

ROUNDTABLE



CORPORATE VALUATIONS & FAIRNESS OPINIONS

Investors and regulators are keeping a trained eye on corporate transactions, and directors need to tread carefully to avoid shareholder activism and costly litigation. When it comes to valuing companies and issuing fairness opinions, increased scrutiny is leading accountants, investment bankers and specialist advisers to seek greater accuracy. They are refining their analysis and installing more stringent internal processes in M&A scenarios involving both public and private companies.

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THE PANELLISTS



Donald E. Anders, ASA

Vice President, AccuVal Associates, Incorporated

T: +1 (262) 241 1000

E: danders@accuval.net

www.accuval.net

Don Anders is vice president of the corporate services practice group at AccuVal, responsible for business and intangible assets valuations. With 25 years in the appraisal business, he offers significant breadth of expertise across a broad number of industries and asset valuation roles. Mr Anders is a multidisciplinary appraiser who has directed appraisal projects and business valuations for major publicly traded and privately held companies throughout the US, portions of Europe and South America.



Jim Clifford

Partner, Baker Tilly

T: +44 (0)7860 386081

E: jim.clifford@bakertilly.co.uk

www.bakertillyinternational.com

Jim Clifford is Head of Valuations at Baker Tilly in the UK. As an M&A specialist he deals with strategic purchases by corporates both buy-side and sell-side. He values companies, derivatives, brands and intellectual property, and joint ventures as well as assets owned by charities and government agencies. These have been in the Courts, for banks as security, and for listed and unlisted corporates, in the UK and cross-border with India, the USA, Europe and the East.



Jay Henry

Managing Director, Dovebid

T: +1 (847) 597 4422

E: jhenry@dovebid.com

www.dovebid.com

As Managing Director of Sales and Marketing, Jay Henry aids clients in pre-engagement planning of valuation issues and specialises in establishing and maintaining client relationships with financial institutions, equity sponsors and corporations. He aids in developing strategies for resolving value-based issues, helps implement analyses, and facilitates report preparation and review. Mr. Henry applies his experience and knowledge of M&A, corporate finance, strategic planning, real estate and transaction-related opinion letters over various sectors across the economy.



Eric Cafritz

Partner, Fried Frank Harris Shriver & Jacobson LLP

T: +33 140 62 22 00

E: cafrier@friedfrank.com

www.ffhsj.com

Eric Cafritz is the managing partner of Fried Frank's Paris office. He concentrates his practice in corporate and securities matters and international transactions. Mr Cafritz represents some of the world's largest European and US-based corporations and banks. Mr Cafritz has been involved in several significant and complex transactions in Europe and Asia over the past three decades – from cross-border M&A to the structuring and financing of pan-European industrial ventures.



Jean-Florent Rérolle

Managing Director, Houlihan Lokey Howard & Zukin

T: +33 1 75 00 14 03

E: jrerolle@hlhz.com

www.hlhz.com

Jean-Florent Rérolle is a managing director at Houlihan Lokey Howard & Zukin Paris office in charge of Financial Advisory Services. Specialised in corporate finance he performs complex business valuations and fairness opinions. He is one of the founders and member of the board of the Institut Français des Administrateurs and is the chairman of the Société Française des Evalueurs. He lectures in two major French Business schools (HEC and ESCP-EAP) and at the Institut d'Etudes Politiques of Paris.



Steven J. Sherman

Partner, KPMG LLP

T: +1 (312) 665 5337

E: sjsherman@kpmg.com

www.kpmg.com

Steven J. Sherman is KPMG LLP's US leader for Valuation Services and is based in Chicago. He has extensive valuation experience that has involved purchase price allocations, divestitures, tax planning, and expert testimony. Recent projects have focused on SFAS 141, 142, 123R, IFRS 3 and US/UK GAAP conversions. Mr Sherman has been qualified as an expert several hundred times, including testimony at more than 20 depositions and nine trials.



Marco Boschetti

Principal, Towers Perrin

T: +44 (0)20 7170 3150

E: marco.boschetti@towersperrin.com

www.towersperrin.com

Marco Boschetti is a principal and leads Towers Perrin's Global Mergers, Acquisitions and Divestitures Practice. He has experience on all issues relating to international HR, including program design, implementation, operation and monitoring. Mr Boschetti has worked on over 200 global mergers, acquisitions and spin-offs, and has developed particular expertise in this area.

In the current environment, what are the biggest pressures facing management / boards in the relation to valuation methods and fair value accounting?

Clifford: In a market where the transactions increasingly include complex financial instruments, directors and officers face greater challenges on matters relating to valuation approaches and accounting policies. Increased scrutiny from shareholders, investors and the public means boards must take care when assessing valuations and communicating the results to all parties. Today, more than ever before, directors are being held accountable for their actions and responsible for getting valuations right. This increase in pressure has led many companies to look to independent specialist valuation experts in an attempt to fully understand, measure and communicate the potential outcome of a transaction.

Cafritz: Over the last couple of decades the US has built up a history of successful litigation against directors who have not obtained quality fairness opinions. Parties are so concerned about getting sued that they have developed better standards in order to argue in court that they exercised the highest degree of care in reaching a decision. So current practices have developed out of litigation in the US and are now being exported in different ways to Europe.

