



THE FAIRNESS OPINION: TIME TO FISH OR CUT BAIT!

Fair to whom? And whose opinion?

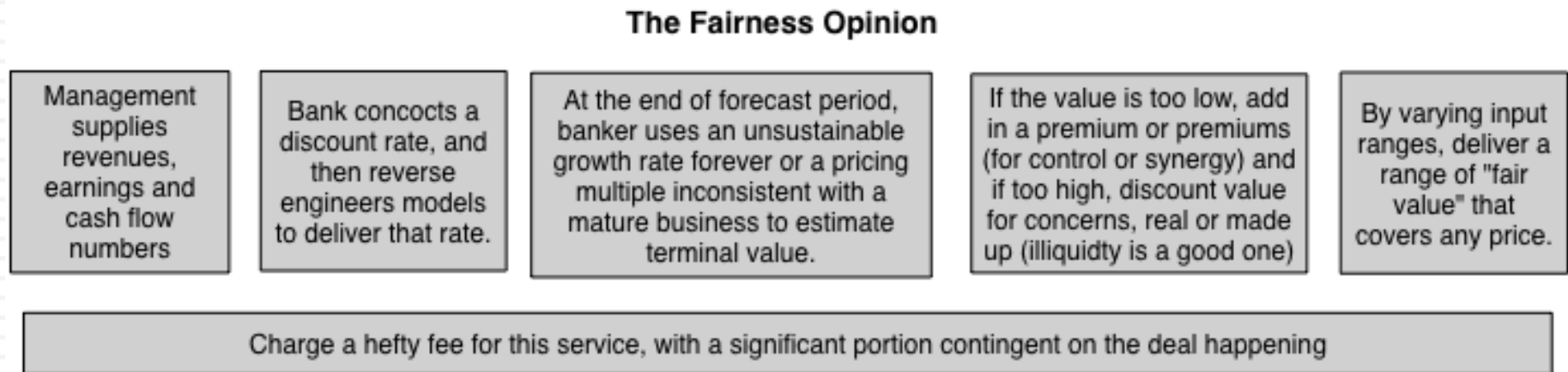
The TSLA/SCTY Post blowback

- Matt Levine notes in his Bloomberg column, where he cites my post, that a “fairness opinion is not a real valuation, not a pure effort to estimate the value of a company from first principles and independent research.”
- Matt also argues that “they (Lazard and Evercore) are just bankers; their expertise is in pitching and sourcing and negotiating and executing deals -- and in plugging in discount rates into preset spreadsheets – not knowing the future.”
- If Matt is right, the problems run deeper than the bankers in this deal, raising questions about what the purpose of a “fairness opinion” is and whether we should continue with the practice.

Fairness Opinion: The what and the why?

- In an excellent article on the topic, Steven Davidoff defines a fairness opinion as an “opinion provided by an outsider (presumably qualified) that a transaction meets a threshold level of fairness from a financial perspective”.
- The fairness opinion is delivered (orally) to the board at the time of the transaction and that presentation is usually followed by a written letter that summarizes the transaction terms and the appraiser’s assumptions and attests that the price paid is “fair from a financial point of view”.
- It’s surge in usage can be traced back to a Delaware Court judgment in 1985, where the court found the board guilty of self-dealing but noted that the liability could have been avoided had the directors elicited a fairness opinion from anyone in a position to know the firm’s value”.

Fairness Opinion: In Practice



1. *How is this fair?*
2. *Why is it an opinion?*
3. *Where is the protection from unfair deals?*
4. *Why are you paying millions for this disservice?*


The Perils of False Protection

- By checking off a legally required box, they have become a way in which a board of directors buy immunization against legal consequences.
- By providing the illusion of oversight and an independent assessment, they are making shareholders too sanguine that their rights are being protected.
- Worse of all, this is a process where the worst (and least) scrupulous appraisers, over time, will drive out the best (and most principled) ones, because managers (and boards that do their bidding) will shop around until they find someone who will attest to the fairness of their deal, no matter how unfair it is.

Fish or Cut Bait?

