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Valuation Issues in Mergers and Acquisitions

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Many Possible Valuation Issues in M&A

- Did some current class of security holders receive “too little”?
  - Did board appropriately accept/reject offer?
  - Did board obtain the largest possible total value?
  - Did some other class receive “too much”?
  - Was a minority financially “oppressed”?
- Were appropriate valuation metrics used for fairness opinion?
  - Discounted Cash Flow (DCF) analysis
  - Current market multiples
  - Past transactions
  - Acquisition premiums
- What assets should be valued, and when?
- And many more…

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Hypothetical: CashCow, Inc.

- Factual background:
  - Large, well established public company in mature business
  - ASX, high trading volume, many analysts
  - Consensus that CashCow trades in an efficient market
  - Management publicly discloses current forecasts of future cash flows
  - No material private information
- CashCow common stock:
  - 100 million shares outstanding
  - Current price per share: $10

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Public Offer to Purchase CashCow

- Board receives unexpected offer to purchase all shares at $11 per share, or $1.1 billion
- Board accepts offer
- Filings include supporting fairness opinion from large investment bank:
  - DCF analysis
  - Comparable companies analysis
  - Historical transactions
  - Acquisition premium of 10% (i.e., $11 versus $10 prior to offer)
- Lawsuit: Board breached fiduciary duty by accepting too low an offer
- ***Issue: Fair value of total CashCow equity just prior to offer***

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Total Value of Equity Absent the Offer:
Your Chance to Pick Between Three Options

- ***Option A: $1 billion***
  - Market capitalization ($10 per share times 100 million shares)
- ***Option B: $1.2 billion***
  - DCF valuation by plaintiffs' expert, based on management's most recent (and public) forecasts
- ***Option C: $1.3 billion***
  - Current market cap of $1 billion ***plus*** a 30% premium
  - Average acquisition premium is 30%

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Delaware Courts Pick Option C (Market Cap + 30%)!

- For example, *Doft v. Travelocity,* 2004 Del. Ch. LEXIS 75 at *45-*47 (cited in G. Matthews, “Misuse of Control Premiums in Delaware Appraisals,” *Business Valuation Review* 27 (2), Summer 2008, p. 108):

  Delaware law recognizes that there is an inherent minority trading discount in a comparable company analysis because “the valuation method depends on comparisons to market multiples derived from trading information for minority blocks of the comparable companies.” The equity valuation produced in a comparable company analysis does not accurately reflect the intrinsic worth of a corporation on a going-concern basis. Therefore, the court, in appraising the fair value of the equity, “must correct this minority trading discount by adding back a premium designed to correct it.” … [T]he recent appraisal cases that correct the valuation for a minority discount by adding back a premium “that spreads the value of control over all shares equally consistently use a 30% adjustment. ***Relying on recent precedents, the court will adjust the … per share value by adding a 30% control premium***” [emphasis added, footnotes omitted].

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Similar Issue Arises in Various Contexts

For example, Australian corporate tax issue:

- Valuation of intangible assets in context of Capital Gains Tax
- Assume agreement on the following:
  - Market capitalization of equity
  - Market value of debt
  - Market value of tangible assets
  - Market value of intangibles equals (market value of equity plus market value of debt) minus market value of tangible assets
- ***Issue: Market value of intangible assets?***

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Arguments Advanced for Option C (Market Cap + 30%)

- The acquisition premium reflects the price a purchaser pays to obtain control
- Hence "acquisition premium" equates to "control premium," which is the flip side of "minority discount"
- Minority shareholdings in closely held private companies typically trade at a discount to pro-rata equity value because a majority shareholder in control may hurt the minority
- The "*Financial Review*" price is the price for, say, 100 shares
- Therefore, the share price for publicly traded companies must contain a minority discount
- Hence, the market cap (price times number of shares) embeds a minority discount, and must be increased by the control premium to get the fair value of total equity

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Problems with Option C (Market Cap + 30%)

- Was traditionally the logic of appraisers, now rejected by some respected appraisers (but still found in expert reports claiming that fair value of equity exceeds observable market cap)
- Argument cannot possibly be correct in general:
  - Observed share price after extended takeover battle?
- Acquisition price, and hence "acquisition premium," reflects any contemplated changes in running current business plus expected synergies
- This differs conceptually from "control premium" and "minority discount" in closely held private companies
- If fair value of publicly traded equity were of necessity higher than the market cap (say by 30%), why not a takeover offer?
- Share price reflects probability of potential takeover offers

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Analysis of Option A (Market Cap)

- No suggestion that CashCow equity's residual cash flows and value are not distributed equally (pro rata) among all shares
- No private information
- CashCow traded in an efficient market
- Stock price represents market consensus view of value of each share, i.e., present value of expected future cash flows to each share
- Hence best estimate of total value of CashCow's equity prior to offer:
  - – $10 per share times 100 million shares, or $1 billion

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Analysis of Option B (Plaintiffs' Expert's DCF)

- Expert's own DCF using management's most recent public forecasts
  - Calculates total equity value of $1.2 billion, or $12 per share pro-rata
  - Claims that $1.2 billion is "conservative" estimate because it implies a control premium over market cap of only 20%, not average premium of 30%
- Problems with Option B:
  - Based on management forecasts—what "control" value?
  - One person's DCF versus market consensus DCF (i.e., share price)
  - Claims of "conservative control premium" incorrect:
    - No basis for any "control premium" here
    - Acquisition premium is not "control premium"
    - Average acquisition premium versus full range

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Conclusions

- No justification for automatic assumption of “minority discount” in stock price of publicly traded companies—but exceptions?
- Use market consensus (stock price) valuations where possible
- Courts?
  - Delaware consistently adds “control premium” to market price to offset supposed “minority discount” if advanced by an expert
  - In *Doft* (cited above), neither expert mentioned a “minority discount” yet court imposed a 30% premium
  - Average acquisition premium provides no basis for automatic asserted “control premium”
  - Traditionally, all appraisers did this—now controversial, in both U.S. and Australia
- Ethics

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