Financial Adviser Due Diligence Related to Financial Information Used in a Fairness Opinion Analysis

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Financial advisers prepare fairness opinions related to a variety of different transactions. An often overlooked component of the fairness opinion analysis is the due diligence process that financial advisers conduct with respect to the target company historical financial information ("HFI") and prospective financial information ("PFI"). It is only after performing sufficient due diligence that the financial adviser can apply the appropriate methods and procedures to opine on the fairness of a particular transaction. This discussion summarizes the typical due diligence that a financial adviser conducts on the target company's HFI and PFI when the adviser renders a fairness opinion.

Introduction

In nearly every transaction involving a publicly traded company, the company board of directors requests that its financial adviser prepare a fairness opinion. The objective of requesting such an opinion is to ensure that the pending transaction is fair to the company shareholders from a financial point of view.

Fairness opinions may also be sought by the boards of private companies when the shareholders of the private company include a broad group of individuals (or entities) who do not necessarily have direct representation on the board of directors. In both cases, the board of directors relies on its financial adviser to provide independent, unbiased, and objective advice on the fairness of the price—and the terms—of the pending transaction.

At the heart of any fairness opinion is (1) the target company historical financial information—or HFI—and (2) the target company prospective financial information—or PFI. In preparing its fairness opinion, the financial adviser typically conducts substantial due diligence on the target company from both a historical perspective and a forward-looking prospective.

In conducting this due diligence, the financial adviser may find it necessary to adjust the target company HFI in order to provide a more meaningful presentation of the company historical financial performance.

As part of its work, the financial adviser also typically conducts due diligence on the company PFI that is incorporated in the fairness opinion analysis.

This discussion focuses on the typical due diligence procedures related to a target company's HFI and PFI. Also, this discussion provides insight into typical normalization adjustments that a financial adviser may make to the HFI when preparing a fairness opinion.

Understanding the Basis of a Fairness Opinion Analysis

Most fairness opinion analyses include various methods and procedures to analyze the following:

1. The target company stock or the target company assets that are the subject of the proposed transaction
2. The consideration that will be paid in the proposed transaction
3. The structure and the terms of the proposed transaction

Furthermore, most fairness opinion analyses include one or more valuation methods. The application of these valuation methods results in a range of value for the subject company stock or the subject company assets. While the fairness opinion analysis is not a valuation of the target business or its shareholder equity per se, the analysis often mirrors that of a typical business valuation engagement.

For example, in a typical business valuation engagement, a profitable, going-concern operating company is often valued by applying a combination of market approach valuation methods and income approach valuation methods.

The market approach valuation methods that are typically applied include (1) the guideline publicly traded company method and (2) the guideline merged and acquired company method.[1]

The income approach valuation methods that are typically applied include (1) the discounted cash flow method and (2) the direct capitalization method.

However, unlike a typical business valuation engagement, where the valuation analyst's objective may be to arrive at a pinpoint estimate of the subject company stock value or the subject company asset value, a fairness opinion analysis usually results in a relevant range of value for the subject stock or the subject assets.

Regardless of the valuation procedures and methods applied, the reliability of the fairness opinion analysis often is a function of the reliability of the subject company historical and prospective financial data that were used in the fairness opinion analysis.

For example, the value indications derived from the application of the guideline merged and acquired company method are typically based on the application of market pricing multiples of recently acquired guideline companies to the normalized HFI of the target company.

The value indications derived from the application of either the discounted cash flow method or the direct capitalization method are based on the application of required rates of return to the PFI of the target company.

And, the value indications derived from the guideline publicly traded company method are typically based on the application of publicly traded company market pricing multiples to both the normalized HFI and the PFI of the subject company.

In each of these instances, the financial adviser needs to use credible financial data for the subject company to arrive at a credible range of values. In other words, the fairness opinion analysis is only as reliable as the subject company financial data upon which the analysis was based.

HFI Due Diligence Procedures

The initial phase of most fairness opinion analyses involves a thorough analysis of the target company historical financial performance. In the course of this work, the financial adviser typically analyzes the target company's performance over several historical periods.

