. All the appraisers have to do is to place their valuations at the appropriate rung of the levels of value chart, which is repeated here for convenience.



Looking at the "traditional" levels of value chart, it is fairly clear that the level called for in the Put's definition is a control value. But what kind of control value? There is a great deal of conceptual room between the "marketable minority value" in the middle box and the "control value" in the top box.

Refining things a bit further on the right side of the chart, we see a concept of "financial control value" and one of "strategic control value." One real key to the valuation will be in the determination of the appropriate kind of control value.

Nextel Partners fairly clearly suggests in their public disclosure (revised proxy) that they believe that the defined value is a "strategic control value."

Sprint Nextel is publicly arguing (Form 8-K August 17, 2005) for a different kind of value, more like a marketable minority, but not quite, because they are concerned about the recent run-up in Nextel Partners share price since the announcement of the Sprint and Nextel merger.

Why Does It Matter?

The differences in conclusions reached by the selected appraisers on just the issues discussed thus far, and disregarding the potential for additional disagreements regarding the outlook for future performance or the appropriate valuation multiples to apply, can likely be in the hundreds of millions or even billions of dollars.

In an attachment prepared for investors to the Form 8-K filed by Sprint Nextel Corporation on August 17, 2005, we begin to see just how clear the definition of Fair Market Value is - or is not. My comments will follow the excerpts, in brackets:

* Some Wall Street analysts have assumed/concluded that "fair market value" equates to market plus takeover premium

[That assumption or conclusion is fairly logical. See the discussion above regarding control premiums. Section 5.7(a) contains several specific references to the applicability of a control premium.]

* But definition of "fair market value" is complex

[See above. The parties went to great length to define Fair Market Value in Section 5.7(a), and now, Sprint Nextel does not like the definition.]

and there is uncertainty as to appraisal standards and process

[Really? No appraisal standards are mentioned in Section 5.7(a), which greatly increases uncertainty regarding their applicability.]

Sprint Nextel believes that intrinsic value is the underlying standard in the put process

[Did you see the words, "intrinsic value," in Section 5.7(a) quoted above? They are not there. Sprint Nextel is advocating an entirely different standard of value here than Fair Market Value as defined in Section 5.7(a).]

Sprint Nextel believes that no "willing buyer" would base its decision primarily on trading prices at a particular time

[Recall the fairly specific language above: "If the Corporation's stock is publicly traded, Fair Market Value will take into consideration (i) the trading activity and history of the Corporation's stock and (ii) the Corporation's most recent 'unaffected' public market stock price." The language does not say how the appraisers should take trading activity into account, but clearly says it should be considered.]

Sprint Nextel believes the relevant valuation methodologies arising from any consideration of "fair market value" should include discounted cash flow ("DCF"), comparable company and precedent transaction analysis

[At this point, it doesn't matter what Sprint Nextel or Nextel Partners "believe." What matters now is how the "nationally recognized investment bankers or appraisers" interpret the language of Section 5.7(a). If the parties had wanted to specify the specific valuation methodologies to be employed by the appraisers, I suppose they could have done so. But that would be rare. Appraisers typically make their own decisions regarding which methods to use in each valuation.]

In Sprint Nextel's view, any valuation analysis (e.g., DCF) should take into account future operating risks to Partners arising from the changing competitive environment, including the advent of new, competing technologies and the evolution of roaming

[That's a pretty specific interpretation of Section 5.7(a), which was written with considerable specificity. Considerations like this are part of any valuation process. To a certain extent, these factors might be reflected in the historical stock pricing of Nextel Partners as well as in the prices of companies that the appraisers use for valuation guideline purposes.]

And the Sprint Nextel arguments continue on....

Interim Observations

Several things are evident thus far:

1. The definition of "fair market value" per Section 5.7(a) is fairly detailed and seemingly specific. It would appear to call for a strategic or synergistic control level of value, which is the highest level of value on the conceptual levels of value chart employed by appraisers today, or at a minimum, a financial control level of value. See further examples of these conceptual levels of value on Mercer Capital's website, www.mercercapital.com.
2. "Intrinsic value" as mentioned in the Sprint Nextel Form 8-K is a different standard of value. According to the American Society of Appraisers Business Valuation Standards noted above, intrinsic value has its own meaning, which is different from fair market value. Intrinsic value is value to a particular investor. Numerous potential investors are implied by the language in Section 5.7(a).
3. Nextel Partners seems ahead in the race to have the Put Price defined at the strategic control level of value, which would provide, other things being equal, a higher price for its shareholders (and require Sprint Nextel to pay more). I base this comment on the discussion/analysis above.
4. The specific qualifications of the appraisers to be selected in the appraisal process are not specified. Note that the qualifications never specify that the selected appraisers should be "independent business appraisers." Nationally recognized investment bankers are not in the business of rendering independent appraisals. And "appraisers" is not a defined term.
5. My guess is that both firms will employ "nationally recognized investment banking firms" as their appraisers, rather than highly experienced, qualified and credentialled business appraisers. However, providing "independent" valuations represents a very small portion of the business of most such investment banks. Investment bankers typically work on behalf of clients to facilitate transactions that are beneficial to their clients' interests.
6. My guess is that the valuation conclusions of the two appraisers will be substantially different. This would mean, according to Section 5.7(b), that the third appraiser will be employed. It will be interesting to see if the first two appraisers (likely investment bankers) will select another investment banker or if they will agree on a nationally recognized (business) appraiser.

The appraisal process is a "one-two-three appraiser rock!" process as described in my previous post. As described in that post, if the first two appraisers are close together, an average price will be determined.

If there is no close agreement, a third appraiser will be selected to provide his/her opinion of fair market value pursuant to Section 5.7(a). The final conclusion will be that of the third appraiser, if within the middle third of the range of the first two conclusions. It will be the average of the lower and the third if below the middle third and the lower value, and it will be the average of the higher and the third if above the middle third. In any event, the minimum value is set by the lower of the first two appraisals. In no event, however, will the final conclusion be lower than the lower of the first two appraisals - and vice versa for the higher end of the range.

If all this sounds clear, you may be hearing things.

It Gets Even More Interesting

In the event there is a challenge to the concluded value based on the prescribed process, according to Section 5.7(f):

The party or parties bringing the challenge "will be required to demonstrate to a tribunal composed of three persons with expertise in valuing companies similar to the Corporation..."

[Note that the "valuation" credentials noted here are even more nebulous than the description of a "nationally recognized investment banker or appraiser".]

"that the Fair Market Value determined under Section 5.7(c)(or the underlying values determined by the Appraisers on which it was based) was grossly incorrect or fraudulently obtained;"

[Now what is meant by "grossly incorrect"? This is an undefined term. And how will the persons with "expertise in valuing companies" determine if fraud has occurred? As we will see in the next post, there are no requirements that all appraisers comply with any set of appraisal standards, which will make any proof of "grossly incorrect" difficult.]

"and what the correct Fair Market Value should be."

[Now we have another undefined term, the "correct Fair Market Value".]

"The tribunal determining the challenge is to determine Fair Market Value and no party will seek to have the determination referred to an investment banker or appraiser (although they may testify or offer evidence to the tribunal."

[So now, a tribunal of three persons "with expertise in valuing companies similar to the Corporation" must determine the "correct Fair Market Value" without referring to "nationally recognized investment bankers or appraisers" (except perhaps for testimony). My questions are: Who are these people? Does anyone know who they might be?]

The Bottom Line

The Nextel Partners Certificate of Incorporation is perfectly clear in that Sprint Nextel must purchase Nextel Partners if the Put is exercised, a process which is already underway.

What is less than clear is how the valuation process will play out. The parties agreed on a specific and detailed definition of Fair Market Value. But we have seen that the "definition" is not as tight as might be desired and leaves room for lots of interpretation.

Nevertheless, an objective first reading of Section 5.7(a) of the Certificate of Incorporation would seem to justify a strategic control level of value, as indicated in the charts above, or something approaching that conceptual level. The appraisers will each make their own decisions based on their interpretations of Section 5.7(a) from a valuation perspective.

Already, as we have seen, both Sprint Nextel and Nextel Partners are attempting to change or influence how the Section 5.7(a) Put Price definition will be interpreted.

As mentioned above, my recent post on buy-sell agreements was entitled: *"Your Corporate Buy-Sell Agreement -- Ticking Time Bomb or Reasonable Resolution?"* The bottom line in that article will do double-duty for this one:

Know this. If these defining elements, including the pricing mechanism, are unclear in your (or your clients') buy-sell agreement(s), they will be the only thing you will be able to think about following a trigger event until the situation is resolved. Absent a clear agreement, this can take lots of money, lots of time, and create lots of hard feelings. And dealing with the issues under adverse circumstances will absolutely distract you from the business of running your business.

And distraction is the name of the game at Sprint Nextel and Nextel Partners.



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