Boschetti: A number of changes in the last five or six years have seriously affected M&A cycles. Looking further back at M&A cycles of the late '80s and late '90s, many deals were affected by relatively little control over what boards and management did in terms of valuing companies, and we saw corporate leaders take significant liberties with this situation. In the current M&A cycle, however, perhaps as a result of Sarbanes-Oxley or simply the increase in shareholder activism, globally there has been no tolerance for surprises. That sentiment has filtered into intensified need for valuation consulting and the specialist support that the companies need during transactions.

Henry: Valuation methodologies have not fundamentally changed yet the pressure of real or perceived conflict of interest for both management and boards has. Companies need to recognise the legal risks associated with possible breach of fiduciary responsibility to their shareholders. Therefore, advisers and directors are faced with greater pressure to assure that when selecting an appraisal firm, that it is independent and qualified to perform the work. Today's corporate governance drives for greater disclosures and in turn makes management more accountable to understand and explain to third parties the appraisal work product. This may include presenting both the technical and theoretical approach of the work as well as the review processes and a discussion of any underlying management assumptions used. Additionally, the potential to 'unwind' the deal has never been greater. This risk may be from minority shareholders, competing bidders or other management. The independent fairness opinion acts as an insurance policy for the benefit of shareholders, boards of directors and corporations alike.

Rérolle: The biggest issues facing management are technical pressures in the form of new accounting standards whose implementation remains unclear in several important aspects. Across Europe the introduction of IFRS is forcing many companies to examine their valuation processes in much greater detail. The frequency of valuations done for a variety of purposes can in some cases lead to inconsistencies. This is another challenge for companies.

Sherman: Even prior to current corporate scrutiny, public companies were sometimes criticised by analysts and the media for 'managing earnings'. This could be accomplished through improper manipulation of accounting rules, including those related to purchase accounting. In today's environment, there is no alternative to proper accounting and transparency in financial reporting. An important step in improving the integrity of financial reporting is for boards to make sure that advisers are reputable, experienced, and independent. In spite of greater sensitivity to proper accounting and transparency, there can still be a substantial divergence in valuation methodologies among professional firms, their clients, and regulatory authorities. Auditors, with input from specialists on their teams, independently review valuations prepared by third-party firms. Thus, selection of an experienced valuation firm that is known by a company's auditor will help enhance the credibility and efficiency of the review process.

Anders: The difficulty most often comes from understanding the rules and interpreting the pronouncements. The FAS 141/142 pronouncements are evolving documents with input coming from valuers, auditors, and the SEC. A revised version will be issued soon. Each situation requires a facts and circumstances application of the allocation rules as to what intangibles need to be set up on the balance sheet, the best method to value them and how to estimate a remaining life over which to amortise them. A consensus is evolving, but opinion will always be a part of the equation. Other issues include levels of materiality of certain assets and issues regarding timing to complete the allocation process.

Valuations and fairness opinions in M&A transactions often face intense scrutiny and the threat of future litigation. Has this changed the level of analysis undertaken by financial professionals or consultants, and their internal processes?

Cafritz: In most parts of Europe, the threat of litigation on fairness opinions is actually a myth. Even in the US, there is a misconception that banks are at serious risk when they provide defective fairness opinions. But, as it turns out, it is very difficult to make a solid claim that a bank was somehow remiss in giving a poor or conflicted fairness opinion. Boards, on the other hand, find themselves in trouble for not exercising a high degree of diligence and for not obtaining fairness opinions and scrutinising them to make sure they are valid. Banks have so many disclaimers in place that there are very few recorded cases where a bank was successfully sued for giving a defective fairness opinion. Of course, there is still a degree of care on the part of banks to avoid being sued, but it's not easy to make a claim against them. ►►

In Europe, the threat of litigation is even less of a risk. Certainly on the continent, there is almost no recorded case law, even against boards, for not having a fairness opinion or for negligently obtaining a biased one. So, in various European countries, the debate about whether a company should get a fairness opinion is actually being driven by regulators, rather than litigation and case law. It's coming from the top down.

Henry: Companies executing acquisition growth strategies face tremendous shareholder and regulatory examination. Did the board overpay? Was the target valued correctly from a technical perspective? What are the tax implications? The level of analysis requisite for these transactions must be of the highest quality. The trend today is a heightened level of concern regarding closed transactions. Even though viewed as fair, these deals may be later judged to have rendered the company insolvent and the board could be found liable for its actions. The practice of retaining the independent adviser is an additional level of protection for the directors in a transaction. In general the three steps of the opinion remain the same; determine the value of the company shareholders' interest in exchange for the received consideration, review and understand germane issues regarding the transactions fairness and present to the board as to the fairness of the transaction from a financial perspective. Educating management and the board on methodologies is perhaps the biggest change.

Anders: In the Sarbanes-Oxley era, everyone is cautious about following the rules, completing adequate due diligence, and documenting the analysis. This requires more time (and hence more costs). The balance has to be found between getting perfect information and materiality/costs. Smaller firms cannot afford the cost of the sometimes excessive scrutiny, especially if, at the end of the day, it does not impact the cash flows that they or their shareholders monitor.