The following question is often raised by users of fairness opinions: Why does the adviser need to conduct an analysis of the target company's HFI when the company's current value is simply the present value of its expected financial performance?

The short answer to this question is that a proper analysis of the target company historical performance can provide insight on:

1. how the company has performed over periods of changing business conditions and
2. the company income-producing and cash-flow-producing capacity.

Often, the end goal of the historical analysis is to arrive at a reliable annual "run rate" of the company revenue; net income; earnings before interest, taxes, depreciation, and amortization ("EBITDA"); or some other measure of cash flow.

In some instances, HFI, when credibly measured and normalized, may be a superior measure of a company's financial performance and capacity than its PFI. This conclusion is especially true if there is a fair degree of uncertainly embedded in the PFI.

A thorough review of the company HFI is also often necessary to bridge any gap that may exist between a target company's historical financial performance and its prospective financial performance.

In the course of rendering a fairness opinion, it is not uncommon for the opinion provider to observe growth and profitability trends in a target company's HFI that are substantially different than the trends observed in the same company's PFI. In other words, the company historical growth rates, profit margins, and the rates of return may be quite different than the company projected growth rates, profit margins, and rates of return.

In these cases, an analysis and normalization of the target company HFI—along with a review of the company PFI, as presented later in this discussion—is helpful in providing a link between a company's past financial performance and its prospective financial performance.

An analysis and normalization of the target company HFI may also be helpful in explaining certain trends that appear in the PFI. Nonetheless, there are instances where a company's HFI—even after adjustment and normalization—may not provide an explanation for the observed trends in the company's future financial performance.

There are many reasons why this result may be the case.

One reason why a company's HFI may not explain the projected trends in its PFI is that a company's financial performance will usually change as it enters a different stage of its lifecycle. Most business entities move through different lifecycle stages. In broad terms, these stages include a start-up stage, a growth stage, a mature stage, and a decline stage.

In the start-up stage and the growth stage, a business typically has significant capital investment, high revenue growth, and increasing profitability. In the mature stage, the same business typically has a predictable and stable level of capital investment, relatively low revenue growth, and stable profit margins. In the decline stage, the same business typically has low capital investment, declining revenue, and stable to declining margins.

To the extent a target company is in the process of gradually moving from one business life cycle stage to another, the financial adviser should expect to see a noticeable difference between its historical financial performance and its projected financial performance. In this instance, the financial adviser should not expect historical financial performance to necessarily be representative of future financial performance.

Another reason why a company's HFI many not explain trends in its PFI is that a company's financial performance will usually change throughout the economic cycle. The U.S. economy—and the economies of other developed nations—are cyclical in nature. In other words, economic booms do not last indefinitely nor do economic recessions.

While the length of economic cycles have varied over time, many of the more recent economic cycles have been, on average, five to six years. If a target company is highly sensitive to changes in economic conditions, the financial adviser should expect that sensitivity to be revealed in the company reported financial performance over time.

Furthermore, certain companies' business prospects may be more sensitive to changes in economic activity than others.

For example, companies that operate as retailers of grocery products generally report stable financial performance during both good and bad economic periods. On the other hand, companies that are in the business of the exploration and production ("E&P") of crude oil and natural gas are highly sensitive to changes in economic conditions.

When analyzing the HFI of the grocery retailer, the financial adviser would generally expect to see relatively stable financial performance over the long term.

Barring any plans the target company may have for expansion or contraction, this stable historical financial performance may provide a reasonable basis for:

1. estimating the company value based on its current financial fundamentals and
2. analyzing the reasonableness of the company's PFI.

Analyzing the HFI of the E&P company would typically be much more difficult. Changes in commodity prices, availability of drilling infrastructure, and availability of labor are just three factors that could severely affect an E&P company's financial performance.

Even after normalizing the HFI, the financial adviser may conclude that, given the cyclicality of the business, basing an analysis on the company's most current financial performance would either grossly overvalue or grossly undervalue the company assets.

As a target company moves throughout the economic cycle, it is important for the financial adviser to understand how changes in economic activity have affected the company's historical financial performance. Furthermore, these changes in economic activity may provide a reasonable explanation of why a company's HFI may not be indicative of the same company's PFI.

