Deloitte.

Fairness opinions: Actions board members can take when the debt comes due

Authors:
Hector Calzada, Managing Director, Deloitte Corporate Finance LLC
Justin Silber, Managing Director, Deloitte Corporate Finance LLC
Sara Elinson, Senior Vice President, Deloitte Corporate Finance LLC

As companies and their boards of directors navigate economic cycles, they often face critical decisions regarding how to stay afloat, let alone thrive. In evaluating strategic alternatives related to business and organizational structure, product mix, or geographic footprint, management and its board may consider a range of financing and transaction alternatives to support the company's growth – or survival – strategies.

In so doing, the board should consider focusing on cutting through the clutter, weighing different funding alternatives and the risks associated with them in a thoughtful and transparent fashion. The board's recommended course should be well reasoned – one that simultaneously considers the interests of the company and its many stakeholders.

The recent credit crisis only adds complexity to a board's evaluation of a transaction. First, substantially fewer funds are now available for either raising new debt capital or extending existing debt than in the aftermath of other recent economic downturns. Companies that need to renegotiate or replace maturing debt in the next several years are likely to find they have plenty of company. Some $2 trillion in high yield bonds, leveraged loans, and commercial real estate loans are coming due globally from 2010 through 2012.[1]

Second, the expected bulge in maturing debt may prove especially inopportune for companies facing operational shortfalls in the still recovering economy. Cash flow stresses add weight and urgency to decisions about how to meet capital needs going forward.

Lastly, while credit markets do appear to be loosening, they also reflect more conservative underwriting standards. Current lenders, if they are willing to renegotiate at all, may seek to negotiate more restrictive debt covenants, short maturities, and higher fees.

[1]Sources: "Global Credit Strategy," December 2009 report, and "Commercial Real Estate 2010: Investments Cross-Currents," both from Morgan Stanley.

Recognizing that reasonable financing may not be available through traditional lending channels, companies are considering other avenues. They may choose to explore alternative debt sources, some form of equity transaction, or a capital infusion from existing equity holders.

As the financing options under consideration expand, so too may the board's burden to demonstrate fiduciary responsibility, and potentially, its liability exposure. Directors must evaluate whether alternatives presented to them by management are likely to allow the company to continue operating, could cause further distress, or have the potential to create disadvantage for certain constituencies of the company. The board faces the risk that shareholders or other stakeholders may claim that a transaction unfairly dilutes their equity interests or creates a debt burden – or fails to resolve an existing one – that threatens the long-term viability of the company and, thereby, their investment.

Choosing among the options

Deciding whether a financing alternative is viable involves reflecting on many issues. Standouts among them are the funding option's potential impact on cash flow, how much control the company must give up to obtain the funding, and the effect on existing equity holders and other sources of capital.

In addition to renegotiating existing credit lines or entering into new debt agreements, most executives and board members are no doubt familiar with the range of possible funding alternatives, including:

Equity financing – Issuance of additional stock; including Private Investment in Public Equity (PIPE) transactions – Issuance of stock to qualified private investors at a slight discount to the company's current market value per share.

Debt-for-equity exchange – Arrangements in which a current debt holder receives equity in exchange for cancellation of debt, thereby retiring or reducing interest and principal costs to the company.

Mezzanine financing – Hybrid financing instruments that provide subordinated debt capital, which may have attached warrants or participation interests on the equity.

Carve out divestitures – Sale of a portion of the business generate additional cash flow.

In many instances, more than one of these alternatives may be considered in connection with a related-party transaction. For example, one of the current stakeholders may be approached with – or may have offered – an alternative to a traditional refinancing. Such a scenario has separate implications that should also be examined by the board.

Each alternative involves particular costs and tradeoffs, as well as impacts and risks (Figure 1). Equity financing, PIPEs, and debt-for-equity transactions can dilute current shareholder value, which can put the board in a difficult position. In especially dire situations, board members may be faced with accepting a lower price per share in a transaction and thereby have a greater expectation of shareholder challenges, or it may hold out for a better share price and, as a result, put the company at greater risk of cash flow problems or even insolvency.

Mezzanine financing is generally more expensive when compared to senior forms of debt. A carve-out can be difficult, particularly if it doesn't involve a separate operating unit, and the transaction may yield a less-than-hoped-for price that reduces the benefits of that deal.