Clifford: Those advisers with sound technical and research capability are developing their approaches to meet an ever more complex range of instruments and assets requiring valuation. Those without that capability, who are showing little beyond a glorified but still basic tax methodology using simplistic and poorly understood multiples, applied to a wide range of commercial situations, are becoming less popular as the clients realise the value that can be gained from an informed view. This is being driven both by increased litigation threats but also by a more discerning audience which requires a more informed view that will then be used and relied upon in developing strategy.

Sherman: Completion of quality, in-depth work plans is the best pre-emptive approach for ultimately defending valuation reports. In the current environment of work being scrutinised by auditors and the SEC, linkage to an experienced valuation firm with global credentials is more important than ever. Regulatory challenges on allocation issues are often related to asset values, especially intangibles that are non-amortising, such as goodwill and certain trade names. Big 4 firms can consult with their SEC audit partners regarding the application, interpretation, and implementation of FASB pronouncements to help avoid regulatory challenges.

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Rérolle: In the context of French law, the threat of litigation is certainly not as significant as in other countries such as the United States. However, with the new regulation being introduced by the Autorité des Marchés Financiers (AMF), the number of situations where companies, particularly target companies, will have to request a fairness opinion from an independent adviser is going to increase significantly. As with similar regulations in other countries, the board of the target will be obliged to obtain an independent fairness opinion in instances where a conflict of interest may exist. Essentially, this new regulation will force many valuation and fairness opinion experts to ensure that the internal processes they adopt are more transparent and, should they be called into question, robust enough to withstand the scrutiny of the board, shareholders, regulatory bodies and in some cases the courts.

Boschetti: Analysis methods have changed in two ways. First, the steps required before a company engages an adviser have altered significantly. More effort is put into the contracts to limit liabilities and so on, and advisers generally require far more legal minutiae to be signed off. Second, advisers must look deeper into the company during due diligence and valuation assessments. Thresholds have changed and what was once immaterial is now deemed material. Even in a highly competitive market with far fewer targets than buyers, due diligence is still fairly detailed even though the process takes longer, because of a fear of litigation.

How has the introduction of IFRS affected valuation requirements, both in terms of transaction valuations and financial reporting?

Anders: Ultimately the goal is convergence on an international basis of the various standards. Auditor groups and valuator organisations are connecting on an international basis to find common ground so that the needs of the investors can be addressed and so that financial reports can be consistent from one country to another. This is an ambitious undertaking given cultural and political differences, but similarities are already appearing. It will be interesting to see how FASB adopts certain forward thinking statements of the IASB, such as IAS 16, which requires periodic ►

regular balance sheet restatements to fair value measurements, if applicable, even absent certain trigger events.

Henry: The implementation of IFRS creates a challenge as it relates to the initial publication of information such that it may have an adverse affect on share price. This is because the interpretations and understanding of IFRS is still changing. CFOs need to ensure that they outline how IFRS valuation requirements have impacted financial reports and that they communicate this impact fully. The market needs to know that the reporting of corporate financial information may have been influenced by changes in the reporting requirements of IFRS and not just from a change in a company's particular performance.

Rérolle: In the past, valuation was more a question of compliance, designed to assist CFOs in demonstrating a transaction's value to board members and shareholders. In the current regulatory environment there has been an increased emphasis placed on the disclosure of the long term financial impact of a transaction. This has led to greater care being taken by management and boards to ensure a greater level of understanding from the shareholders.

Clifford: For more than 25 years the industry has been trying to reach some level of consistency with comparable data, but there is much work left to be done. Despite the hope of greater comparability with the introduction of IFRS, past experience of harmonisation suggests this may not achieve perfection. Real consistency and true comparability across all companies remains a significant challenge, and we are still doing a lot of analysis to try and get down to comparable gearing, comparable equity structures with many transactions. In transactions with profit-linked earn-outs or other value elements based on future figures, well-informed advisers are ensuring that acquisition agreements work around the likely changes in disclosed figures as earn-out periods cross over with the introduction of new standards for accounting. For those advisers that do not, they may be looking at an increase in litigation.

Boschetti: We often focus on the pensions aspect of valuations, which is now of huge importance for certain types of companies in mature markets. All standards are far from perfect, and indeed numerous negotiating points remain. However, IAS, and its gradual

alignment with US GAAP, does bring a welcome standardisation, which in turn facilitates negotiations.

Sherman: IFRS 3 applies to all business combinations after 31 March 2004, in contrast to SFAS 141, which was adopted in 2001. It prohibits the pooling-of-interests method and brings purchase accounting under International Auditing Standards (IAS) much more in line with US GAAP. The convergence of financial reporting for acquisitions under IAS and US GAAP will bring accounting efficiencies to foreign listed companies, many of which have their ADRs traded on US exchanges. Although IFRS 3 brings more consistency to the accounting treatment of acquisitions, there are some differences with SFAS 141. These differences include the potential inclusion of contingent consideration, recognition of IPR&D as an asset (or subsumed into goodwill), and the one-step impairment testing of goodwill (as opposed to the two-step method under SFAS 142).

In light of the regulatory pressure they face, what methods are auditors adopting to assist in assessing third-party valuations?