Industry-specific changes may be another reason why a company's HFI may not explain trends in its PFI. Generally, more rapid industry-specific changes yield greater variation in historical financial performance results. Industry-specific changes may encompass factors such as the competitive landscape, market penetration, new product development, and technological obsolescence.

The mobile phone market is a current example where each of these factors come into play. And, an analysis of the leading mobile phone manufactur-

ers would reveal historical financial performance that may not necessarily be representative of future financial performance expectations.

In situations such as this, the financial adviser needs to evaluate whether an analysis based on historical financial performance would result in a meaningful value conclusion—given the speed of change in a company's particular industry.

One of the primary reasons for analyzing a target company's HFI is to develop a reliable level of revenue, earnings, or cash flow that can be used by the financial adviser in its fairness opinion analysis. In the case of a mature company that operates in a mature industry that is not susceptible to large industry-specific changes, the HFI may provide a reasonable basis for estimating a company's value and evaluating its PFI.

Alternatively, if a target company is in a stage of growth or decline and operates in an industry that is subject to constant and rapid change, the company HFI, while informative, may not be particularly useful in estimating the company value or understanding its PFI.

HFI Normalization Adjustments

While conducting its due diligence, a financial adviser often applies normalization adjustments to the subject company HFI. Most users of fairness opinions who are familiar with these types of adjustments focus solely on adjustments to historical company expenses.

However, normalization adjustments are not limited to necessary changes in the company expenses. The financial adviser may determine that it is also appropriate to adjust a company's historical income and, in some cases, its revenue.

The normalization adjustments to revenue, income, and expenses are intended to produce a normalized level of revenue, earnings, and cash flow that could be used by the financial adviser in its fairness opinion analysis.

Whether analyzing a company's historical income or historical expenses, normalization adjustments are generally characterized as either nonrecurring items or extraordinary items. However, in many cases, there is an element of overlap between the two descriptions. As a result, these terms are used interchangeably throughout this discussion.

In terms of a historical revenue and income analysis, a company may report nonrecurring/extraordinary revenue or income from a variety of difference sources.

For example, a company may report gains on the sale of assets or business divisions, and, in some instances, these gains may be substantial. To the extent these gains are not expected to recur, the financial adviser may reduce the company income in each applicable year for the amount of the gains to arrive at a more realistic picture of the company's income-producing capacity.

Other more typical examples of nonrecurring/extraordinary revenue or income that may require a normalization adjustment include the following:

- Revenue or income associated with nonrecurring or extraordinary litigation judgments or settlements
- Revenue or income associated with one-time insurance settlements
- Extraordinary customer revenue associated with one-time contracts or orders
- Interest and dividend income associated with cash and investments that are not directly used in the company operations

When evaluating potential normalization adjustments to company revenue or income, the financial adviser also considers that certain nonrecurring or extraordinary revenue/income for one company may not be considered nonrecurring or extraordinary for another company.

For example, gains that are realized through the sale of company assets may be viewed as nonrecurring for a company such as a manufacturer or distributor that rarely sells any of it fixed assets. However, gains realized by a commercial bank through the routine sale its loan and investment assets would not necessarily be treated as nonrecurring income, especially in instances where the bank is conducting sale transactions on an annual basis.

In terms of historical expense analysis, a financial adviser may identify during his or her due diligence that various historical expenses are either nonrecurring or extraordinary in nature.

Some of the more typical examples of nonrecurring or extraordinary expenses that may require a normalization adjustment include the following:

- Expenses associated with nonrecurring or extraordinary litigation
- Losses on the sale of assets or business divisions
- Nonrecurring restructuring charges
- Asset impairment charges
- Severance-related expenses

As is the case with an analysis of revenue and income, the financial adviser should use care when evaluating whether a historical expense is

nonrecurring or extraordinary. In situations where the financial adviser determines such an adjustment should be made, the subject expense is added to company income to restate the company profitability on a normalized basis.

One fault in many fairness opinion analyses is to treat recurring expenses as nonrecurring expenses. In doing so, the adviser runs the risk of overstating normalized earnings and potentially jeopardizing the reliability of its fairness opinion analysis.

