How boards can use fairness opinions to avoid transaction pitfalls

M&A transactions are becoming increasingly complex, which makes it challenging for boards to assess the fairness of a deal without outside professional advice.

Boards of both public and private companies increasingly recognize M&A valuation complexities and ask us early in the transaction process to identify potential transaction pitfalls and help improve the outcome of the deal. Three examples of pitfalls we often see relate to complex deal structures, the use of high-level tax assumptions and reliance on biased forecasts.

Complex deal structures
The simplicity of past “back of the envelope” deals stands in stark contrast against the reality of a modern M&A transaction. Today’s transactions often include complex features such as contingent payouts, equity rollover, seller financing and financial instruments such as put and call options. In the heat of negotiation, deal parties may incorporate these features into the transaction structure without completely understanding valuation implications. These features can create challenges for a board that is deciding whether a deal is in the best interest of the shareholders.

In a recent divestment, the transaction consideration included a promissory note from the buyer. By analyzing various factors, including the seniority of the note in the buyer’s capital structure, the buyer’s capacity to make interest payments, the adequacy of collateral and the buyer’s credit rating, we determined this form of seller financing was negotiated at below-market interest rates. These below-market rates resulted in the true value of the promissory note being at a significant discount to face value, thereby reducing the consideration to the seller. These insights prompted our client to renegotiate the note to market terms, thereby increasing the consideration received and improving the outcome of the company sale.
Use of high-level tax assumptions

When assessing the fairness of a transaction to shareholders, the importance of taxes should not be underestimated given their impact on cash flows. Multiple tax attributes must be considered and can impact a fairness opinion analysis to varying degrees. Some of these tax attributes include:

- Bonus depreciation for certain qualified capital expenditures
- Tax deductibility of domestic and foreign research and development expenditures
- Changes to net operating loss carryback and carryforward rules
- Limitations on net operating loss use in any given year
- Limitations on tax deductibility of interest expense
- Taxation of pass-through income and qualified business income deduction

It is important to account for these tax attributes in a fairness opinion analysis, as high-level tax assumptions can result in inaccurate cash flow estimates and may provide the board with a distorted view of the fairness of the transaction. We saw this firsthand when providing a fairness opinion to a client that was contemplating an acquisition of a US software company. We determined that the target's annual tax expense was millions of dollars more than management's high-level estimates. This was due to a significant portion of the target's research and development activities taking place outside of the US, resulting in lower annual amortization expense for tax purposes. This analysis was shared with the board and helped the directors make a more informed decision on the proposed acquisition.

Reliance on biased forecasts

At the core of almost every M&A transaction is a set of financial forecasts that are relied upon to determine the adequacy of the consideration to be paid or received. Boards must recognize that biased forecasts, either overly aggressive or conservative, could lead to a wrong conclusion about the fairness of the contemplated transaction and increased risk of personal liability for board members.

In a recent management buyout, we started fairness opinion procedures early in the deal process, allowing us to raise concerns related to key assumptions in management’s forecasts. A market study indicated that pricing and volume assumptions used in the forecasts were overly conservative. Considering the company's revised assumptions, we advised the board that management's buyout offer was inadequate. The board re-entered the negotiations, including with other buyers, and ultimately sold the company for a purchase price that was hundreds of millions of dollars higher than management's initial offer.

These are just a few examples of valuation pitfalls that we see in the course of providing fairness opinion services. Early detection of these issues helps boards alleviate pitfalls and improve deal outcomes.

Given the strategic importance of mergers, acquisitions and divestitures, we encourage boards and management teams to consider a fairness opinion. A fairness opinion is not only a cornerstone of sound corporate governance, but is also an effective tool for mitigating board member liability and protecting shareholder value.