Financial Adviser Due Diligence in a Transactional Fairness Opinion

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The use of a management-prepared financial projection in the income approach discounted cash flow analysis presents certain issues for the valuation analyst acting as a financial adviser. This statement is certainly true with respect to the independent financial adviser's duties to perform due diligence in a transactional fairness opinion context. While a fairness opinion may be utilized in several contexts, fairness opinions for transactional purposes (i.e., for a merger and acquisition transaction), are typically relied upon by the participating company board of directors. This discussion summarizes fairness opinions in a transactional context and provides insights into the financial adviser's role in utilizing management-prepared financial projections in the income approach discounted cash flow business valuation method.

Introduction

The valuation analyst acting as an independent financial adviser ("adviser") in a merger and acquisition transaction is often asked to provide advisory services to the participating companies. These transaction-related services are typically requested by a participant company board of directors.

Often, the participating company board of directors, acting as fiduciaries, request the adviser to perform the following tasks:

1. Analyze the deal price
2. Analyze the proposed deal structure
3. Provide the fiduciaries with a fairness opinion related to the proposed transaction

A fairness opinion is generally a formal letter prepared by an adviser to the participating company fiduciaries. The fairness opinion typically states whether or not the proposed transaction is fair to the company shareholders.

Fairness is often determined (1) from a financial point of view; (2) as of a specific date in time; and (3) based on certain assumptions, limitations, and analytical procedures.

While fairness opinions are not legally required in merger and acquisition transactions, based, in part, on the Delaware Court of Chancery (the "Chancery court") opinion in *Smith v. Van Gorkam*,[1] participant company board of directors have increasingly requested fairness opinions. Directors request such transaction fairness opinions in order to help ensure compliance with their fiduciary duties.

These fiduciary duties include:

1. the duty of loyalty and
2. the duty of care.

In the development of a transactional fairness opinion, the financial adviser will typically consider

the three generally accepted business valuation approaches:

1. The income approach
2. The market approach
3. The asset-based approach

While an adviser is required to consider all three business valuation approaches when developing a fairness opinion, the income approach is often relied on by advisers.

Such reliance is based on the fundamental understanding that, “in the simplest sense, the theory surrounding the value of an interest in a business depends on the future benefits that will accrue to its owner. The value of the business interest, then, depends upon an estimate of the future benefits and the required rate of return at which those future benefits are discounted back to present value as of the valuation date.”[2]

Within the income approach, the discounted cash flow (“DCF”) business valuation method is based on the calculation of a current (i.e., present) value of the company’s expected future income.

The two principal components of the DCF business valuation method are as follows:

1. The projection of the company’s expected future income
2. The estimation of an appropriate risk-adjusted required rate of return used to discount the expected future income to present value

While the measurement of each component is equally important in applying the DCF method, this discussion focuses on the development and the use of management-prepared financial projections as an expectation of a company’s future income.

Specifically, this discussion considers the development and application of financial projections within the context of performing a transaction-related fairness opinion for participating company fiduciaries.

The objectives of this discussion are as follows:

1. To describe a fairness opinion and the reasons why the participating company board of directors would obtain a fairness opinions in a merger and acquisition (“M&A”) context
2. To describe the function of financial projections within the application of the income approach, DCF method
3. To describe best practices procedures that the adviser can take to ensure the appropriate treatment and reliance on management-prepared financial projections in a fairness opinion context

Fairness Opinions and the Role of Participating Company Fiduciaries

By general definition, a fairness opinion is an advisers’ opinion as to whether the price to be paid or received in an M&A transaction is fair to the client’s shareholders. Fairness opinions are regularly obtained by boards, special committees, and other fiduciaries.

Fairness opinions are requested in order to:

1. gain a comprehensive understanding of the financial aspects of a transaction and
2. demonstrate that these fiduciaries have agreed to a transaction with due care.

Thomson Reuters defines a fairness opinion as follows:

> An opinion by a company’s financial adviser, most often an investment bank, to the company’s board of directors in connection with a transaction that would have a material effect on stockholder value or present a potential conflict of interest. The opinion, which is usually written in the form of a letter, generally concludes that a specific transaction’s terms are fair to the company’s stockholders from a financial standpoint.
>
> While not legally required, the receipt of a fairness opinion can give the board additional comfort that it has satisfied its fiduciary duties in recommending approval of the transaction.
>
> A fairness opinion typically includes:
>
> - A description of the transaction.
> - The due diligence review of the financial adviser.
> - A description of the information the financial adviser relied on in issuing the opinion.[3]

A fairness opinion is typically presented as a formal letter to a participating company fiduciary. The document represents the adviser’s opinion

that an M&A transaction, in its entirety, is fair or not fair to the participating company fiduciary shareholders.