Also, the financial adviser should decide whether its objective is to normalize the company's generally accepted accounting principles ("GAAP") earnings or some other measure of non-GAAP earnings.

In the typical case, where the financial adviser's objective is to estimate a normalized level of non-GAAP earnings, such as EBITDA, it may be necessary to make normalizing adjustments for most, if not all, noncash expenses reported on the income statement.

While these expenses may be neither nonrecurring nor extraordinary, normalizing adjustments may still be needed to arrive at the desired measurement of normalized earnings.

Another area of potential controversy when reviewing and normalizing HFI may be the financial adviser's treatment of expenses such as stock-based compensation ("SBC") expense. Some financial advisers have a tendency to adjust earnings for the entire amount of SBC expense.

The typical rationale for doing so is that a normalization adjustment should be made for SBC expense because it is a noncash expense. However, other financial advisers may consider other important factors in addition to whether the expense is a cash expense or a noncash expense.

In the case of SBC expense, the financial adviser may also consider the dilutive effect of awarding SBC to employees and whether the target company intends to continue the practice of awarding SBC compensation in the future. SBC expense is just one of many examples of expenses that may be treated differently by different financial advisers.

When deciding whether to make normalization adjustments to the HFI of the target company, the financial adviser may also consider the nature of the transaction that is the subject of the fairness opinion.

If the target company is private and the subject of a management buyout, it may be appropriate to evaluate the company's historical financial performance under the current stewardship. This may be particularly true if the buyout group is not anticipating major changes in how the company will operate post transaction.

However, in the case of a transaction involving a strategic buyer, the financial adviser may consider various assumptions regarding how the target company revenue may increase and/or the target company expenses may decrease as a result of being acquired by a larger industry participant.

These assumptions may guide the financial adviser in determining which normalization adjustments may (or may not) be appropriate for the subject analysis.

The financial adviser has a fair degree of discretion in deciding what revenue, income, and expenses are nonrecurring or extraordinary in nature. The general rule of thumb is that any income or expense that is reported by the company on an annual basis, in the normal course of business, is usually considered to be a recurring item.

As previously discussed, various valuation methods that a financial adviser may apply in the fairness opinion analysis may be based on the historical financial fundamentals of the target company. It is only after conducting sufficient due diligence on the target company HFI that the adviser can use the HFI within valuation methods and arrive at a reliable range of values for the target company.

Due Diligence Related to PFI

While it is often debated how much due diligence needs to be conducted on a target company's HFI when preparing a fairness opinion analysis, there tends to be less debate about how much due diligence should be conducted on the target company's PFI.

Most financial advisers agree that there should be an adequate level of due diligence performed on the target company PFI that would give the financial adviser comfort in relying on the prospective information. This is especially true if the information is an important component of the fairness opinion analysis, which is often the case when a discounted cash flow analysis is applied by the financial adviser.

In spite of the agreed-upon need for adequate due diligence, financial advisers typically include standard language in their fairness opinions that disclaims responsibility for the accuracy of the PFI.

While the language may vary from adviser to adviser, the disclaimer language will usually include statements such as the following:

- The financial adviser relied on, and assumed the accuracy and completeness of, all information that was provided to the adviser, including any PFI.
- The financial adviser has not independently verified any information provided by the

client, or its accuracy or completeness, and has no obligation to undertake any such independent verification.

- The financial adviser relied on financial analyses and forecasts provided to it by the client, and in doing so, has assumed that the analysis and forecasts have been reasonably prepared, based on assumptions reflecting the best currently available estimates and judgments by management as to the expected future results of operations and financial condition of the company.
- The financial adviser expresses no views or opinions regarding the financial analyses and forecasts provided to it by the client or the assumptions on which the analyses and forecasts were based.

While the tone of the above-described language would suggest the financial adviser intends to perform little, if any, due diligence on the PFI, the opposite tends to be true in most cases. The primary objectives of the financial adviser in analyzing the PFI is to understand the following:

1. How the PFI was prepared
2. The assumptions upon which the PFI is based
3. The overall reliability of the PFI

There are several questions that financial advisers raise when conducting due diligence on PFI that will be used within a fairness opinion analysis. The following discussion summarizes some of the typical financial adviser questions.

