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Code Word

 TAKEOVERS PANEL

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Independent Advisers

The Takeovers Panel has published a third edition of its *Guidance Note about the Role of Independent Advisers for the purposes of the Takeovers Code*. This edition of Code Word explains the Panel's thinking behind the new edition.

Key points

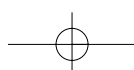
- The Panel suggests that it is not appropriate for takeover offers or Code transactions to be described by the independent adviser as “fair” or “not fair”. Instead the adviser's report should set out all the merits of the particular offer or transaction.
- Where a subcontractor is required to assist an independent adviser with the preparation of a particular Code report the primary adviser should select that subcontractor (who will form part of the Panel's approval) who must meet the same standards of competence and independence as the primary adviser.
- Where an adviser is giving advice in relation to a partial takeover offer, whether for the bidder to reach more or less than 50% of the voting rights of the Code company, the Panel suggests that the adviser should pay careful attention to all the merits of the offer, including the impact on immediate and future potential changes of control.
- The Panel's view of the independence of advisers when a bidder makes two takeover offers for the same company in quick succession.
- The Panel's *Guidance Note about the Role of Independent Advisers* has been updated and a new version is now available on the Panel's website.

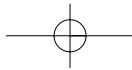
Introduction

One of the key features of the Code is the importance placed on the role of independent advisers in relation to most Code transactions, that is takeovers, acquisitions, allotments, and buybacks. Generally where a shareholder is to increase its control percentage in a code company above the 20% level an independent adviser will be required to give a report on the “merits” of the takeover offer or Code transaction. The report will be addressed to the shareholders who are either receiving the takeover offer or who have the right to vote on a shareholder resolution where another party is seeking to increase its level of control.

The Panel approves each appointment of an independent adviser for the Purposes of a Code transaction. In the first six years since the Code came into force the Panel has considered some 260 applications for approval of advisers, 231 of which were approved. The Panel pays careful attention to both the competence and independence of advisers when their proposed appointment is put forward for approval. The Panel also considers the competence and independence of any subcontractors who will be assisting the primary adviser.

The Panel reviews the content of reports produced by independent advisers. For some time now the Panel executive has been reviewing draft reports before they are sent to shareholders. The executive often proffers suggestions and comments to the adviser on ways in which the report can be improved.





Such comments may relate to the description of Code issues or the comprehensiveness of the discussion on the merits of the proposed takeover or transaction. They will not relate to the adviser's methodology or valuation analysis.

The Panel's aim is to see the continual improvement in the standard of reporting by independent advisers while at the same time broadening the number of advisory firms able to undertake Code assignments.

Based on its early experiences with the review of draft and completed independent adviser reports the Panel decided that it should give some guidance to the independent advisers as to the scope and content of reports required for each type of transaction under the Code. The Panel published the first edition of its *Guidance Note about the Role of Independent Advisers* in March 2003. This was followed by the publication of a second edition in July 2003 incorporating helpful comments received from the market.

In general the feedback on the Panel's guidance note has been positive. Some advisers found the guidance particularly helpful as they were able to point out to prospective clients the scope of reports required under the Code.

With the benefit of more recent reports and feedback from the advisers themselves the Panel decided to further revise its guidance note. The third edition has been published and is available on the Panel's website. The new edition incorporates additional comment on four particular areas:

- an excessive emphasis by independent advisers on the "fairness" of transactions;
- the appropriate relationship between an independent adviser and any subcontractor required to assist the independent adviser in undertaking adviser assignments under the Code;
- the need for clarification in relation to the way independent advisers comment on the merits of partial offers;
- the question of independence of advisers when a bidder makes successive offers for the same target company.

These issues are discussed in turn.

The evolution of independent adviser reports and the use of "fairness"

When the Code started in operation in 2001 the concept of a "merits" report was new to most advisers. The experienced

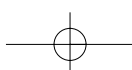
advisers had been routinely involved with reporting to the New Zealand and Australian stock exchanges as independent appraisers on transactions where the usual requirement of the respective listing rules was that the appraiser should express a view on the "fairness" of transactions to the relevant shareholders.