Sherman: Review of third-party valuations by auditors has increased dramatically in recent years. When a client completes an acquisition deemed to be material, auditors generally require that an independent firm be engaged to perform the Purchase Price Allocation study in accordance with SFAS 141. Audit teams usually involve internal valuation specialists to review and scrutinise these third-party reports. Being current on the latest valuation related accounting rules is critical to providing audit teams with support, and we gain ongoing input from other Big 4 firms, the SEC and the FASB regarding emerging issues related to purchase accounting. Sometimes, third-party firms develop conclusions that may be theoretically supportable but are inconsistent with current accounting rules. The SEC's interpretation of accounting rules will almost always trump opposing views from valuation firms related to methodology. Examples of this dichotomy are the valuation of 'overlapping customers' and the valuation of media/gaming licenses through a residual method.

Rérolle: Based on the increasing risks from market and regulatory forces, auditors are becoming noticeably nervous about valuations and the methods used to conduct valuations. The real challenges arise in the different valuation methods used. A true business valuation goes far beyond the numbers and many of today's top valuation experts spend a considerable amount of their time understanding the business plan, analysing the industry and speaking with management. Continued communication between experts is essential if there is to be a greater understanding of the valuation process and the mechanics used within the industry.

Henry: Impartiality and objectivity of auditors working with third-party valuation firms is critical. Auditors inspire board confidence by hiring independent valuers to best assure impartiality both in action and appearance. Auditors should be able to demonstrate how the primary requirement of impartiality is fulfilled and demonstrate, by policies, procedures and training, how to deal with the pressures that can compromise or ►►

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JAY HENRY

be expected to compromise an auditor's objectivity. Auditors, and in this case the client of a third-party valuation, must have a review process in place relating to third party valuations that provides a review of draft work to ensure of its completeness before a final report is delivered.

Clifford: Valuations are relevant to audit firms through the annual audit, but also through the various value opinions that can only be given by an auditor or someone qualified to act as such (whether by contract or by statute). In practice this is leading to many of the larger firms developing their own in-house expertise and training their audit teams in commissioning and interpreting these opinions. In addition, we are seeing companies access specialist sector advisers who will give valuation opinions to the auditors and more frequent independent opinions or reviews.

Boschetti: Auditors provide an excellent function when it comes to valuing the status quo of a company. Our biggest concern is that they are less well positioned to value where the company will be in the future, once it has merged with another organisation. As an example, if Company A buys Company B with intent to fully merge workforces, and company B has a pension plan that is half the annual cost of Company A, the impact on merging will be to double the cost of their existing pension plan. Auditors tend not to look at this impact; they consider inherited liabilities – and whether they are fully accounted for – rather than how this inheritance will impact the company going forward. In our view, it is critical for companies making acquisitions to not only look at inherited issues and liabilities but also their future influence so that cash flows can be projected and valued accordingly.

Anders: Auditors have established guidelines like SAS 73 to evaluate the work of valuers. Most audit firms have their own valuation staff who are capable of assessing the appropriateness of the third party valuations. Those valuation people seek the same certifications, such as Accredited Senior Appraiser-ASA (American Society of Appraisers), and they attend the same educational seminars to keep abreast of the latest developments in the valuation world. They are often enjoined to shadow the work of the independent valuator to keep the analysis moving along in a timely and appropriate manner. If the audit firm does not have the valuation expertise in-house, it will sometimes subcontract the valuation review work to a reputable valuation firm, especially for valuations for publicly-traded companies and for situations that are more likely to garner SEC scrutiny, such as Fresh Start Accounting.

In today's business climate, shareholders such as hedge funds are becoming more involved in the governance of corporations. Is this leading to increased scrutiny by the board of directors of valuations and fairness opinions provided by financial advisers?

Cafritz: A fear of shareholder activism, whether in the form of litigation or simply taking flak from people you want to invest in your company, is definitely putting pressure on boards to have better procedures in place. Advisers are discussing the fairness opinion issue with directors in a similar way to Sarbanes-Oxley

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DONALD E. ANDERS, ASA

issues. They are explaining that if companies want to be involved in acquisitions, it is important for them to approach the process sincerely and whole-heartedly. The market is watching, there is a lot of scrutiny, and investors need to have a sense that the company is transparent and a good corporate citizen. Satisfying investors in this way will improve the company's stock value over time.

Anders: Providers of valuation services must take steps to remain impartial and independent, being vigilant not to be swayed by aggressive projections and outlooks that do not reflect the economics of the geographic area or industry in which the company operates. Collecting valuation fees in advance of the work effort is a good way to avoid undue influence from investors, board of directors or management.

Henry: The increased scrutiny of boards only heightens the need to have an independent fairness opinion. This is especially true whenever there is legal risk that a transaction may be challenged such as buyouts of minority shareholders by controlling shareholders, bankruptcy proceedings and M&A.

Clifford: I do not believe that hedge funds are having a major impact on corporate governance and related valuations. However, the growth of hedge funds has probably created different pricing dynamics with a broadening of risk profiles and hence costs of capital from the funding markets. They may also tend to allow quicker placement for private equity, a broader range of quasi-equity instruments that can be placed, but also a speeding up of the potential churn of investments. This almost inevitably leads to a remoter relationship between funder and funded, which can affect the dynamics of a developing business. This in turn affects valuation as it may place constraints on the more radical and flexible business models.

