

Dual Fairness Opinions

and the Role of the Valuation Firm

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Controversy

What is Fair? Fairness?

- » Fair – adjective ... just, equitable, legitimate in accordance with the rules or standards
- » What rules and standards?
- » Fairness, like valuation, is a range concept
- » Process is important
- » Deals may be not fair, close calls, fair or very fair
- » Does a second fairness opinion matter?

Controversy

*“Fairness Opinions
are not worth the \$3.00
(€2.70) stationary they
are written on”*

*“A fairness opinion, you
know—it’s the Lucy sitting in
the box: FO, 5 cents”*

A large investor and a M&A attorney
expressing their views



Board Duties

Duty of Loyalty

Act in the best interests of all shareholders

- » No personal gain at the expense of shareholders
- » No preference for class of shares
- » Disclose conflicts

Duty of Care

Good faith effort to make a fully informed decision

- » Commit time
- » Hire experts
- » Understand the analysis and the impact on the company
- » Does not require accepting short-term gain vs a reasonable long-term plan

Corporate Shield

No breach of duties

Directors are generally shielded by Business Judgement Rule – courts usually defer from second guessing decisions made in good faith

Duties breached

Burden of proof that actions taken were in the best interest of shareholders shifts to the directors – Entire Fairness Standard re: price and process

US Fairness Opinion Evolution

Trans Union Case

Benchmark Delaware (DE) case
Smith v. Van Gorkom (1985)

Focused on directors' duty of care

Bad process - board did not hire
advisors to review deal price, relied
upon executives' analysis

Board "grossly negligent"

Fairness opinions became standard
part of board deliberation, but never
formally mandated

Evolution

Second fairness opinions never
mandated either

Litigious society – majority of M&A
has some form of challenge

Retention of a second advisor and
issuance of a second opinion spurred
by FINRA Rule 5150 in 2007

Rule requires conflicts and firm's work
processes to be disclosed

Rural Metro Corp.

Looks Bad

RBC ran a 2011 auction to sell RMC – Warburg winner @ \$438M

RBC sought share of \$55M of financing fees for Warburg, 11x its advisory fee

Plaintiff's argued RBC: (a) pushed directors into a fast sale; (b) lowered its valuation to align with Warburg offer; (c) did not disclose the financing angle; and (d) did not disclose efforts to finance the buyer of RMC's main competitor

Outcome

Court found price for RMC \$91M too low and ordered RBC to pay \$76M for “aiding and abetting” directors’ fiduciary breach

Ruling for RBC’s appeal to DE Supreme Court is pending

Second opinion no help - Moelis settled before trial for \$5M

Price too low? RMC filed for bankruptcy protection in 2013

Why a Second Opinion?



Second Opinions

Legal Protection?

FO is not a legal pass

Board exercising “duty of care” – to be informed of all relevant facts by obtaining

That the second advisor is conflict free supports a “safe harbor” decision

May reduce conflicts with first advisor (e.g., stapled financing)

Will not make-up for any deal shortcomings

Deal Improvement?

If the second advisor is brought in early improvement is possible

If the advisor’s objections can be addressed, a board may seek to:

- » Change price or terms
- » Nix a bad deal

Second Opinions

Auction (Revlon Duties)

Board as auctioneer seeking the highest price in a sale

Triggered if cash deal, break-up or transfer of control to a private company or public company with a majority shareholder

Second opinion?

- » Procedural—why not
- » But—robust auction is the ultimate market check

Everything Else

Business judgement rule re: making an informed decision

Second opinion?

- » Yes—why rely upon a conflicted banker
- » Merger (share exchange)
- » Selling a major asset
- » Significant acquisition
- » Dilutive capital raise

Why?