In the context of developing a fairness opinion, fairness is determined:

1. from a financial point of view;
2. as of a specific date in time; and
3. based on certain assumptions, limitations, and analytical procedures.

Specifically, a fairness opinion should be based on rigorous financial analysis, including a comparison of the target company value to the proposed purchase price, to assess whether the transaction's economics are fair to participating company shareholders.

This rigorous financial analysis of the target company is generally similar to a business valuation. The adviser will typically value the subject target company equity by considering the three generally accepted business valuation approaches: (1) the income approach, (2) the market approach, and (3) the asset-based approach.

The adviser will then typically conclude a reasonable range of potential transaction equity values based on the sensitivity of certain underlying assumptions to determine if the proposed price of the target company falls within this range.

However, a fairness opinion is a separate and distinct analysis as compared to a business valuation. This is because a fairness opinion does not represent an independent appraisal or valuation of the participating company. Rather, a fairness opinion presents a comparison of a target company's intrinsic value to a proposed transaction price.

This is why the intrinsic value of a target company is typically presented as a range of values rather than a single point estimate in a fairness opinion.

Further, a fairness opinion does not represent an opinion that the proposed transaction price is the best possible price or even the most likely price of a target company, nor does a fairness opinion represent an endorsement or recommendation to enter into a proposed transaction.

Rather, a fairness opinion is simply an opinion that a proposed transaction price is "fair" or "not fair" to the participating company shareholders from a financial point of view.

In certain circumstances, fairness opinions can also address other important fiduciary considerations by a participating company board of directors. However, these considerations are typically not included in a standard fairness opinion.

These additional considerations may include the following:

1. Quantifying how the proposed transaction will increase or decrease shareholder value (including an analysis of proposed synergies)
2. Quantifying how noncash consideration (i.e., equity consideration, seller note consideration, earnout consideration, option consideration) may affect the proposed transaction price
3. Quantifying whether the proposed transaction is accretive or dilutive to current shareholders
4. Quantifying the income tax impact based on the structure of transaction (such as whether the transaction is an asset sale versus an equity sale)

As mentioned, fairness opinions are not legally required in M&A transactions. However, and based in part on the Delaware Court of Chancery[4] opinion in *Smith v. Van Gorkam*, fairness opinions have increasingly become an important tool for participating board of directors.

In *Smith v. Van Gorkam*, the Delaware Court of Chancery stated that:

> Under Delaware law, the business judgment rule is the offspring of the fundamental principle, codified in 8 Del.C. § 141(a), that the business and affairs of a Delaware corporation are managed by or under its board of directors.[5]

This management of the business affairs creates, in part, the fiduciary duty required of corporate board of directors. Specifically, "In carrying out their managerial roles, directors are charged with an unyielding fiduciary duty to the corporation and its shareholders."[6]

These fiduciary duties required of a company board of directors are typically known as:

1. the duty of loyalty and
2. the duty of care.

The duty of loyalty generally requires board of directors to act in good faith in advancing the best interests of the corporation, and to refrain from conduct that could potentially injure the company and its shareholders.

Further, the duty of loyalty strictly prohibits board of directors from using their position to fulfill (or advocate for) their own personal interest.

The duty of care requires board of directors to exercise the care that a prudent, reasonable person in a like position would use under similar circumstances.

Specifically, as noted in the *Smith v. Van Gorkam* judicial decision:

> Thus, a director's duty to exercise an informed business judgment is in the nature of a duty of care, as distinguished from a duty of loyalty.[7]
>
> . . .
>
> To summarize: we hold that the directors of Trans Union breached their fiduciary duty to their stockholders (1) by their failure to inform themselves of all information reasonably available to them and relevant to their decision to recommend the Pritzker merger; and (2) **by their failure to disclose all material information such as a reasonable stockholder would consider important in deciding whether to approve the Pritzker offer** [emphasis added].[8]

Based in part on the Delaware Court of Chancery guidance noted above in *Smith v. Van Gorkam*, board of directors of companies participating in M&A transactions have more often looked to fulfill their fiduciary duties through the use of fairness opinions.