Figure 1. Potential impacts and risks of financing alternatives

Option	Impact	Risk
Equity capital raise	Provides for cash without the burden of future debt service or other periodic payments	Potential dilution of existing shareholders – who may argue that new equity got too good a deal
Debt-for-equity swap	Preserves cash by reducing on-going debt service	Potential dilution of existing shareholders – who may argue creditors got too much value
Mezzanine financing	Provides capital, while attempting to better balance debt service and equity dilution	Potential for equity dilution and financial distress under the added debt burden – arguments by existing shareholders that equity upside in the financing is too rich or that debt service is too onerous
Carve-out divestiture	Monetize future cash flows of a business through a transaction	Accusations of fraudulent conveyance – lender arguments that the debt retained outweighs the value received in the deal

While board members sort through the options and try to decide on the best approach, investors also have issues to consider. Current shareholders, particularly in a distressed company, may feel compelled to provide additional capital (debt or equity) to protect their existing investment. Savvy institutional investors may view the challenges facing the company as an opportunity to step in with bridge financing.

Creating an environment for appropriate board review

Directors who face the task of evaluating and selecting among various funding options can take several steps to increase the likelihood of making a better supported recommendation:

Establishing objectivity and developing a well-developed process – Board members may face intense scrutiny of their financing decisions, especially when there is a real or perceived conflict of interest. It is therefore important to consider, with the assistance of legal counsel, establishing an independent committee when there are any real or perceived conflicts of interests. Whether an independent committee is formed or not, the board should evaluate funding alternatives using a reasoned, consistent process, keeping in mind that running low on cash or facing pending debt maturities may not be a good reason, in and of itself, for doing a deal. To the extent the board is considering a related-party transaction, additional measures should be considered when evaluating the alternatives available to the company through an arm's-length transaction, as well as any consideration given to stakeholders subsequent to the transaction.

Striving for transparency – To enhance credibility and accountability, it is important to disclose relevant information and circulate it to potentially affected stakeholders or people who may need to approve or otherwise weigh in on or challenge the deal, including shareholders, company management, and regulators. It is critical for directors to be able to demonstrate that they have used reasoned business judgment and completed a rigorous analysis prior to consummating or recommending a transaction to company shareholders.

Conduct an operational review – Boards can benefit from commissioning an advisor to help the board understand whether this is a "good" company with a "bad" capital structure or fundamentally a troubled company. Objective industry specialists can help peel back the layers of the onion to reveal the true source of distress.

Facilitating a fairness opinion

A fairness opinion can assist in demonstrating the board has exercised reasoned business judgment in selecting among financing alternatives and in executing its fiduciary duties. Steps that a board can take to support the provision of well-founded fairness opinion services include:

Engaging an advisor early – Initiatives to raise new capital are more fluid and unpredictable than a pure sales transaction. It is therefore a good idea to bring in advisors to look at the alternatives under consideration before a deal is consummated. Doing this may help raise potential additional avenues the board may want to consider, ultimately helping to substantiate that it has used a well-developed process.

Carefully choosing advisors – A primary consideration in selecting a fairness opinion advisor should be objectivity. The absence of advisor conflicts of interest and non-contingent fees for the opinion services help to demonstrate objectivity. The institutional strength and viability of the advisor should also be carefully evaluated.

Prudently scoping the opinion – Although a fairness opinion can be a valuable tool, it does have limitations. Ultimately, the board is responsible for understanding these limitations, defining the scope of the opinion, considering the methodologies the financial advisor proposes to use and, ultimately employs, managing conflicts, if any, that might arise from the process of rendering the services, and – above all – reviewing and understanding the analysis conducted by the advisor and the rationale behind the results.[2]

[2]Other considerations in the scoping of fairness opinion services are covered in: "Maximize The Utility of Fairness Opinions," Chris Ruggeri, reprinted from Directorship magazine, September 2008 (http://www.deloitte.com/view/en_US/us/Services/Financial-Advisory-Services/765a8ed08affd110VgnVCM100000ba42f00aRCRD.htm).

Along with being independent and having demonstrated institution longevity, an experienced advisor may bring insight to a broad array of fairness issues which may ensue as the transaction evolves. Using recognized methodologies, an experienced service provider can assist the board in its assessment of the multiple scenarios it may be facing during the decision making process.

Laying a solid foundation

With the mountain of corporate debt maturing over the next several years, many companies will be facing decisions on how to obtain the financing and liquidity needed to remain competitive or, in the extreme, viable. Carefully assessing the various alternatives can support making a sound funding choice. Then, once they decide how to proceed, good process, proper analysis, and a defensible fairness opinion can help boards demonstrate diligence in their decision process.