Board recognizes advisor conflict and takes action to minimize

Legal counsel requested it

Vet valuation and process

Non-Revlon (i.e. other than an auction) situation may entail a difficult or nuanced deal where the board wants/needs another perspective

Minimal cost vs. deal cost



Second Opinion Objectives

Clean Opinion – No Conflicts

Insight to the Board

- » Industry expertise (ideally)
- » Confidence in the second opinion provider

Own the Numbers and Valuation

- » Transaction structure and implications
- » Transaction valuation relative to an expected range
- » Articulate “why” if value indications differ by a sizable amount
- » Acquirer’s shares and other forms of consideration
- » Preparation of supporting “fairness memorandum”

Second Opinion Objectives

Vet the Transaction Process

- » Who initiated the transaction and why?
- » Who negotiated the transaction?
- » What market checks occurred—full or limited auction? If none is the value pre-emptive? Go shop provisions?
- » Were there any efforts to improve the transaction price?
- » Was the board fully apprised of the process as it occurred?
- » Any insider conflicts and what processes employed to manage?
- » Any agreements that could be construed as shifting value to insiders?

Banker vs. Valuation Firm

Banker

Hired for execution and connections

Connectedness and conflicts are inherent

Most connected are most sought after bankers

Providing a fairness opinion may be a given, but contingent fee creates apparent conflict with opinion objectivity

Valuation Firm

Financial analysis

Valuation analysis

Transaction analysis

Process review

No contingent fee conflict re: issuing a fairness opinion

Important that the firm be experienced in the industry and transactions

Less Conflicted

	Advisory Fee	Fairness Opinion Fee
Lead Banker	Contingent	Contingent or Fixed Fee
Valuation Firm	None	Fixed Fee

Second Opinion Fees

	U.S. Commercial Banks	U.S. Specialty Finance	U.S. Financial Tech	U.S. Insurance Underwriters
<u>Seller M&A Fees (Median)</u>				
Advisor Success Fee (%)	1.20%	1.11%	1.18%	0.65%
Advisor Fairness Opinion (%)	0.17%	0.22%	0.20%	0.12%
Second Fairness Opinion (%)	0.10%	0.21%	0.07%	0.06%
Second FO vs Lead Advisor	-0.06%	-0.01%	-0.13%	-0.05%
<u>Buyer M&A Fees (Median)</u>				
Buyer Success Fee (%)	0.76%	0.41%	0.55%	1.01%
Buyer Fairness Opinion (%)	0.13%	0.14%	0.08%	0.03%
Transactions *	591	158	255	196
% with Sell-Side Advisor	83%	42%	47%	52%
% with 2nd Sell-Side Advisor	7%	9%	9%	7%

** Source: SNL Financial - Data reflects only those deals in which the value was disclosed from Jan 1, 2012 - Oct 23, 2015; however, not all deals with an announced value had banking fees disclosed. Fees are expressed as a % of the announced deal value.*

Second Opinions

Second opinion has greater significance when

- » The facts of a transaction can lead reasonable (or unreasonable) shareholders to believe an alternative transaction is preferable
- » When there is the reality or perception that insiders could take advantage of their positions to enrich themselves
- » There is lack of unanimity among directors over the appropriateness of the transaction and/or adequacy of consideration