For Code purposes the advisers' reports typically open with a discussion of the offer and of the target company and its sector of operations. They usually include a valuation of the target company, generally using the recognised valuation method considered most appropriate by the adviser. The reports generally conclude with an evaluation of the "merits" of the offer.

Up until recently the first, and usually highlighted, part of the merits section of the report involved a comparison between the adviser's valuation of the target company and the offer price. If the offer price came within the adviser's valuation range then the adviser would describe the offer as "fair". If the offer price was below the adviser's valuation range then the offer would be described as "not fair".

This approach influenced the takeovers market in a number of ways:

- the advisers' emphasis on offer price versus assessed value as the determinant of "fairness" made price appear to be the most important issue in a takeover, rather than being just one of a number of merits;
- independent directors of a target company generally would not recommend acceptance of an offer that was "not fair". In a number of cases the consideration given under takeover offers was increased to within the independent adviser's valuation range so that the target company's independent directors could then recommend the offer to shareholders – largely ignoring consideration of the wider merits of the offer;
- offerors would use a conclusion of "fair" in relation to an offer price as an argument for shareholders to accept their offer despite the offer otherwise being considered unmeritorious by the independent directors.
- there is anecdotal evidence that directors of some companies have been relying too heavily on the analysis work of the adviser rather than developing their own fully considered views on a particular offer.
- the media would generally concentrate on the summary statement by the adviser that "the offer is fair" (or "not



fair”) when reporting on an offer. Few would pay much attention to the other merits of an offer;

- there is anecdotal evidence to suggest that the “fair” description is quite influential with many shareholders when deciding whether or not to accept an offer. It seems to be difficult for a shareholder not to accept an offer when he or she is told by an independent adviser that it is “fair”.

Because of these influences the Panel became increasingly concerned at the emphasis in independent adviser reports on the “fairness” of offers.

The Panel recently began encouraging independent advisers to discontinue referring to and emphasising the “fairness” of offers and instead to present a more balanced view of the merits (that is, the pros and cons) of the offer. Encouragingly, most recent independent adviser reports on takeover offers have avoided use of the term “fairness” when opining on the price given under an offer.

While the price offered by a bidder as compared with the adviser’s assessment of the value of a target company will always be an important merit of an offer, it should not necessarily be the determining factor of acceptance or rejection. For example, the ceding of both immediate and potential future control to the bidder, particularly in the case of partial offers, may well be far more important than the price which the bidder is proposing to pay to achieve that level of control. (Partial takeovers are discussed in more detail later in this article.)

The Panel looks to the directors of target companies to also, themselves, properly address the merits of the offer and give comprehensive and helpful recommendations in the target company statement that is sent to their shareholders. The Panel sees this as an important part of the duties of target company directors.

The Panel’s guidance note has been amended to suggest to advisers that they not refer to the “fairness” of an offer in their Code reports except in circumstances where the primary purpose of the report is in relation to the consideration that is likely to be payable on the compulsory acquisition of shares in the target company.

Use of subcontractors by approved independent advisers

The second issue that has been of concern to the Panel has been that of the use of subcontractors by independent advisers, particularly where there is a special skill required that the approved adviser does not possess.

The term “subcontractor” as used here generally means a professional who has a specialised skill outside of the usual skills possessed by an independent adviser, and who will be reporting to the shareholders of the target company as part of the independent adviser’s report.

Although it is the responsibility of the target company board to appoint an independent adviser, that appointment must be approved by the Panel. The Panel carefully considers both the experience and the independence of an adviser put forward for approval.

In some cases it is apparent that the adviser will need specialist help with a particular aspect of an assignment. One example may be that the target company operates in a specialist field such as mineral exploration. Another example may be that the most important aspect of the takeover is that it will result in a change of legal form of the investment (for example conversion from shares in a company to units in a unit trust).

In such cases the firm to be appointed as the primary adviser may need additional assistance, such as specialist mineral valuation advice, specialist legal advice, or specialist financial advice. The person or firm providing this specialist assistance will be a subcontractor to the principal independent adviser and their contribution will be identified and attributed in the adviser’s final report.

When the need for such subcontracted assistance arises the Panel expects to see the same standard of competence and independence observed by the subcontractor as for the primary adviser. Detail about any proposed subcontractor should be provided to the Panel along with the original application for the primary adviser’s approval. The Panel will satisfy itself as to the competence and independence of the subcontractor before the primary adviser is approved, and the Panel’s approval of the primary adviser will be given on the basis that the named subcontractor carries out a particular role.