Rérolle: In France we are beginning to see a significant number of board members paying closer attention to the motives of shareholders. In the case of hedge funds, value is the principal driver, and companies will begin to place significant emphasis on current valuations and more forward-looking value creation methods. ▶▶

With fewer protections available to directors, advisers and auditors, what steps should be taken to minimise the risks that they face?

Henry: The best thing to do is to obtain an independent fairness opinion with a firm of integrity that provides a quality work product. Additionally, all parties should make sure that adequate time is allowed for the presentation to management so that they have time to debate the issues. Finally, it is important to have written documentation of the presentation to the board so that the members can review and analyse and debate the transactions merit.

Clifford: Selecting the best adviser and getting the job done properly is absolutely essential. It is also imperative that management fully understand the valuation techniques and approaches that will be used, and consider whether they would reach a real understanding of the target business during the course of the valuer's work. It is also important that the process is managed properly and in cases where the valuation is of ongoing relevance, as so many are either for compliance or for strategy, a plan for regular reviews and updates must be implemented.

Rérolle: The most important step in avoiding regulatory risk is for all constituencies to develop a greater understanding of the valuation process and its significance to value creation. It is also important for companies to enhance their internal valuation procedures which should include employing experienced professionals and coordinating valuation processes in an efficient manner. This will significantly reduce inconsistencies among valuations done for different purposes and provide an excellent tool to assist with monitoring the company's success going forward.

Sherman: From the perspective of auditors and valuation advisers, key risk minimisation strategies include performing quality work, assigning experienced engagement teams to projects, and undertaking detailed engagement and client acceptance procedures.

Anders: It is important to use qualified and trained staff that are

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STEVEN J. SHERMAN

aware of the latest developments in a particular valuation arenas such as book vs. tax. Knowledge of the literature, best practices, and court precedence is important. They should also diligently review all appraisals completed for the company and make certain they understand the methodologies and assumptions used to value the assets and that they truly feel the balance sheet is now generally representative of the fair value of all of the assets of the company.

Boschetti: With regard to pension matters, there is also a greater level of scrutiny that has led companies, their auditors or their lawyers to bring in specialists to assess pensions because of their increased importance. This is in contrast to companies dealing with the issue themselves back in the '90s. Dedicated experts add a layer of protection to the process that mitigates the risk to companies and their advisers.

In your opinion, what are the main factors that companies should consider when selecting a financial adviser for the purposes of a valuation or fairness opinion on an existing transaction?

Sherman: Depth of knowledge related to valuation and accounting experience should be carefully considered when selecting an adviser for financial reporting or tax regulatory purposes. An accounting firm has the ability to gain immediate insight from its audit partners related to understanding FASB pronouncements, interpreting GAAP/IFRS rules, and obtaining timely SEC/FASB commentary. Industry experience and global networks are also important factors in choosing an adviser.

Henry: Industry and fairness opinion experience is very important when selecting an independent financial adviser for the purpose of a valuation or fairness opinion. In general terms, more is better than less. In other words, the more experience the firm has, the better off all participants will be. This is true for the final product and for ease of working with participants. Also, it is important to select a firm who has the availability to provide the work on a timely basis. Sufficient time is requisite for the analysis and presentation to the board. This prevents the appearance of rubber stamping a deal thereafter and allows the time requisite for presentation. The board needs adequate time to demonstrate that they rigorously debated the merits of the transaction.

Anders: Prior experience in the particular industry or the particular issue at hand. Smaller firms often have more value for the fee charged and may have a unique expertise that others don't have. Look at the specific personnel who would be assigned the task or you may end up getting the lowest price staff member to work on your assignment. If the valuation is for a financial reporting support purpose, the financial adviser should be aware of all of applicable FASB 'emerging issues' (EITF) and exposure drafts regarding its statements.

Cafritz: A range of experience is obviously the first characteristic. A firm that can provide independent, specialist fairness opinions is also important in a regulatory regime where transparency and objectivity is encouraged. In the US, the National Association ►►

of Securities Dealers (NASD) proposed a set of rules that, while not making independence obligatory, made disclosure of any conflict of interest issues mandatory. The idea is to give investors sufficient information to make rational decisions. Europe, in contrast, takes a more paternalistic view of making decisions for investors to ensure their protection.

Rérolle: In my opinion the two most significant skills would be valuation experience and transaction experience. In addition, companies want to be confident that the experts they select are able to efficiently manage the process and are respected by all investors in general and by the most active investors in particular.

Boschetti: In our space, there are two main ones. First, the adviser should have relevant expertise in the subject matter. Second, since there is a growing proportion of cross-border transactions, it becomes necessary for advisers to have a network of expertise in multiple countries.

Clifford: It is my view that technical capability and knowledge of transactional dynamics and the real market place are critical to this process, since there are still dabblers in the market purporting to know what they are doing, but without that real experience. Approachability is also essential, as making the valuation relevant to the target and the acquirer's business model means that the valuer and client will be working more closely together than the traditional, well-researched but remote desk-top approach.