Second Opinions

Second opinion has greater significance when

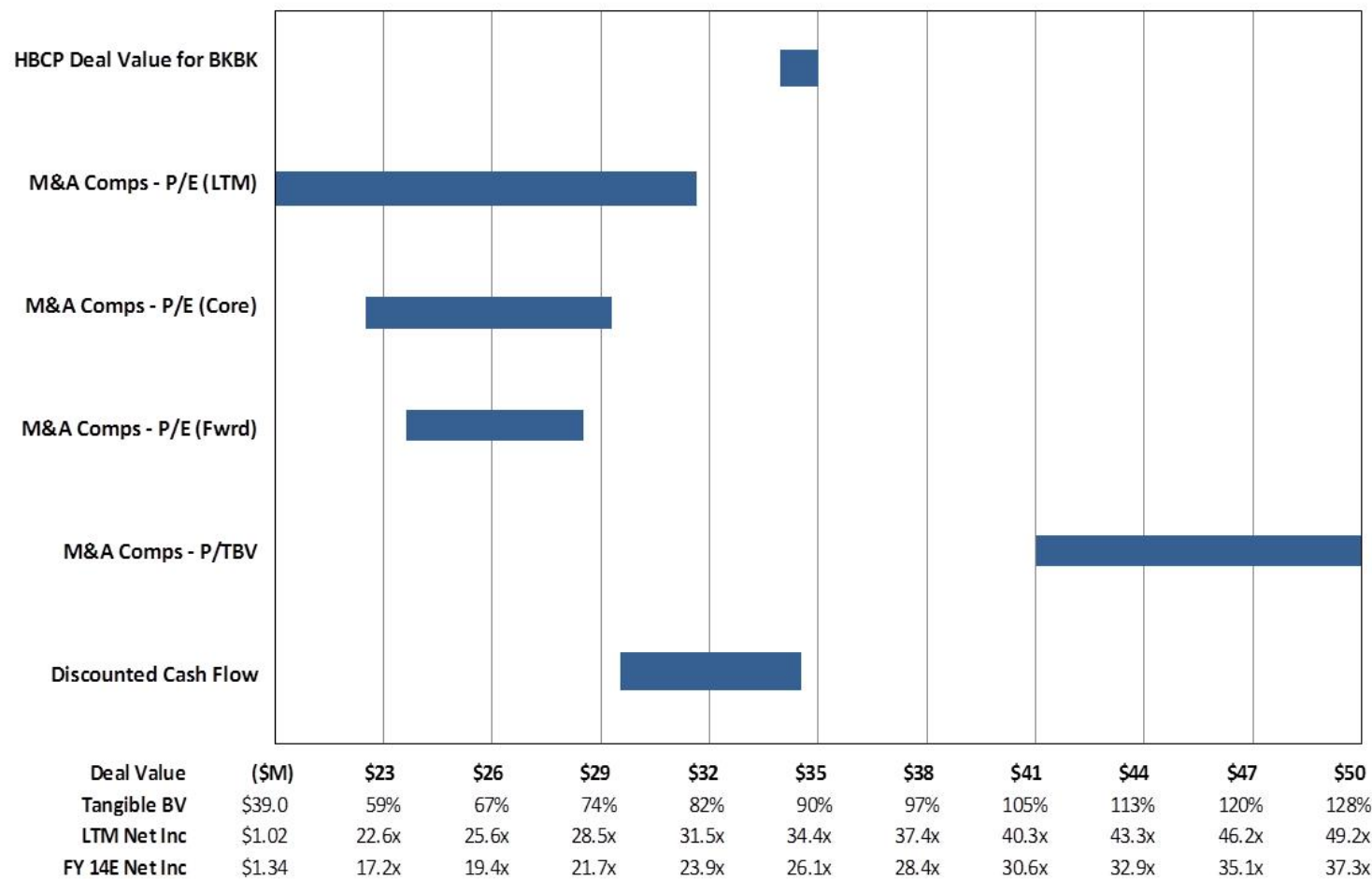
- » Limited market checks for a company being sold and value falls toward the lower end of an expected range
- » Questions about the value of the consideration
 - Buyer's shares are private or thinly traded
 - Valuation multiples for the buyer's shares are high compared to peers
 - Contingent consideration, buyer notes, preferred shares