The Panel’s view is that the choice of subcontractor is one which the primary adviser (and not, for example, the target

company) must make. The primary adviser retains ongoing responsibility for the advisory role throughout the Code transaction. The subcontractor must, like the primary adviser, satisfy the Panel that it is suitably qualified and independent.

In a recent case the adviser seeking the Panel's approval proposed to use a specialist company to provide valuations of the particular assets of the bidder and the target (it was to be a scrip bid). The primary adviser was to be assisted by a specialist asset valuer who was in turn to be assisted by two experts with a close knowledge of the company. One of these experts was closely associated with the target company (named in the annual report). The Panel had to point out that the primary adviser had to be independent and could not use as subcontractors experts too closely associated with the target company.

The Panel's guidance note has been amended to make it clear that the Panel expects the primary adviser to choose its own subcontractors and that its choice should not be dictated by the target company or any other party to the takeover or transaction.

Comment on partial offers

The third issue of concern to the Panel relates to the content of reports about partial takeover offers.

The ability to make partial offers in a takeovers market regulated by a code is unusual in a global context. Most regulated takeover markets do not allow for partial offers.

Under the New Zealand Code bidders have the ability to make offers which give them the minimum of legal control (i.e. a holding in excess of 50% of voting rights). They also have the ability, with the consent of the majority of the remaining shareholders (that is, those shareholders other than the bidder and its associates) to make an offer that would result in the offeror holding between 20% and 50% of the voting rights in the target company.

Partial offers – minimum legal control

A partial offer that allows a bidder to increase its holding to 50.01% could confer considerable benefits on that bidder. The independent adviser opining on the merits of the partial takeover needs to consider the impact on shareholders of these benefits as well as on the merits for the shareholders. They

could include:

- the bidder will have legal control of the company for the minimum of outlay. In particular, any premium for control will only have to be paid to those shareholders who accept its offer and then only to the extent that their shares are acquired by the bidder. The Code's scaling rules will impact on the take-up from each shareholder;
- the bidder will be put in a position where it is able to "creep" at the rate of 5 percentage points of control each year (after the first twelve months) without having to make an offer to all shareholders or require their consent for future acquisitions;
- there is probably much less likelihood of a successful takeover offer being made for the target company in future because of the controlling stake held by this bidder. Any future takeover offer that is made is likely to be on terms and with timing to suit the now majority shareholder;
- the acquiring of control by a new majority shareholder may well provide new direction and drive as well as stability and financial support for the company into the future. To provide appropriate comment in this area the adviser should try to ascertain the intentions of the offeror for the target company in the event that its partial offer succeeds. If the offeror will not provide this information the adviser should note its report accordingly.

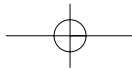
The bidder making only a partial offer will be aware that, as the majority shareholder, it will have to take account of significant minority interests in all the decisions it makes and would not be assured of the ability to pass special resolutions.

Partial offers – less than legal control

Special considerations apply if the bidder is seeking to make an offer that would result in it holding between 20% and 50% of the voting rights in the target company. In such a case the offer document must be accompanied by a separate approval document which offerees should complete and return to the target company before the end of the offer period.

In the case of a partial offer requiring shareholder approval the adviser will need to report to shareholders on both their right to vote for or against the partial offer and their ability to either accept or reject the partial offer.

An independent adviser's description of a partial offer as



“fair”, on the basis of price, is particularly problematic because either relatively few shareholders will get the benefit of any premium paid by the bidder (because of a low number of acceptances) or, if there are a large number of accepting shareholders, the premium will be well spread. All continuing shareholders will experience the consequences of being minority shareholders in the ongoing company.

It is important that independent advisers give a balanced analysis of all aspects of partial offers to ensure target company shareholders are fully apprised of all the control and other issues. These issues may include the benefits that continuing shareholders will get from remaining in the company with a new controlling shareholder.

Where an offer is being made for 50% or less of the voting rights in the target company the quality of the adviser’s advice is particularly important because shareholders have two decisions to make.