- Does the company routinely prepare PFI?

  Some companies routinely prepare PFI as part of their annual budgeting process. However, many companies do not. In general, a financial adviser has a higher degree of confidence in PFI that was prepared by a management team that routinely prepares such information than in PFI prepared by company management that is not experienced in preparing such information.

  Likewise, a financial adviser will generally conduct more due diligence on PFI that was prepared by a company that is new to the budgeting process than on PFI that was prepared by a company with a long track record of providing reliable prospective data.

- Under what circumstances was the PFI prepared?

  In asking this question, the financial adviser is attempting to learn whether the PFI was created in the normal course of business or whether the PFI was created for a specific event or transaction. PFI prepared in the normal course of business usually includes information that is prepared in conjunction with the company recurring budgeting and forecasting process.

  In contrast, PFI prepared for a specific event or transaction may be a "one off" set of projections or other prospective financial data that is influenced by the specific event or transaction for which the information was prepared.

  In many cases, PFI that was prepared in the normal course of business is viewed by the financial adviser as having the highest degree of objectivity.

- Was the PFI prepared by and approved by people who have the necessary knowledge and experience?

  This question tends to go hand-in-hand with whether the company routinely prepares PFI. In situations where the company routinely prepares PFI, there is usually a formal budgeting process in place where people with the requisite knowledge and experience prepare such information.

  The PFI is then reviewed and modified by senior management and eventually approved by the company board of directors. However, in situations where the budgeting process is less formal, or less frequent, the financial adviser will typically want to know who prepared the PFI and the level of oversight that was provided during the process.

  An evaluation of the preparer's qualifications usually provides the financial adviser with some insight as to how thorough the PFI may be.

  Also, whether the PFI was subject to review and approval by senior management or the board of directors often provides insight into the confidence company management has in the data.

- Was the PFI prepared on a bottom-up basis or a top-down basis?

  Most PFI is prepared one of two ways. With the bottom-up procedure, prospective data that is prepared by management of the company operating divisions is rolled up, or consolidated, to arrive at a top level projection.

With the top-down procedure, the PFI is prepared at the highest level of the organization and each operating division becomes responsible for their allocated portion of the total prospective financial performance.

Each procedure has its own strengths and weaknesses. In general, the bottom-up approach will lead to a more comprehensive set of PFI, which potentially may lead to data with a higher degree of reliability.

- What key assumptions are incorporated in the PFI?

In most cases, the PFI includes a projection of items such as revenue, expenses, income, working capital, and capital spending. The financial adviser typically reviews each line item and its underlying assumptions to evaluate the reasonableness of the PFI.

For example, due diligence regarding projected revenue may begin by comparing the company projected revenue growth rate with its historical revenue growth rate. However, little can be concluded about the PFI based on this comparison alone.

As a result, the financial adviser also evaluates the assumptions behind the projected revenue growth rate, such as the assumptions related to projected product sales volume and projected product pricing. In terms of expenses and income, the financial adviser typically reviews projected expense margins, income margins, and the breakdown of fixed expenses and variable expenses.

In terms of projected working capital and capital spending, the financial adviser typically researches whether the company is projecting an appropriate level of working capital and fixed assets that would allow the company to achieve the level of growth and profitability included in the PFI.

- Is the PFI a benchmark for actual performance or a motivational tool for company employees?

Some companies prepare PFI that is a realistic projection of expected financial performance. Other companies create overly optimistic PFI that is used as a tool for motivating employees to exceed certain benchmarks.

In the course of its work, the financial adviser inquires as to whether the PFI represents management's best estimate of expected performance or whether it represents a "stretch" goal that exceeds expected performance.

Furthermore, the financial adviser evaluates how expected performance is measured. In that regard, expected performance is often best measured by a probability-weighting of various possible outcomes.

For example, a company may prepare three projection scenarios—an upside case, a base case, and a downside case. In this regard, an "expected" case projection results from a probability weighting of the three possible outcomes.

