THE EVALUATION OF INDEPENDENT EXPERT'S ADVICE ON TAKEOVER OFFERS: AN ECONOMICS-FINANCE PERSPECTIVE†

by

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INTRODUCTION

Under s. 23 of the new Commonwealth *Companies (Acquisition of Shares) Act*, the National Companies and Securities Commission (NCSC) has the right to call for "independent expert's" advice on whether a takeover offer is "fair and reasonable". The NCSC defined the concepts of "expert", "independent" (or "association" of expert) and "fair and reasonable" in its Release No. 102. This release has been effective from 27th August, 1981, and already in a number of takeovers independent expert's advice has been sought on the "fairness and reasonableness" of takeover offers.

The objective of this article is to propose that the required valuation of the offeree company and the statement on the "fairness and reasonableness" on a takeover offer by an "independent expert" are unnecessary regulation of economic activity. This argument is based on the view that when the question of "whether to" regulate as opposed to "how to" regulate certain aspects of takeover activity is addressed, little or no justification and support can be found for an independent expert's advice on takeover offers.[1]

To develop the arguments of this article, a number of concepts are explicitly defined. The need to define these concepts arises from their frequent use in both academic and professional circles, but often they are used in different context. These concepts are: information, efficient and inefficient markets, independent expert and superior investment analyst.

Information is defined as any data, which affect the expected prices (returns) of shares. Information which is restricted to a small group of people is defined as inside information. Information which is freely available is defined as public information. This article will only be concerned with publicly-available information.[2] All the publicly-available information, which is relevant to forming expectations about the future returns of shares, is "labelled" as the total information set.

The concept of an efficient market can be simply defined in terms of informational efficiency. That is, a market is efficient if all information, which is relevant to the pricing of shares, is fully reflected in share prices. The efficiency of the Australian share markets has been extensively tested by using different sources of information such as past prices, earning announcements, dividend announcements, bonus issues and advice of investment analysts. Generally, the results indicate that: (i) the Australian share markets are efficient; (ii) current share prices fully reflect all past information, and (iii) no abnormal profit opportunities exist in the market.[3]

Despite the overwhelming empirical evidence of market efficiency in Australia, there are a number of investment analysts who question the validity of these conclusions.[4] Therefore, the analysis in the article is extended to include inefficient markets as well. A market is inefficient if all publicly-available information is not fully reflected in the share price that is, the current share prices are different from the true economic worth of the company. The share market may be inefficient for at least two possible reasons,[5] (i) shareholders and investment analysts have the total relevant information set, but they do not act upon it and/or (ii) shareholders and investment analysts do

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not have the total relevant information set, but only a subset of it (and they have different subsets of the total information set).

The notion of "independent" again can be defined with respect to information. A person is "independent" of a company, if he does not have any information beyond what is publicly available. An "independent expert" is a person with proven experience in investment analyses who has only publicly-available information.

"Superior investment analyst" is defined as an analyst who is utilising publicly-available information and can repeatedly forecast the future better than all other participants of the market.

Given the above definition of information, efficient and inefficient markets, independent expert and superior investment analyst, the article develops a number of scenarios based on different assumptions and demonstrates that in each there is very little justification for the advice of an independent expert. The next section of the article questions the need for the advice of an independent expert in both efficient and inefficient markets. The third section argues against the advice of an independent expert by proposing that it is impossible to define a general concept of "fair and reasonable" price. The final section proposes some tentative policy implications of the arguments.

THE ROLE OF AN INDEPENDENT EXPERT IN EFFICIENT AND INEFFICIENT MARKETS

The first scenario is that the market is efficient. In this case, the task of valuation of the offeree company by the independent expert is a simple task. The best possible estimate of the value of the offeree company is the last available market price. This is so because at any given time, the latest market price reflects all publicly available macro and micro information, that is, the total information set. The "catch-22" position of the independent expert is obvious; if he is a truly independent and expert person he has to accept the market price as the best estimate of the value of the offeree company. This is so because at any give time, the market price of a share reflects the consensus of opinion of all independent experts (that is shareholders and investment analyst) based on all publicly-available information. If there is a disagreement about the likely effect of all publicly-available information on the share price, the share would be traded to establish the new consensus price.

If the independent expert does not accept the last market price as the best estimate of the value of a share, then he is either not independent (that is, he has information beyond what is publicly available) or he is not an expert. As the best estimate of value in an efficient market is the last market price, which is readily available from many easily accessable sources such as daily newspapers, the additional report by an independent expert seems to be a rather unnecessary regulatory requirement.

