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Valuation Challenges: The Management-led Going Private Transaction

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In the valuation community, we are all aware of small public companies that really do not belong in the public markets. Periodically, we see such firms undertaking the process of going private but it is not always an easy feat — in terms of meeting the needs of all shareholders it is a bit like coaxing a genie back into the bottle. My focus in this article is the situation where management is attempting to take control of the firm, whether with a financial partner or not, by buying out minority shareholders. In theory, going private transactions can be good for three parties: the minority shareholders who gain liquidity through the process; the company whose characteristics do not fit the public markets; and management who can spend more of their time managing the business. These transactions have both procedural and valuation challenges. I am concerned here with the latter, though the two are often related.

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2.1 The Situation

The following are some of the more common issues that lead management to consider a going private transaction:

- A ***depressed share price***, however arbitrary, is a constant reminder to management and shareholders that the investment is not performing.
- ***The legal and regulatory environment*** facing public companies is challenging, and directors and officers are exposed to litigation, even if unfounded. Regulatory disclosure and oversight requirements have become more onerous ever since the introduction of Sarbanes-Oxley (and its international equivalents).
- The ***fixed costs*** associated with being public are particularly daunting for smaller firms. These include the costs of completing financial statements and MD&As; holding annual meetings; keeping up with regulatory filings; compensating directors, lawyers, auditors and investor relations firms; and paying securities regulation fees, exchange fees and insurance premiums for directors and officers.

- Smaller entities often experience ***poor liquidity*** due to light trading volume and scant analyst coverage or institutional interest. The result is constrained access to financial markets to raise capital and a share price that may not be reflective of value.
- The ***constant distraction*** with meeting investor and analyst expectations each quarter can interfere with managing the business to create long-term value.

2.2 The Rules

Several legal processes are available to effect a going private transaction. Each results in terminating the interests of some security holders, sometimes without their consent. In Canada, such transactions are normally either take-over bids or squeeze-out mergers, where the latter involve a plan of arrangement, amalgamation, share consolidation or other transaction. For the valuator, going-private transactions are subject to the requirement of both the OSC and the CICBV. The OSC's MI 61-101 requires a formal valuation based on the rationale that insiders are privy to information about the company's business and prospects that other shareholders are not and that the other shareholders should have the benefit of an independent valuation to assess the merits of the bid put forward by management. Section 6.4(2)(d) of MI 61-101 stipulates that the formal valuation not include a downward adjustment to reflect the liquidity of the securities, the effect of the transaction on the securities or the fact that the securities do not form part of a controlling interest.

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As regards the CICBV requirements, Appendix A to Standard No. 110 applies to valuation reports that are prepared for the purposes of securities legislation, regulations or policies in the context of non-arm's length transactions, such as going private transactions. For these transactions, the standard lists numerous disclosure items to be addressed, including a comparison of valuation calculations and conclusions arrived at through different methods, a discussion of the rationale for accepting or rejecting each methodology and the relative importance or weighting of relevant methodologies in arriving at a final valuation conclusion.

2.3 The Valuation Challenges

The special valuation requirements of the OSC and CICBV for going private transactions stem from issues related to the non-arm's length nature of these transactions. These issues make the job of the valuator more difficult from an informational point of view. Where key management of the business seek to acquire control, they will have at their disposal inside information that relates to the value and prospects of the business, which public shareholders do not share. While an independent committee of directors may be appointed to guard the interests of minority shareholders in the transaction, they too may be at an information disadvantage where they have no day-to-day involvement in the business and rely on information filtered by management. The ability of the valuator to conduct an independent analysis of value will necessarily hinge on the quality and thoroughness of information provided to them by management.

Of course, the concerns underlying the OSC and CICBV rules are not simply the information gap between management and minority shareholders. A potential conflict here arises because the management group have an incentive to purchase at the best possible price, though no real incentive to emphasize the income potential of the business if that would have the effect of increasing the price.

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Below, three specific challenges that face the valuator in these situations — and some possible solutions — are considered.

2.3.1 Financial projections may be non-existent or lacking in rigour

Financial projections enable valuators by facilitating the discounted cash flow methodology. The DCF is theoretically a sound means of arriving at value, since going concern businesses “are worth what they can earn.” In practice, of course, estimating future performance is fraught with error and it is perhaps understandable that management is less than willing to provide projections. In the going private case, there may be a history of under-performance relative to projections. There may even be uncertainty as the strategic direction of the firm or the funding of future operations may be in a state of flux.

From the perspective of management seeking to bid for the shares of the company, there is little incentive to lay out projections that show cash flows increasing steadily into the future, as projections are often apt to do. Where a projection does exist, it is helpful to compare it to previous ones (and to the accuracy of the forecast, albeit with hindsight) to determine whether there is a manifest change in management’s expectations. Where a projection is discernibly less optimistic than previous versions, the valuator should discuss with management what the rationale is for the going private transaction is — i.e., what makes the company attractive as an acquisition for management? There may, in fact, be financial or strategic changes contemplated that have not been feasible within the public company structure.

2.3.2 Stock price is not representative of value

Minority shareholders will always be inclined to measure the bid price in a going private transaction against the current (pre-bid) stock price as well as the original purchase price. Clearly, the original stock price may be of only historical interest, but even the current price may be of little relevance if the stock is thinly traded and not subject to analyst coverage.

Most valuators are adept at valuing private entities, which, by their nature, are valued without appeal to the quoted price of the underlying stock. However, where there is a quoted price for the securities of the firm, the valuator will need to assess whether these prices are at all representative of underlying value and, if not, clearly state why they should be discarded in arriving at value.

2.3.3 Normalization adjustments related to the transaction

Most valuations include some adjustment to normalize the earnings or cash flows of the firm for specific events, accounting practices or changes in business operations. However, normalization adjustments for prospective changes in the company post-transaction are particularly problematic. MI 61-101 6.4(2)(d) states that the valuator should

> not include in the formal valuation a downward adjustment to refl ect the liquidity of the securities, the *effect of the transaction on the securities* or the fact that the securities do not form part of a controlling interest (italics added).

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Removing consideration of the effect of a prospective transaction from the valuation is obviously consistent with point-in-time valuation principles that form a basic tenet of valuation theory. On the other hand, if the company was never well suited to the public markets, an-add back to adjust forpublic company costs is consistent with the rationale by which valuators normalize for practices and events that do not "fit" the company. Here, subsection 6.5(2) of MI 61-101 may be instructive. It deals not with the valuation per se but with the information that the company is required to provide to shareholders in the circular. It states that where

> an issuer or offeror is required to provide a summary of a formal valuation, the issuer or offeror shall ensure that the summary (a) discloses… (ii) any distinctive material benefit that might accrue to an interested party as a consequence of the transaction, *including the earlier use of available tax losses, lower income taxes, reduced costs or increased revenues* (italics added).

In essence, any benefits or reduced costs that follow from the transaction need to be pointed out to shareholders, even if they might not form part of the valuation. To this end, it may be helpful to shareholders — and to the independent committee tasked with advising them — for the valuator to segregate certain of these items in the valuation and indicate how and to what extent they contribute to (or denigrate from) the value of the company.

2.4 Conclusion

The traditional fair market value definition contains the assumption of a notional transaction "between informed and prudent parties." Where information about the business and its prospects resides primarily with the party bidding for the shares, this assumption becomes harder to meet. The result is a higher level of diligence, inquiry and critical analysis demanded of the valuator — by minority shareholders, the independent committee and the law.

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