If presented with multiple sets of PFI, all else being equal, a financial adviser would tend to use the data that represent company management's best estimate of expected future performance.

- Is the PFI stated on a GAAP basis or an income tax basis?

Many companies prepare their historical financial statements in accordance with GAAP. And, many companies may prepare their PFI on the same basis.

Preparing both historical and projected performance under the same basis of accounting allows for an apples-to-apples comparison of past financial performance to future financial performance.

However, there are instances where the financial adviser may be interested in an alternative presentation of the PFI.

For example, if using the discounted cash flow method in its fairness opinion analysis, the financial adviser may want to estimate after-tax cash flow to the company capital providers. In doing so, the financial adviser may be interested in a projection of depreciation, amortization, and income on an income tax basis rather than on a GAAP basis.

Quite often the financial adviser determines that the PFI needs to be adjusted to arrive at financial fundamentals that are suitable for the fairness opinion analysis.

- Does the PFI reflect the company on a stand-alone basis or on a merged basis?

Most PFI that is prepared in the normal course of business presents the company on a stand-alone basis. However, company management may also evaluate the company in the context of a potential transaction and its effect on the company revenue or cost structure.

"[T]he financial adviser should conduct proper due diligence on the company-provided financial information to ensure the analysis is based on a solid foundation of information."

When conducting due diligence, the financial adviser should be aware of whether the projections reflect the target company on a standalone basis or whether the projections include expected post-acquisition expense reductions and synergies. The type of transaction may also have an influence on the PFI.

In a cash-based acquisition of the target company, it may be appropriate for the financial adviser to review the PFI of the target company on a standalone basis.

However, in a transaction where the merger consideration is the stock of the newly merged company, the financial adviser may also focus on the PFI of the newly merged company to evaluate the fairness of the merger consideration.

- How has the company performed in the past relative to its prior PFI?

  As part of the due diligence process, a financial adviser may request company management-prepared PFI from prior periods. This request is made in order to evaluate how the company performed in the past relative to its financial projections.

  If a company has a history of either consistently underperforming or overperforming its financial projections, the financial adviser usually considers that fact in reaching a conclusion about the quality of the PFI.

- Does the PFI make sense given overall economic activity, the condition of the industry in which the company participates, and the lifecycle stage of the company?

  Some of the most important due diligence that a financial adviser conducts on the PFI is to evaluate the overall reasonableness of the information. This procedure is performed by evaluating whether the company's projected performance makes sense relative to projected economic growth and projected growth in the company's industry.

  For example, a financial adviser would be skeptical of a general contractor's PFI if it showed uninterrupted growth during an economic recession and a downturn in construction activity.

  Likewise, the PFI may not make sense if the company is in the mature stage of its lifecycle, but the PFI includes growth rates that exceed the rate of growth of the industry as a whole. The PFI should make sense relative to external economic and industry factors.

Financial advisers who include a discounted cash flow analysis in their fairness opinion analysis typically spend a fair amount of time evaluating the quality of the PFI provided by target company management. As is the case with HFI, it is only after conducting sufficient due diligence on the subject company PFI that the adviser can use the PFI within a valuation method and arrive at a reliable range of value for the target company.

Summary and Conclusion

The methods and procedures applied in a fairness opinion analysis often mirror those that are applied in a valuation of the target company equity. However, the fairness opinion analysis—much like a valuation analysis—should not be a mechanical process where valuation methodologies are based on untested HFI and PFI.

Instead, the financial adviser should conduct proper due diligence on the company-provided financial information to ensure the analysis is based on a solid foundation of information.

Small changes in the HFI or the PFI of the target company can determine whether or not a transaction is fair from a financial point of view. As a result, a component of a robust fairness opinion analysis typically includes a thorough review of both the target company HFI and PFI.

The naive acceptance of the company-provided financial information by not conducting sufficient due diligence may lead the financial adviser to issue a compromised fairness opinion.

Notes:

1. In the context of a fairness opinion analysis, the guideline publicly traded company method may be referred to as the comparable public company method and the guideline merged and acquired company method may be referred to as the precedent transaction method.

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