How are market perceptions of presumed or actual conflicts impacting the industry?

Rérolle: In France, and across much of Europe, the introduction of new legislation has in many ways tackled the issue of avoiding conflicts of interest. Certainly in France we are seeing new rules introduced that require all fairness opinion providers to be fully independent from any transaction. This regulation, in theory, removes any presumed or actual conflict and, given the scale of the steps taken, seems to be an attempt to avoid the potential for conflicts and disputes that we have seen on an international level.

Cafritz: In Europe, solutions to the conflicts of interest issue seem to be coming from the top down because the markets are not considered to be as sophisticated as in the United States. Fairness opinions processes have come to the attention of regulators mainly through US hedge and pension funds that want to invest in continental Europe, but are shocked and angered that they cannot benefit from the same level of transparency when investing in European public companies through arbitrage strategies and so on, since the same rigorous processes are not in place. No mandatory fairness opinion requirements in standard tender offers exist in France, Luxembourg, Spain or Italy. But, as has occurred in France, the regulators are responding to the demands of large institutional investors by adopting standards that will allow them to continue investing billions in the local market. Almost 50 percent of the total market capitalisation in France is foreign, so the incentive to attract overseas capital is compelling. When the French financial markets regulator, AMF, implements its rules

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ERIC CAFRITZ

scheduled for 15 September 2006, the country will have the most highly evolved and draconian set of rules for fairness opinions in the world. It will be the only jurisdiction where fairness opinions will be mandatory in straight up tender offers and where the expert providing them must be independent, with no conflicts and no contingency fee. That will be the biggest shock to the banking community.

Clifford: One might think that costs are increasing with the perceived inefficiencies of two learning curves: that of the lead adviser or broker and that of the valuer. However I do not think that is necessarily so. With larger organisations more frequently encountering these perceived conflicts, opportunities have grown for the boutiques and the accountancy firms just outside the Big 4, several of which have teams including former merchant bankers and Big 4 personnel. I would argue that the effect is that there is both more choice, and there are emerging specialist skills (such as film and music portfolio valuations) that might have been lost in a larger organisation. There is also probably a cost benefit to the client in the mid-market in that the availability of mid-market specialist valuers, with their lower cost base, and the broader competition they imply, is probably keeping cost inflation down.

Sherman: In the US, under SEC and AICPA rules, valuation services are generally prohibited on behalf of audit clients, except for tax strategy valuations. In today's environment, maintaining independence is critical and is taken very seriously by audit firms and their clients. It is common practice when an engagement opportunity surfaces to assess potential conflicts early in the process. We have developed detailed independence procedures that are required prior to accepting an engagement.

Anders: Even the appearance of conflict is starting to be of concern to many accounting firms. Many of these firms have a ranked target list of companies for which they will pursue the external audit work. In these instances, its internal appraisal group may now be conflicted out of doing any appraisal work that will have a financial reporting impact due to internal priorities, as opposed to any decision by the target company or restrictions ►

under Sarbanes-Oxley. In these instances they will often develop referral lists of valuation firms that they have developed knowledge of and respect for.

Henry: The appearance of impropriety or potential bias has impacted the industry in a significant way. This is true for both the board and their advisers. For example, the NASD may investigate potential conflicts of interest that may arise when a company's financial adviser provides an opinion on a deal that they are working on. The NASD is concerned that disclosure may not adequately inform investors about the subjective nature of the opinion and provides a full explanation of potential biases.

Boschetti: In our case, we value pensions aspects or employee aspects, so it is not the same as providing a valuation of the entire business. Conflicts of interest is certainly a sensitive issue and valuation firms need to handle it head on. As long as a firm like ours has in place suitably strong procedures to disclose and handle conflicts of interest, companies are fairly open to the notion that you operate for multiple buyers, or for both buyer and target.

Are investment banking firms doing anything different when rendering a fairness opinion today than they did five to ten years ago?

Rérolle: Everyone has reviewed their practices to ensure that conflicts are identified early and appropriately disclosed to the client. Moreover, with the advent of stapled financing and other relationships, there are far more instances when a bank will decline to render an opinion due to a perceived conflict. There has been a general 'tightening' of the review and valuation analyses as risk has increased. Of course, banks have always been very careful, but given the increased likelihood litigation in the US, the most reputable banks that render fairness opinions are more deliberate, more thorough, and will probe further in due diligence to make sure that they are comfortable with their opinions.

Henry: The investment banking firms have been under scrutiny over conflict of interest. A reputable investment bank will take a macroscopic perspective when looking for any potential con-

flicts in both an internal and external process. These banks have much to lose by way of their reputation and possible legal action. Many reputable investment banks will not render a fairness opinion when there is a success fee involved or if they do, they will ensure that a second fairness opinion is rendered.

Cafritz: For investment banks, the practice of providing a fairness opinion is really just an add-on. The investment banker's primary role is as an adviser under a contingency fee. They offer a fairness opinion as a side issue, often billing it out at hourly rates. However, bankers are definitely walking on eggshells at the moment. Regardless of how rare it is that banks are successfully sued, they do feel at risk and are taking greater care when reaching and issuing fairness opinions.