It may be in shareholders’ best interests to both vote against a partial takeover because the bidder would achieve effective control of the target company while, at the same time, also to accept the offer. If the offer is approved and succeeds, the shareholder will at least sell some of his or her shares.

On the other hand, if a shareholder is comfortable with remaining a minority shareholder in a company effectively controlled by the bidder because of the benefits the shareholder considers the bidder will bring to the target company, then it may well decide to approve the partial takeover but not accept the offer.

The guidance note has been amended to include additional suggestions for independent advisers in relation to their discussion of the merits of partial offers, including those for 50% or less of the target company’s voting rights.

The independence of advisers when successive offers are made by the same offeror for the same target company

During the period of the Code’s existence there have been a number of occasions where bidders have made successive offers for the same target company. In the initial years these “follow-up” offers tended to be made a year or more after the first offer had failed to achieve total control for the bidder. However over the past two years some follow-up offers have been made very soon after the closure of the first offer. There is no restriction in the Code on how soon a follow-on offer can be made after an earlier offer has closed.

In two of these follow-on takeovers the same independent adviser was approved by the Panel to prepare the independent

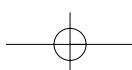
adviser reports under rule 21 of the Code as had prepared the first report. However, in another case, the Panel declined to approve for the second report the adviser who had prepared the first rule 21 report.

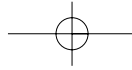
This decision was no reflection on the competence or integrity of the particular adviser. Instead, the decision reflected a number of factors including:

- that this was the last independent adviser’s report that shareholders would receive before compulsory acquisition was initiated, and outstanding shareholders could have the right to object to the compulsory acquisition price;
- the proximity between the time of preparation of the two reports;
- the fact that there had been no significant change in the business, circumstances or prospects of the company through the period covered by the two offers;
- the fact that the offer price for the second offer was above the top of the valuation range in the first report;
- whether the shareholders were likely to benefit from receiving an adviser’s report prepared by a different advisory firm.

Every application for approval of an independent adviser is considered on its merits and in the particular circumstances of the transaction. Where the transaction is a follow-on cash takeover offer for a Code company being made in close proximity to an earlier offer, and the offer is expected to reach the compulsory acquisition threshold, then it is likely that the Panel would not approve the same adviser to prepare the rule 21 report on the final offer that it had approved to prepare the rule 21 report on the previous offer.

The third edition of the Panel’s *Guidance Note about the Role of Independent Advisers* involved in Code transactions is now available on the Panel’s website www.takeovers.govt.nz.





New Members

The Minister of Commerce announced the appointment of three new members Pip Greenwood, Keith Taylor and John Waller to the Takeovers Panel in December last year. Members of the Panel are appointed by the Governor-General on the recommendation of the Minister for a term of five years.



Pip Greenwood

Pip is a partner at Russell McVeagh specialising in securities offerings, mergers and acquisitions, takeovers and general corporate advisory work. She is a member of Russell McVeagh's board of management.



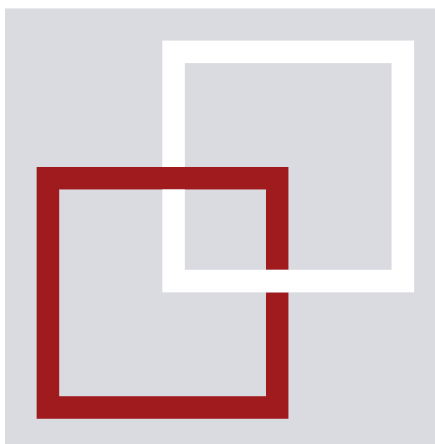
Keith Taylor

Former Tower Chief Executive, Keith Taylor has considerable experience gained over many years in the corporate world.



John Waller

John has in-depth commercial experience from his role leading the PricewaterhouseCoopers Advisory Division. He is a member of the PwC New Zealand board.



If you wish to receive Code Word in hard copy or by email please contact poly.banerjee@takeovers.govt.nz

HOW TO CONTACT US

Takeovers Panel
Level 8, Unisys House
56 The Terrace
PO Box 1171
Wellington
Phone: 64 4 471 4618
Fax: 64 4 471 4619
Email: takeovers.panel@takeovers.govt.nz
Website: www.takeovers.govt.nz

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