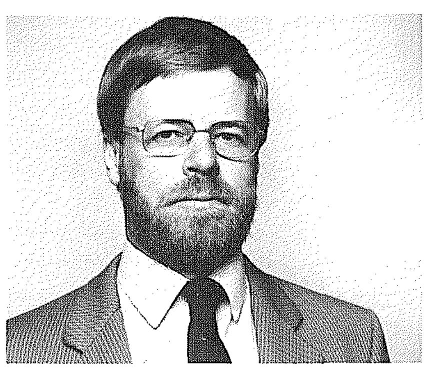
MAKING SURE THE PRICE IS RIGHT

HOW 'EXPERT' ARE THE INDEPENDENT EXPERTS?

by WAYNE LONERGAN and TOM FENTON



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In major corporate moves, minor shareholders often rely on the reports of independent experts. Do the shareholders always get a fair deal? Should experts be more rigorously regulated?

In view of the severity of the sharemarket crash we have witnessed an extraordinary amount of corporate activity relating to the privatisation of companies, the restructuring of corporate conglomerates and the rationalisation of assets and businesses. Much of this activity has involved the purchase or sale of shares or assets between companies or individuals who are not dealing at arm's length, or who are deemed to be associated under the Companies Act, 1981/Codes or the Australian Stock Exchange Listing Rules.

Such transactions often affect the interests of minority shareholders through the underlying value of their shares, the transfer of control of the company in which they have invested, or by requiring decisions on whether to hold their shares or sell to an offeror.

This paper examines the role of the independent expert in such circumstances and discusses whether the current debate over the independence of experts might be resolved:

- more practically, by ensuring fuller disclosure of all relevant information in Independent Experts' Reports (IERs) to minority shareholders;
- by more regulation and a tougher stance by the Australian Stock Exchange Limited, the National Companies and Securities Commission (NCSC) and the Australian Securities Commission (ASC); or
- by a series of writs against incompetent or biased "experts".

IERs are required to be presented to shareholders in a variety of situations under the Companies Act, 1981/Codes (Companies Code), Companies (Acquisition of Shares) Act, 1980/Codes (Takeovers Code) and the Australian Stock Exchange Listing Rules. They are most commonly prepared under sections 12(g) and 23 of the Takeovers Code and Listing Rule 3J(3); however, such reports are also required under sections 43 and 60 of the Takeovers Code and section 316 of the Companies Code.

The underlying principle of the Takeovers Code is that in a takeover, shareholders in a company should be offered full value, including a premium for control, for their shares. It is not the place of this paper to discuss the practical imperfections, and in some cases the commercial injustice, of assessing fairness against the existence of such egalitarian principles.

Section 12(g) allows a shareholder to obtain a controlling interest in a company without making a takeover offer, provided that the acquisition or allotment of those shares is approved at a general meeting by the other shareholders after being provided with an independent expert's opinion of whether the transaction is fair and reasonable.

NCSC Policy Statement Release No. 116 *(Acquisitions Approved by Shareholders)* provides guidance to the independent expert in relation to the

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preparation of such reports. The key question that the expert must address is whether the non-associated shareholders will be worse off if the transaction proceeds (or does not proceed). In making this assessment, the expert must consider the value of the shares being sold or allotted, compared with the value of the consideration being paid.

If the acquirer is paying a premium for those shares, then the other shareholders may be forgoing this premium in favour of the existing shareholder. Alternatively, they will be giving up the possibility, at least in the short term and possibly forever, of receiving premiums in respect of their own shares. Provided that shareholders are fully informed and aware that they may be forgoing such a premium, they can vote on the proposal after consideration of the other advantages and disadvantages of the transaction.

An IER is required, under section 23 of the Takeovers Code, to be included in a Part B statement by the directors of a target company in a takeover situation where the offeror is entitled to 30 per cent or more of the target company's shares, or where the offeror is a director or has common directors with the target company. The NCSC again provides guidance to experts in the recently revised Policy Statement Release No. 102 *(Experts Reports)*. This revised release now provides the financial community with stricter guidelines on the independence of experts based on the types of relationships between the expert, his client and the offeror, including guidance on communication between the expert and the target company before and during the preparation of the report.

Release No. 102 requires the expert, in providing an opinion as to whether an offer is fair and reasonable, to:

- assess the fairness of the offer by comparing the value of the offer price and the value of the securities which are the subject of the offer, without regard to the size of the holding in the securities by the offeror or its associates;
- assess the reasonableness of the offer by determining whether there is justification for the offer price on objective grounds after reference to the above value and with regard to the holding of the offeror; and
- consider the value of the securities by assessing the capitalisation of future maintainable profits and the realisable value of surplus assets of the company, the amount an alternative acquirer might be willing to offer if all the securities in the target company were available for purchase, and the amount that would be distributed to shareholders on an orderly realisation of assets.

In some cases, accountants and merchant banks have been less than professional and less than independent in the preparation of IERs.

The Companies Code, Takeovers Code and the Listing Rules recognise that conflicting interests (either real or apparent) may arise between a company, its directors and major shareholders. In such circumstances the minority shareholders of a company should be fully informed and have the information necessary to make rational decisions about the actions of directors and the disposition of their own shares.