Clifford: It's not just investment banking firms, but the specialist teams within the larger accountancy practices, together with some smaller boutique specialists that are doing this work. Generally the approach is probably less theoretical and better related to real market data and conditions, with many valuers, like our own, working alongside their organisations' M&A teams. Also, there is probably a wider use of specialist firms to value part of a target (perhaps particular IPR) which is then embodied by a more general corporate valuer into a valuation of the whole company or group. Finally, driven partly by the need for self-protection in the face of a more litigious environment, and partly by better technical capability in-house in more companies, valuers are reporting to their client companies in greater detail. This enables the company better to examine and agree upon key assumptions, and perhaps results in both greater accuracy and the ability to use the valuation better. This is important both where the directors are responsible for compliance, but also where the valuation is given to support the development of strategy.

What are the actual risks of using the same firm as the investment banker and the fairness opinion provider, and are most firms actively taking steps to avoid possible conflicts?

Henry: The look of impropriety is enough to raise eyebrows and warrant outside scrutiny. When an investment banker's compensation is tied to a success fee, it would be a considerable challenge to prove that there is no inherent conflict of interest whatsoever. To provide clarity to the conflict of interest issue, many boards are forming special committees of independent directors to evaluate these issues. The use of a second independent fairness opinion is a good step to avoid the look of any impropriety.

Boschetti: Put simply, the risk is that you can be deemed to be favouring one side over the other and therefore be open to litigation. Interestingly enough, we find that in transactions where we work for both buyer and sellers, the actuaries are even more prudent and engage in more discussions and arguments than if two different companies were valuing pensions. That shows the growing awareness of conflict risk. But, as long as the company is open, honest and reputable, the issue should not go any further.

Clifford: There seems to be a growing sensitivity not only to actual conflicts, but also to perceived ones. However this is ►►

Given the heightened litigation environment in the US, the most reputable banks that render fairness opinions are more deliberate, more thorough, and will probe further in due diligence to make sure that they are comfortable with their opinions.

JEAN-FLORENT RÉROLLE

still tempered with a degree of practicality since bowing to this division of roles almost inevitably increases overall costs which can make compliance an expensive element of an otherwise cost-effective transaction.

Anders: Independent financial advisory firms that use generally accepted valuation methods should be used to avoid the risk of having any potential conflict of interest.

Cafritz: Whether it's a contingent fee or a flat fee, if you are in the business of providing fairness opinions, the basis on which you are paid does not make much difference. A contingent fee, paid as a percentage of the deal value, encourages the provider to see that the transaction occurs at a good price. But a fixed fee will not necessarily make an opinions provider more impartial, because it has an incentive to be board-friendly if it wants the next fee. It is not a good idea for firms wanting to stay in business to be in hostile confrontation with their clients. So the type of fee does not in itself drive neutrality of opinion.

Have you seen an increase in the use of a second independent fairness opinion or private fairness opinion in M&A transactions?

Cafritz: In the US, this is certainly the case. It's down to a lack of trust, built on concerns that the first opinion is a throw away to make sure a second opinion is sought as a back-up. But I have seen little use of a second independent fairness opinion in European cross-border deals. In Europe, where even first opinions are not used systematically, second opinions are virtually non-existent.

Henry: Many investment banks who issue an opinion and are compensated with success fees obtain a second opinion. These are typically requested from the board members to ensure best practices. The fairness opinion provider is in many cases, asked to evaluate additional alternatives for the deal and/or deal structure. Again, allowing enough time for the opinions provide greater benefit to all parties.

Boschetti: Second opinions in pension matters are rarely sought. Most agreements allow for an independent assessment if the parties disagree, which happens, on occasion. Normally it is used as a form of dispute resolution, rather than as a pre-emptive avoidance of potential disputes. In other words, second opinions are called in when it's too late to do anything else.

Anders: It seems like the momentum is moving toward having several opinions in place, especially for larger transactions. Certainly providers of such opinions are suggesting as much.

Clifford: I have certainly seen an increase in cases where the brokers have a perceived conflict, or the likelihood of challenge is high, for example where there is a backdrop of disagreement between shareholder groups. I would say that the increased use is as much before the event, to head off problems, as in dispute resolution.

In pension matters, second opinions are normally used as a form of dispute resolution, rather than as a pre-emptive avoidance of potential disputes.

MARCO BOSCHETTI

In major corporate transactions, what factors are driving the increased interest in buy-side fairness opinions?

Clifford: The sheer complexity of the risk management tools being used buy-side is more often leading to non-executives on the boards requiring an independent evaluation of the price they are paying, partly to give comfort that all relevant risk has been considered, and partly to ensure the often highly incentivised executives are not getting carried away.

Cafritz: Buy-side opinions are not part of the regulatory environment but the practice is growing. In the US, there has been a fairly consistent drive to include buy-side opinions in transactions for some time now. It is logical for an acquiring board to want to be seen acting in a reasonable manner. It wants to demonstrate a rigorous basis for proceeding in a major transaction, which means being fully informed, exercising diligence on the enterprise and seeking a buy-side fairness opinion. The importance of this has risen as conflicts of interest by investment bankers are being called into question.