To ensure that they have reasonably considered all relevant data and information in determining whether to proceed in an M&A transaction, participating company board of directors have increasingly relied upon fairness opinions to satisfy the duty of loyalty and the duty of care to the participating company stockholders.

In developing a fairness opinion, the financial adviser will apply generally accepted business valuation approaches and methods to analyze the target company. Many times such a valuation analysis includes the application of the income approach and the DCF business valuation method.

The DCF Method and Management-Prepared Financial Projections in a Fairness Opinion Context

Within the income approach, there are a number of generally accepted business valuation methods. Each method is based on the principle that the value of an investment is a function of the economic income that will be generated by that investment over its expected life.

There are several business valuation methods that can be used to estimate value based on this principle (or in the case of a fairness opinion, a value range). Most of these methods are based on the estimation of an investment's future income stream and the application of an appropriate risk-adjusted, present value discount/capitalization rate.

The DCF method is a generally accepted business valuation method used to value companies on a going-concern basis. It has appeal because it directly incorporates the trade-off between risk and expected return, one component to the investment decision and value calculation process.

The DCF business valuation method provides an indication of value by:

1. projecting the expected future income of a business and
2. projecting an appropriate risk-adjusted required rate of return to discount the expected future income to present value.

There are many considerations that a valuation analyst should undertake to estimate a present value discount rate that reflects the related risk associated with the future company income. This discussion focuses on the development and the application of the expected income projection utilized in the DCF method for fairness opinion purposes.

To develop the expected future financial fundamentals of a business, there are several considerations that should be made, including the following:

1. Expected level of dividends or partnership distributions
2. Net cash flow to equity or net cash flow to invested capital (i.e., total market value of company debt and equity)
3. Various accounting financial fundamental measures of income such as net income, net operating income, and other

The valuation analyst, acting as an adviser, has the responsibility when developing the DCF method for a fairness opinion to align the appropriate income measure to the subject interest of the valuation.

Generally, if the subject of the valuation is the value of the company equity, then the appropriate income measure is net cash flow to equity. Similarly, if the subject valuation interest is the business enterprise, then the appropriate income measure is net cash flow to invested capital.

Once the adviser determines the appropriate measure of income to apply in the DCF method, the next step is to project the expected income over a defined future time period. The judicially preferred method (as proffered by the Delaware Court of Chancery) in projecting future income of a target business is to obtain financial projections from company management.

Such financial projections ideally should be generated during the normal course of operations and utilized for general management planning purposes.

While it may seem unimportant, the simple labeling of the expected future income of a business as either a forecast or a projection is a topic of discussion within the valuation profession.

As presented in *Understanding Business Valuation*, the difference between a financial forecast and a financial projection is as follows:

1. Financial Forecast. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows. A financial forecast is based on the responsible party's assumptions reflecting the conditions it expects to exist and the course of action it expects to take.
2. Financial Projection. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows. A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as, "What would happen if . . . ?"[9]

According to *Understanding Business Valuation*, the analyst should generally refer to the management-prepared expected future income as a financial forecast. However, there exist a diversity of professional views. For instance, *Valuing a Business*[10] prefers the term *projected* when defining the expected future income of ownership of a business.

Similarly, as noted in *Financial Valuation Applications and Models*,[11] author James Hitchner

applies the term *projection* (*or the formal projection method*) to define estimated future cash flow or economic benefits used in a DCF method analysis.

Therefore, for purposes of this discussion, the term *projection* (rather than the term *forecast*) will encompass all management estimates of future cash flow, earnings, or benefits to be utilized in the income approach DCF method.

It is our opinion that an analyst typically should not use the term *forecast* unless he or she is prepared to be the "responsible party" for all of the financial information used to prepare said forecast.

A projection, however, and again in our opinion, generally means that the analyst is utilizing data that has been provided by the company management (ideally prepared in the normal course of business and not for the specific purpose of estimating the value of the company in anticipation of the transaction),[12] and adjusted, if necessary, by the analyst.

In a fairness opinion context, and considering the participating company board of director's required fiduciary duties of duty of loyalty and duty of care, the adviser should clearly refrain from being the "responsible party" and may refer to the expected future cash flow used in a related DCF method analysis as *projections*.