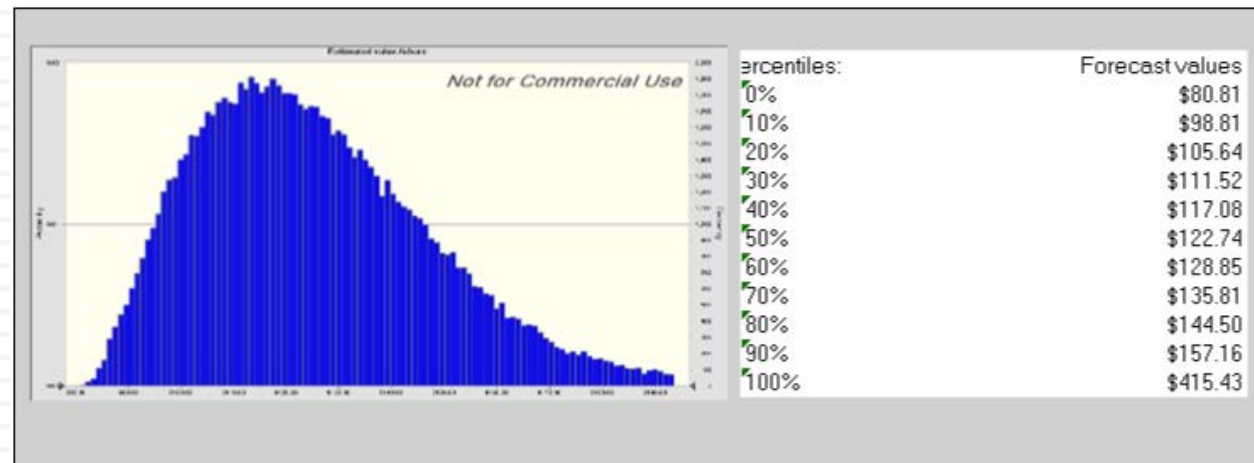
1. Abandon: If the fairness opinion is neither fair nor opinion and it is not protecting shareholders, perhaps it is time to abandon its usage and save shareholders millions of dollars.
2. Fix: If the fairness opinion is to serve its original purpose, it will require
 - More activist (and questioning) judges
 - Punishment for bad behavior (at least in the fairness opinion part of the process)

1. A Fairness Questionnaire (for Judges)

Question	Green	Red
1. Who is paying you to do this valuation and how much? Is any of the payment contingent on the deal happening?	Payment reflects reasonable payment for valuation services rendered and none of the payment is contingent on deal outcome.	Payment is disproportionately large , relative to valuation services provided, and/or a large portion of it is contingent on deal occurring.
2. Where are you getting the cash flows that you are using in this valuation?	Appraiser estimates revenues, operating margins and cash flows, with input from management on investment and growth plans.	Cash flows supplied by management/ board of company.
3. Are the cash flows internally consistent? 	<ol style="list-style-type: none"> <u>Currency</u>: Cash flows & discount rate are in same currency, with same inflation assumptions. <u>Claim holders</u>: Cash flows are to equity (firm) and discount rate is cost of equity (capital). <u>Operations</u>: Reinvestment, growth and risk assumptions matched up. 	No internal consistency tests run and/or DCF littered with inconsistencies , in currency and/or assumptions. <ul style="list-style-type: none"> - High growth + Low reinvestment - Low growth + High reinvestment - High inflation in cash flows + Low inflation in discount rate
4. What discount rate are you using in your valuation?	A cost of equity (capital) that starts with a sector average and is within the bounds of what is reasonable for the sector.	A cost of equity (capital) that falls outside the normal range for a sector , with no credible explanation for difference.
5. How are you applying closure in your valuation?	A terminal value that is estimated with a perpetual growth rate < growth rate of the economy and reinvestment & risk to match.	A terminal value based upon a perpetual growth rate > economy or a multiple (of earnings or revenues) that is not consistent with a healthy, mature firm .
6. What valuation garnishes have you applied?	None.	A large dose of premiums (control, synergy etc.) pushing up value or a mess of discounts (illiquidity, small size etc.) pushing down value.
7. What does your final judgment in value look like?	A distribution of values , with a base case value and statistics.	A range of value so large that any price can be justified.

Four simple proposals

1. Deal makers cannot be deal analysts: For obvious reasons.
2. No deal-contingent fees: There is no simpler way to introduce bias into fairness opinions than to tie fees to whether the deal goes through.
3. Valuing and Pricing: I think that appraisers should spend more time on pricing and less on valuation, since their focus is on whether the "price is fair" rather than on whether the transaction makes sense.
4. Distributions, not ranges: The question is not whether the price is possible but whether it is plausible (or even probable).



2. Punishment for bad behavior

- For the appraisers: If the fairness opinion is to have any heft, the courts should reject fairness opinions that don't meet the fairness test and remove the bankers involved from the transaction, forcing them to return all fees paid. I would go further and create a Hall of Shame for those who are repeat offenders, with perhaps even a public listing of their most extreme offenses.
- For directors and managers: The boards of directors and the top management of the firms involved should also face sanctions, with any resulting fines or fees coming out of the pockets of directors and managers, rather than the shareholders involved.