In some cases, accountants and merchant banks have been less than professional and less than independent in the preparation of IERs. Accordingly, one of the major issues the revised Release No. 102 addresses is the independence or perceived independence of the expert. It has even been suggested that the NCSC maintain a panel of experts. While this has some superficial attractions, the NCSC is not infallible in the choice of acceptable panel members. In any event, such proposals suffer from the inherent objection that they discourage, or may even prevent new (competent) participants from entering the field.

Sceptics may suggest that no expert is independent, since he has received a financial advantage (ie, a fee) for providing the advice. This view is unrealistic: independence is not just a question of perception; it is a question of fact. No matter how strict are the standards forbidding conflict of interest, they can never eliminate biased IERs prepared by people whose lack of professionalism or whose greed permit them to give biased advice.

Further, although the regulatory authorities have focused on past or present commercial associations as a test of conflict of interest, there is a much more insidious potential conflict of interest where a purportedly independent expert's opinion may be coloured by the expectation of future commercial associations.

Real independence is a function of the state of mind of the expert. Professional investors in the marketplace are already aware of which so-called experts are to be treated with scepticism. Unfortunately, for the less-sophisticated investors and the less-experienced independent directors, finding out which experts can be trusted is often an expensive learning curve.

It will be some years before successful negligence writs will drive the biased and/or less-competent "experts" from the marketplace. Meanwhile, despite the current push for deregulation, the responsibility for monitoring reports and/or insisting on the appointment of independent experts remains with the ASX and the NCSC/ASC.

Good intentions

It is easy to appreciate the NCSC policy objective of providing all shareholders with the opportunity to share in any premium for control. However, the valuation criteria and the NCSC policy guideline that "in arriving at the latter, the percentage holding of the offeror or its associates in the target company should not be taken into consideration by the expert" do not reflect reality.

If an offeror already has control, the holders of the minority shares do not have it to sell. In fact, the shares subject to the offers are in practice likely to suffer a discount from their pro rata value as a whole.

The requirement that the values determined by the expert should ignore any applicable discount for minority interests can lead to unrealistic expectations by shareholders. While an indication of value could be given if control were available, the expert should be free to give his opinion about the "real" value, including any applicable minority discount.

The NCSC also considers that the expert should state whether the offers should be accepted. An expert would require an extraordinary amount of knowledge about the offerees to be able to make a recommendation suitable to all parties. For instance, the tax position of individual shareholders will vary significantly, depending on factors such as:

- whether the income will be taxable or non-taxable;
- whether capital gains tax will apply and the extent to which indexation might mitigate the result; and
- the need for taxable incomes or deductible losses to offset the effects of other transactions inherent in an individual's position.

Similarly, the financial condition and expectations of individual shareholders vary greatly and might affect decisions on whether an offer should be accepted.

Any amendment to the existing guidelines to require the expert to make such a recommendation would be unrealistic and would not consider the level of knowledge the expert will have about the individual investors to whom he is reporting.

Such a requirement would also result in an unacceptable level of responsibility and risk to the expert. Changes in market conditions subsequent to the date of the expert's report (eg, the October 1987 stockmarket crash or technological breakthroughs by competitors etc) or "market imperfections", which exist but which the NCSC guidelines require the expert to ignore, could result in the expert being the subject of litigation, with potential damages out of all proportion to the fees involved. This potential liability would result in increased costs, without any benefits to the offerees or the market generally, and would tend to discourage reputable, competent firms of substance from being involved in the preparation of reports.

Listing rules

Listing Rule 3J(3) requires shareholders to approve the sale or purchase of assets by a listed company, where the consideration payable or the value of the assets is greater than 5 per cent of that company's total issued capital and reserves, if such a sale or purchase is transacted with an associated party. The rule requires that in such circumstances shareholders must be provided with an independent report to establish whether the purchase or sale price is fair.

Unlike the NCSC, the ASX has not issued guidelines to assist experts in determining what criteria should be applied in assessing whether the consideration is fair. Fortunately, experts generally comply with the basic thrust of the NCSC guidelines.

It is clear that many situations require an independent expert to report to shareholders. Although the circumstances may vary, the underlying purpose of an expert's report is to provide shareholders with unbiased and objective information about the company or the asset which is the subject of a proposed transaction.

Parties to the transaction will often have access to the information necessary to make an informed investment decision. For example, a shareholder holding more than 30 per cent of a company who is bidding for all the shares in that company is likely to be in a controlling position and have information about the company that would not be generally available. It is the role of the expert to assess this information, to apply a stated valuation methodology in assessing the value of the company against the price being offered, and to form a view on whether the offer is fair and reasonable. It is also best market practice to set out in the report as much information as possible so that more sophisticated investors can form their own assessments of the proposals.

Unfortunately, in some cases the directors of a target company are uncooperative about disclosing information.

Unfortunately, in some cases the directors of a target company are uncooperative about disclosing information. Independent experts, in their reports, should fully disclose any limitations imposed on their access to information and set out fully in the IER their reservations. It is hoped that in such situations the appropriate regulatory bodies will act promptly and effectively to bring directors into line. Unfortunately, shareholder apathy is still such that shareholders cannot always be relied on to follow the advice: "If in doubt, vote no."