Anders: The investment value (i.e., to a specific buyer) can be different than the fair market value. Synergies can be more fully examined from the perspective of a particular buyer which can bring to bear its resources and assets to a combined entity.

Henry: The buy-side opinion indicates that the price to be paid is in the value range based on an accepted valuation model and hence, is fair to the acquiring firm's shareholders. In developing a buy-side opinion of fairness, the terms, price, and legal issues are reviewed and an opinion is provided. In doing so, the board has a very good independent perspective and understanding of the target and the germane issues surrounding the deal in order to be better informed on whether or not the firm should go forward or possibly re-evaluate other strategic alternatives. In general the larger the deal, the more there will be at risk and the greater the demand from a large minority shareholder group for an independent opinion. ►►

Rérolle: In instances where critical questions of value exist, it is becoming increasingly common for board members and shareholders to ask those questions. As a result, in many transactions it has become essential to seek a fairness opinion to satisfy all stakeholders that a particular transaction and the proposed purchase price is in the best interest of the company. In some cases it may prove difficult to convince shareholders of the value of a particular merger or acquisitions and when this uncertainty exists, a fairness opinion can assist greatly in demonstrating management's intentions on the basis of value.

How have the dynamics of buy-side valuations and fairness opinions changed in recent years?

Henry: There is a greater demand for the use of buy-side opinions. This is because boards are looking for additional perspectives to possible acquisitions above and beyond their current management, investment bank and accounting firm's view of the potential transaction. The buy-side opinion, from an independent valuator, provides an additional data point to facilitate informed decision-making. This is especially important when there is a shareholder vote involved. Additionally, transactions of almost any size will warrant a buy-side opinion when pricing premiums may dilute the acquirer's share price.

Sherman: Experience in recent years shows a substantial increase in early stage valuations to identify intangible assets and estimate annual amortisation charges. These valuations are often performed prior to the buyer winning the deal. They are undertaken to advise boards if acquisitions will be dilutive or accretive to EPS based on estimated amortisation levels.

Clifford: Generally buy-side opinions have to be more sophisticated for a number of reasons, particularly in areas with increased focus on risk evaluation. The funders, particularly the banks, are becoming more detailed in their analysis of prospects and the risks associated with them, and having an ever wider range of funding packages to suit different opportunities. This, too, drives more flexibility and complexity in buy-side valuation. This development in valuation work has been supported by more readily available comparable data and well-developed methods of evaluating business opportunities and risk and planning those going forward.

Anders: The question is not so much is it a fair deal, but to whom? Corporate stewardship might demand that the buy-side opinions are a responsible route to follow.

When should board members of a privately held company seek a fairness opinion? Are you seeing an increase in this area as many companies strive to emulate what is happening on the public markets?

Clifford: With shareholders becoming in some cases better informed, and in many cases more litigious, directors are more frequently recognising the need to protect themselves in this context. This is probably also driven by an increasing number of corporate transactions by an ever wider group of businesses – hence

more transactions needing more views. Further, with a fairly lively competition by investment, private companies, leaving strategic buyers, and the added dimension increasingly strong secondary investment markets such as the UK's AIM and the possibility that waiting even six months might totally change that balance for reasons that may or may not have anything to do with the target, vendor directors or buyers seem increasingly to be taking the view that they need some extra help in researching and assessing the opportunities to better the owners' lot.

Cafritz: Some of the most contentious valuation situations involve companies with private equity, venture capital or hedge fund investment. There are many such companies, as the most active piece of the acquisition market in Europe for six years has been leveraged buyouts. The minority shareholders in these companies are sophisticated funds with rising power, and they insist on highly objective valuations before they agree to major corporate control transactions. For example, a corporate parent company that has admitted venture capital or private equity funds into its ranks through a subsidiary company must be careful about the way it deals with its stock in a future transaction. Trying to run roughshod over the interests of a small group of powerful investors in a closed company, without getting objective views on valuation, can be highly litigious.

Sherman: On transactions deemed to be less material, a company has three options regarding external valuation advice; do nothing, obtain a fairness opinion, or undertake a strategy in-between. An 'in-between', less costly alternative might include obtaining third-party due diligence reports and fair market value studies. A fair market value study might be restricted for internal use only, unlike a fairness opinion. It would, however, demonstrate a board's effort to gain independent advice. Legal counsel is the best source to determine the optimum level of third-party support required on less material acquisitions.

Henry: Private companies that have many shareholders who do not have direct board representation and/or institutional shareholders should strongly consider seeking a fairness opinion. The trend is that the larger private companies are emulating public companies especially when there is risk that the transaction may be challenged on the grounds of a breach of fiduciary responsibility by minority shareholders of the private company.

Anders: A litigation-prone environment might suggest that, to be safe from the concerns of several investors/owners, in the long-term, a fairness opinion might be warranted.

Rérolle: Private company fairness opinions, particularly for companies with private equity shareholders, are becoming increasingly common. This is partly due to the heightened levels of deal activity in the European private equity industry and also the fact that many private equity-backed transactions act as an exit for the private equity shareholders. As the profile of the private equity industry grows and the sophistication of private equity fund limited partners increases it is expected that more and more fairness opinions will take place. ■

**From one
point of view
it's a
great deal.**

**But
we help you
look at
all the angles.**

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