Second Opinions

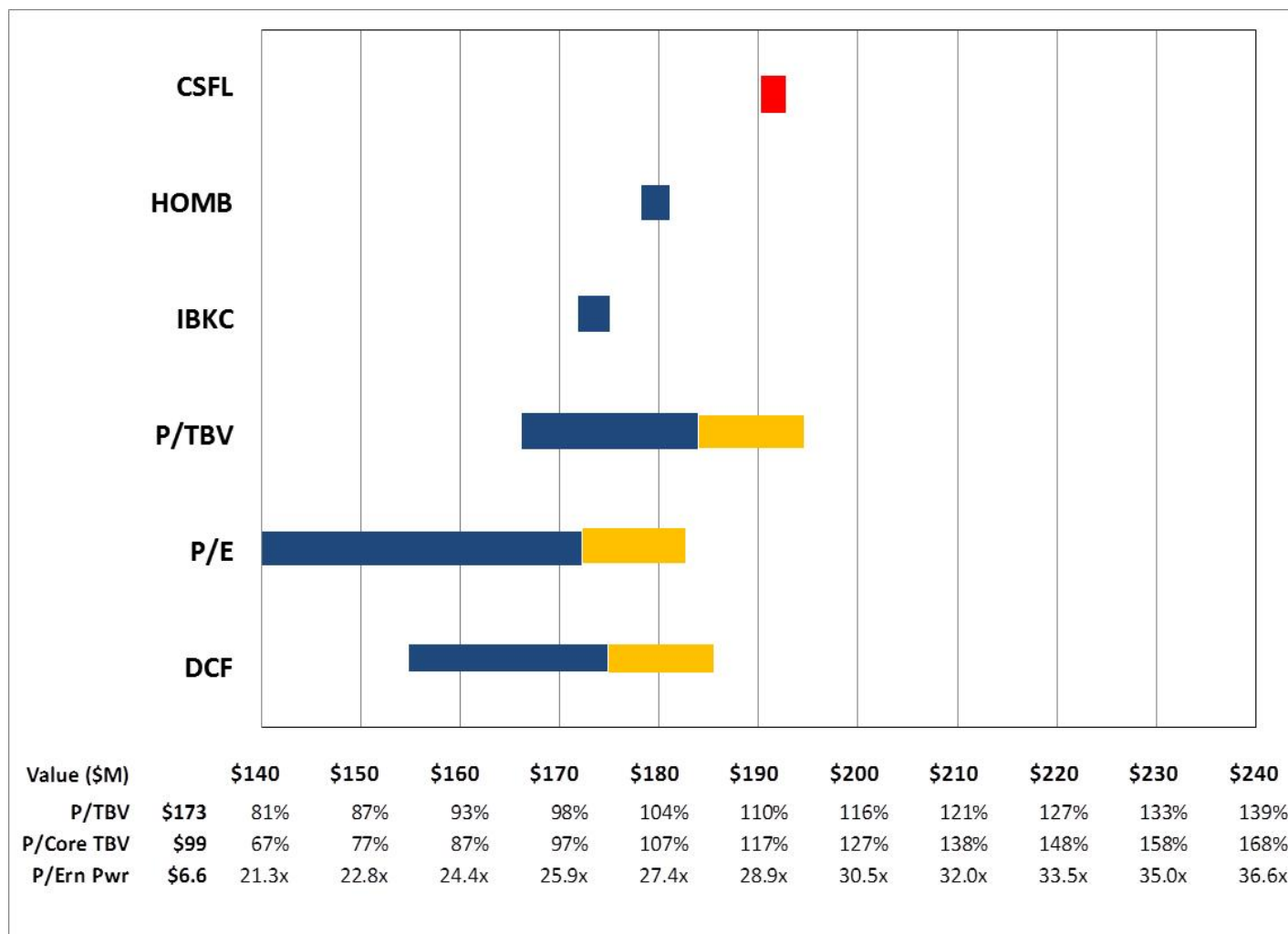
Second opinion has greater significance when

- » EPS and EBITDA per share accretion appears to be rich from the seller's perspective (or too dilutive with too long of an earn back period from the buyer's view)
- » Questions about the pro forma capital structure
 - Appears to be too levered
 - Unclear ability to raise cash to close
 - Regulatory and market constraints on leveraged deals

Explaining a Divergence



Value is not always Clear



Where from here?

Gradual trend toward more second advisors providing a fairness opinion for a fixed fee seems likely

Possible that the legal and regulatory environment results in the contingent fee lead bankers passing on issuing opinions

Rural/Metro remains problematic to the extent banker is deemed to have “aided and abetted” board in breach of its duty of care

Key remains full upfront disclosure so that a board selects and evaluates a transaction on a fully-informed basis

And pushing for a role by valuation firms as the (largely) disinterested secondary advisor

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Provides financial advisory services primarily related to the valuation of privately-held equity and debt issued by financial services companies and advisory related to capital structures and M&A

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