The second scenario is that the share market is inefficient because shareholders and investment analysts have all public information relevant to the pricing of a share but do not act upon it.[6] In this case the last available market price would not reflect the true economic worth of the company, and there might be some justification for estimating the true value of the firm by an independent expert. However, even if the independent expert's valuation of the offeree company is correct and published, there is no reason to believe that investors would treat this public information differently from all the other public information and act upon it. That is, investors are either rational and act upon all information, or they are irrational and do not act upon information. Therefore the regulatory requirement of publishing an independent expert's opinion again seems to be unnecessary.

The third scenario is that the share market is inefficient, because shareholders and investment analysts do not possess all of the information relevant to the pricing of shares, but only a subset of the total information set.[7] Furthermore, different groups of shareholders and investment analysts may have different subsets of the total information set. The last available market price would not reflect the true economic value of the offeree company and there might be some justification for requesting the opinion of an independent expert on the true economic worth of a company. However, in this scenario none of the independent experts would have the total information set relevant to the pricing of shares either, and the valuation of any one of the independent experts could not reflect the true economic worth of the company. In fact, the valuation of a number of independent experts would lead to a number of alternative values even if their method of valuation would be identical due to the fact that they would have different subsets of the total information set. Therefore, in this scenario the publication of another "informed" opinion by regulation is unnecessary and rather misleading.

THE IMPOSSIBILITY OF A GENERAL CONCEPT OF FAIR AND REASONABLE

Under fairly restrictive and perhaps naive assumptions, it is possible to generate a fourth scenario, in which the advice of an independent expert is useful. In this scenario, it is assumed that: (i) the market is efficient; (ii) investors are rational and act on new public information; (iii) the independent expert is a "superior" investment analyst, and (iv) the independent expert does not engage in share trading as the result of his own valuation, but reports his own valuation in conjunction with the Part B Statement.

Given these assumptions, the report of an independent expert would be "new" information and its publication is likely to help investors in making their decisions about a takeover offer. However, even in this scenario, the independent expert could not advise the public whether the takeover offer is "fair and reasonable" to all investors.

Generally, the notions of fair and reasonable are not value-free concepts, but they depend on the attitude and the value judgements of individuals.[8] In the context of investments, the notion of "fair and reasonable price" would depend upon individuals' expectations about the likely future risk and return (or price) performance of a share. It is not at all obvious how a general concept of fair and reasonable could be determined. The economic-finance literature has addressed this question on numerous occasions, but to date could not provide a satisafactory solution to the problem. The professional literature also could not provide a pragmatic answer to this problem.

To illustrate this argument, consider two hypothetical investors, (i) the old lady in white tennis shoes, who lives on her dividend income, and (ii) a young dynamic executive, who has a high "salary package". It is unlikely that any investment adviser would suggest the same investment portfolio to these two investors, as they would have different risk and return preferences and accordingly, different investment packages for each may be considered as "fair and reasonable".

These two hypothetical investors are likely to be at the two extremes of the risk and return spectrum; between them there is an array of investors with each and every one with a unique risk and return preference.

In this scenario, the independent expert's advice may determine the economic worth (price) of a company, but not whether the takeover offer price is fair and reasonable. Individual investors make their own judgements on the basis of their risk and return preferences.

If all individuals' risk and return preferences could be aggregated and an overall risk and return preference determined for society, then the specification of a "fair and reasonable" price for all investors would be an acceptable notion. To date this problem of aggregation has not been solved either at the theoretical or pragmatic level. In fact, numerous arguments and supporting proofs demonstrate that it is impossible to aggregate individuals' risk and return preferences, in order to specify the overall risk and return of preference of society.[9]

Without the specification of the overall risk and return preference of society, the requirement to make a statement on the fairness and reasonableness of a takeover offer is therefore not only an unnecessary regulation, but an impossible imposition.

POLICY IMPLICATIONS

The policy implications of the arguments raised above are more difficult to identify. Policy decisions are the result of the interactions between disciplinary inputs (that is, economics, legal studies, administrative studies) and political processes. Nevertheless, on the basis of the above arguments, the following tentative conclusions may be derived:

(i) Future proposals of regulatory changes should first address the question of "whether to regulate" before probing the question of "how to regulate".

(ii) The onus is on the regulatory bodies and/or on supporters of the provisions of s. 23 of the new takeover Act to develop theoretical arguments and/or to provide evidence, which demonstrate the net benefit of an independent expert's advice on a takeover offer.

(iii) Given the current state of knowledge and in short of the evidence specified in (ii), the NCSC should ignore the provisions of s. 23 of the new *Companies (Acquisition of Shares) Act* and should not call for an independent expert's advice on the fairness and reasonableness of a takeover offer.

Whether the above policy recommendations are acceptable to the policy-making bodies and participants of the capital markets will primarily depend on their own subjective regulatory preferences.