Independence with regard to a fairness opinion, and the assumptions on which that fairness opinion is based, will greatly assist the participating company board of directors in fulfilling its fiduciary duties.

It is also intuitive that wholesale acceptance of management projections when applying the DCF method in a fairness opinion context eliminates the adviser's objectivity (and similarly the participating companies board of director's objectivity).

If the data provided by company management are simply accepted by the adviser without any due diligence, then a conclusion of value (or opinion with regard to the fairness of a specific transaction) could be influenced by the company management.

This lack of due diligence suggests a lack of impartiality by the analyst (thereby failing the participating companies' board of director's duty of loyalty). This situation may also fail the participating companies' board of director's duty of care.

Adviser who do not perform a diligence analysis of management-prepared financial projections may be providing a fairness opinion that lacks all information reasonably available to them (and relevant to the decision of the board of directors).

Further, additional scrutiny is required, depending on the source of the management-prepared financial projections. For example, if the adviser is performing a fairness opinion for the acquiring corporation and has received projections that were sourced by the acquiring company's management (as opposed to target management-prepared projections that were constructed in the ordinary course of business), the adviser may take care to analyze these projections.

The purpose of this analysis is to ensure that they are not self-serving (which would fail the duty of loyalty fiduciary requirement of a participating company board of directors and open up the possibility of shareholder litigation).

As presented in *Understanding Business Valuation*, there are several factors that the adviser may consider when analyzing management-prepared financial projections, including the following:

1. Company-specific factors
2. Economic conditions
3. Industry trends[13]

These factors are relevant for an adviser to consider in a transactional fairness opinion context. Further, looking at company-specific factors, *PPC's Guide to Business Valuations* suggests several company-specific assumptions related to management-prepared financial projections that the adviser may examine, including the following:

1. Assumptions about revenue and receivables
2. Assumptions about cost of sales and inventory
3. Assumptions about other costs (such as selling, general, and administrative costs)
4. Assumptions about property and equipment, and related depreciation
5. Assumptions about debt and equity
6. Assumptions about income taxes[14]

Similar adviser professional guidance is relevant when performing fairness opinions for employee stock ownership plans. As presented in *Best Practices—Thought Leadership in Valuation, Damages, and Transfer Price Analysis*:

> C. Perform prospective financial statement analysis
>
> 1. Identify important financial variables that drive the company financial performance (e.g., capacity constraints, cost/volume profit relationships, etc.) for prospective results of operations.
> 2. Obtain (if available) and analyze financial projections of prospective results of operations.

3. Assess the reasonableness of all historical management-prepared financial projections relative to historical results of operations.
4. Assess the reasonableness of all historical management-prepared financial projections relative to historical industry data.
5. Assess the reasonableness of all historical management-prepared financial projections relative to current industry data.
6. Obtain and explain alternative management-prepared financial projections covering the same time period.[15]

It is important that the adviser vet the assumptions on which the management-prepared financial projections are based. It is also important that the analyst document and justify any changes made to these management-prepared financial projections.

For purposes of a fairness opinion, and to provide transparency for the participating company board of directors (and ultimately to provide transparency for the participating company shareholders), any changes made to the management-prepared financial projections should be documented and presented in the fairness opinion DCF method analysis.

Based, in part, on the above-referenced guidance, best practices suggest that the analyst assess the reasonableness of management-prepared projections, in a transactional fairness opinion context, by considering if the financial projections meet the following criteria:

1. They are consistent with the company's growth prospects.
2. They are reasonable as compared to the company's historical financial results.
3. They are achievable based on the company's operating capacity and expected future capital expenditures.
4. They are reasonable as compared to the company's client and supplier projected financial results.
5. They are reasonable based on the industry's historical and projected financial results.
6. They are reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy.
7. They are extensively documented and justified if the projections are adjusted or revised by the valuation analyst.
8. They are explainable based on alternative management-prepared financial projections covering the same period (if applicable).

Summary and Conclusion

An analyst acting as an adviser in an M&A transaction may be asked to provide advisory services to the board of directors of the participating companies. These advisory services can include the development of a transaction fairness opinions.

Fairness opinions are formal letters prepared by advisers to the participating company fiduciaries that state whether or not the proposed transaction is fair to the company shareholders.