There may be legitimate situations where the disclosure of sensitive information may cause commercial damage to the target company or may be precluded by law. These latter cases are rare and can be dealt with on a case-by-case basis. As a general rule, claims that information disclosure would harm the target commercially should be treated with considerable scepticism.

Market participants

We can divide company shareholders into two broad groups:

- Sophisticated market participants – major institutional investors, stockbrokers and professional investors; and
- Unsophisticated market participants – small portfolio investors who do not have the capabilities or resources to analyse market information adequately.

If we assume that the market is fully informed, then market theory suggests that the sophisticated market participant will be able to analyse all available information and arrive at an informed investment decision. The pricing of securities or assets will therefore be efficiently reflected in the market.

The unsophisticated market participant is not able to analyse all available information and will, in theory, rely on the expert or, if the investment justifies it, have access to sophisticated financial advisers who can provide appropriate advice, provided sufficient information is set out in the IER. In practice, far too many unsophisticated investors do nothing, and this increases the responsibility of the independent expert.

Differences will, of course, arise from the assessments made by sophisticated market participants and advisers because of differing methodologies and differences in judgment. If, however, an offeror is acting on information which is not available to the public, then rational investment decisions on an equal footing cannot be made. It is the duty of the expert, through his report, to ensure that all of this information is placed into the public domain. It is also the duty of the expert to explain to less-sophisticated market participants the significance of the information and to form an independent view of the merits of the proposal.

Conflict between the desirability of disclosure and claims that it may be detrimental to the operations of the business occur particularly in the case of profit forecasts.

In such circumstances the shareholders must rely heavily on the judgment of the expert. The expert must decide whether in fact the release of the information may be detrimental to the company and to what extent management's profit forecasts are unduly optimistic (if management are sellers) or pessimistic (if management are buyers).

Future profitability is perhaps the most difficult and crucial area for an expert to assess. Not only do profit and cashflow forecasts often give the best indication of the underlying value of a business; they are also a potential minefield for the independent expert.

Profit forecasts must be vetted by the NCSC if used in an IER under section 23 of the Takeovers Code. There is a duty of care on both management, in preparing forecasts, and on experts, in reviewing and including them in their reports.

Non-disclosure of profit forecasts in the IER does not diminish the expert's duty of care. The mere fact that management has made a forecast of profitability, regardless of whether the expert discloses such a forecast or relies on it, places an obligation on the expert to assess the forecast.

As a minimum, the expert should:

- review the assumptions used in the profit forecasts, particularly in relation to external economic factors;
- ensure the forecasts have been accurately compiled;
- ensure the forecasts have been compiled on the same accounting basis as the historical results;
- discuss the forecasts with senior management to ascertain their reasonableness;
- corroborate the forecasts, whenever possible, with external information; and
- review past forecasts and historic results to assess the reliability of forecasting procedures and the reasonableness of the projections.

If the expert then considers that the forecast is implausible, any reservations should be stated in the IER.

Summary

An IER is not a black box, with company information being fed into one end and a perfect result coming out of the other. There are inherent limitations in any IER:

- most of them are prepared quickly (within about two weeks);
- the criteria against which fairness and reasonableness are assessed are laid down by the NCSC and are not always commercially realistic;
- there are often statutory limitations on the level of disclosure that may be made; and
- if independent experts were infallible they would all be retired and living on the Riviera.

Added to the existing difficulties, the preparation of the IER may be hampered by self-interested directors, incompetent experts or biased experts.

The independence of an expert becomes a much more relevant issue if there is a lack of critical company information in the IER to enable others to make objective decisions. Independence is also critical where there are relatively few sophisticated market participants as shareholders and where they control the company or will control the company if the transaction proceeds.

That is why "full disclosure" in IERs should be encouraged, and in fact insisted on, by the regulators. If full disclosure is made then investors, particularly the sophisticated market participants, can make their own evaluation of the company or its assets using the same information that is used by those participating in the transaction.

No matter what rules are set by the regulatory authorities, independence is a function of the state of mind of the expert. There are already far too few real experts in the marketplace. Excessive concentration on the question of apparent (as distinct from real) independence may have the inadvertent result of forcing independent directors to seek advice from those inadequately qualified to give that advice.

In closing, we set out some general rules for directors:

- Reputable directors should not employ unknown, unproven or incompetent "experts" (no matter how smooth their sales-pitch is).
- Experts should be paid on an hourly basis, at a remuneration level sufficient for them to do their job properly (shopping for the cheapest quote is to be abhorred).
- Experts must be independent as a state of mind (ask them when they last said a transaction was not "fair and reasonable").

And for the experts:

- As an expert, if your reputation is not worth more than the fee you are getting for an IER, your reputation is not worth much.
- Disclose all relevant facts and material associations in as much detail as practicable.
- Tell it like it is (and be prepared to make unpopular decisions).

Directors and experts have already been on the receiving end of legal actions. If they are not careful, there will be many more actions before the current economic downturn is over. □

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