Board of directors of companies involved in M&A transactions have increasingly requested fairness opinions to ensure the fulfillment of their fiduciary duties, in part due to the judicial decision in the Delaware Court of Chancery case *Smith v. Van Gorkam*.

These fiduciary duties required of participating company board of directors are known as:

1. the duty of loyalty and
2. the duty of care.

The duty of loyalty generally requires a board of directors (1) to act in good faith in advancing the best interests of the corporation and (2) to refrain from conduct that could potentially injure the company and its shareholders (which strictly prohibits boards of directors from using their position to fulfill, or advocate for, their own personal interests).

The duty of care requires board of directors to exercise the care that a prudent, reasonable person in a like position would use under similar circumstances.

In developing a fairness opinion, fairness is determined:

1. from a financial point of view,
2. as of a specific date in time, and
3. based on certain assumptions, limitations, and analytical procedures.

These analytical procedures many times include the application of the income approach DCF business valuation method. The DCF business valuation method provides an indication of value by:

1. projecting the expected future income of a business and

"[F]inancial projections should be prepared in the normal course of business operations and utilized for general management planning purposes."

2. applying a risk-adjusted required rate of return to discount the expected future income to present value.

The judicially preferred method (as proffered by the Delaware Court of Chancery) in projecting the future income of a target business (i.e., in a transactional fairness opinion context) is to obtain financial projections from company management.

Ideally, such financial projections should be prepared in the normal course of business operations and utilized for general management planning purposes.

However, the adviser should consider relevant guidance to ensure that the management-prepared financial projections are:

1. consistent with the company's growth prospects;
2. reasonable as compared to the company's historical financial results;
3. achievable based on the company's operating capacity and expected future capital expenditures;
4. reasonable as compared to the company's client and supplier projected financial results;
5. reasonable based on the industry's historical and projected financial results;
6. reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy;
7. extensively documented and justified if the projections are adjusted or revised by the valuation analyst; and
8. explainable based on alternative management-prepared financial projections covering the same period (if applicable).

Notes:

1. Smith V. Van Gorkam, 488 A.2d 858 (Del. 1985).
2. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: The McGraw-Hill Companies, 2008), 56.
3. Glossary, 2022 Thomson Reuters, https://content.next.westlaw.com/7-383-2185?__lrTS=20211213094715477&transitionType=Default&contextData=(sc.Default)&firstPage=true. (accessed 1/31/2022).
4. The Chancery court, which decides on matters concerning shareholder equity claims, is generally viewed as the primary forum for ruling on dispute litigation involving matters related to corporate M&A transactions. With its significant influence on valuation matters, attorneys and valuation analysts/advisers alike frequently look to the Chancery court for guidance regarding corporate M&A matters and board of director fiduciary duties.
5. Smith v. Van Gorkam, 488 A.2d 858, 872.
6. Id.
7. Id.
8. Id. at 893.
9. Gary Trugman, *Understanding Business Valuation*, 5th ed. (New York: American Institute of Certified Public Accountants, 2017), 253–254. Also presented in Jay E. Fishman, Shannon P. Pratt, J. James R. Hitchner, J. Clifford Griffith, Stanton L. Meltzer, and Eric G. Lipnicky, *PPC's Guide to Business Valuations*, 30th ed. (Fort Worth, TX: Thomson Reuters/PPC, 2020).
10. Pratt and Niculita, V*aluing a Business*, 57.
11. James R. Hitchner, *Financial Valuation Application and Models*, 4th ed. (New York: John Wiley & Sons, 2017), 133.
12. Financial projections prepared by company management in the ordinary course of business (and for general management planning purposes) represent the most independent data that can be used in a DCF method analysis. This is because financial projections prepared for other purposes, such as for litigation purposes, transactional purposes, and lending/loan purposes, can many times be tainted based on the goals of the litigation, transaction, or loan acquisition.
13. Trugman, *Understanding Business Valuation*, 255.
14. Fishman, Pratt, Hitchner, Griffith, Meltzer, and Lipnicky, *PPC's Guide to Business Valuations*, 5–9.
15. Robert F. Reilly and Robert P. Schweihs, *Best Practices: Thought Leadership in Valuation, Damages, and Transfer Price Analysis* (Ventnor City, NJ: Valuation Products and Services, LLC, 2019), 704.

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