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The Risks in Experts' Reports: A Merchant Banker's Perspective

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SUMMARY

Experts' reports are increasingly being challenged in order to delay or defend takeover offers and corporate reconstructions. In addition to legally challenging the Part A Statement, one of the first things a target looks to for guidance in a contested takeover is the expert's report. Ironically, companies that are slow on continuous disclosure or in pursuing shareholder value enhancing strategies, are sometimes the quickest to disclose all to the expert as a means of enhancing value as a takeover defence. As a result, the expert is becoming a more prominent player in the completion of major corporate transactions and therefore faces increasing scrutiny and consequently more risk. They face the risk of damage to reputation and even court action if they are not able to adequately justify the manner in which they undertook the role, their methodology or their conclusions.

Not only are bidders, targets and parties subject to takeovers paying more attention to experts' reports but the corporate regulators are also looking at them more closely to ensure shareholders are fully and adequately informed and sometimes that the methodology is appropriate. In some instances, the Australian Securities and Investment Commission (ASIC) has engaged its own expert to review publicly released expert reports to ensure minority shareholders are protected.

The expert needs to be aware of all potential risk areas in preparing the report, not only for the serviceability of the document, but also for the protection of his or her reputation. In the back of his or her mind, it is wise to ask how he or she would justify an action, an approach, a methodology or a conclusion if he or she were being cross-examined in court.

In this paper I look at some common issues faced by merchant bankers in preparing experts' reports and describe our suggested

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approach to some of them. While the majority of the issues discussed in this paper are common across industries, I have used the gold mining industry as an example for many of the points made. In addition, I have described our approach to one of the more contentious issues in any expert report; the determination of the control premium, taken from our recent expert's report for Great Central Mines Limited.

BACKGROUND

Prior to investigating the risks in expert's reports it is pertinent to explore the definition of an expert, his role and requirements.

Who is an Expert?

The most authoritative definition of an expert is contained in ASIC Practice Note 43, where

> "an expert, in relation to a particular matter, is a person whose profession or reputation gives authority to his or her statements in relation to the matter. Whether a person's profession or reputation gives such authority to his or her statements is a question of fact".

In practice it is common and sensible to make qualifications explicit in the report. For example, we clearly state the services we as a merchant bank provide which includes corporate valuations and experts' reports, name the persons primarily responsible for the preparation of the report and state their experience and that each is an authorised representative of SG Hambros pursuant to its Dealer's Representative Licence held under Pt 7.3 of the *Corporations Law*. In addition, we name those additional persons who have assisted in the preparation of the report.

When is an Expert Report Required?

The role of an expert is based on the *Corporations Law* principle that an expert

> "will be able to provide security holders of the target company with an objective and disinterested view and provide them with sufficient information to make an effective, informed decision. The role of the expert requires them to provide security holders with a report that is as simple, clear and as useful as possible".

There are ostensibly two chapters of the *Corporations Law* referring to mergers and acquisitions of companies that may raise the need for the provision of an expert's report:

- Chapter 5, which relates to Schemes of Arrangement; and
- Chapter 6, which relates to the acquisition of shares. This chapter is designed to ensure that certain basic rights of shareholders are protected under a change of control. Those rights are set out in s 731 which states that "the Commission shall take account of the desirability of ensuring that the acquisition of shares in companies takes place in an efficient, competitive and informed market".

Within each of these chapters there are various sections which raise the requirement for an expert's report. We generally rely on legal advice and the written instructions from our client in determining the precise legal requirements of a report. Apart from not being lawyers, we are usually responding to a deal that has been structured and set some time before and therefore there is often little chance to become involved in structuring the deal even if one had an appetite to do so. In any case, as discussed below, getting involved in the structuring of a transaction will jeopardise the expert's real or perceived independence.

The Australian Stock Exchange (ASX) Listing Rules also require independent experts' reports in various situations. For example, where a substantial asset is acquired from or disposed of to a related party, substantial shareholder or an associate, ASX Listing Rule 10 requires an independent expert to state whether in his or her opinion a transaction is "fair and reasonable" to shareholders not associated with the transaction.

RISKS AREAS

As stated, the expert is usually engaged to prepare a report to assist a group of shareholders. However, in undertaking that role the expert is required to make a number of subjective judgments. While Policy Statements 74 and 75 and Practice Notes 42 and 43 provide some methodological guidance for experts, they do not precisely define methodology. As a result, experts are called upon to make judgments guided by their knowledge and experience, with market practice generally playing a large role in defining correct methodology.

Many of the valuation issues involve the expert making a subjective judgment which may be disputed in the press and in court. Different experts can commonly come to different conclusions on

some of these issues based on the same set of facts; especially if this is done at a desk without access to the physical assets, operations and people. What is therefore important is that the expert fully and logically explains his or her reasons for any conclusions drawn. In this report I describe some of the more common risks faced by merchant bankers in preparing experts' reports, including:

- the distinction between an "independent expert" report and an "expert" report and the implications of this distinction;
- the importance of the engagement letter and information gathering stage of the assignment;
- the reliance on technical experts;
- the definition of "fair and reasonable" and "in the best interests of"; and
- common valuation issues, including determination of the gold premium in gold company valuations, the discount rate and control premium.

The ASX and to a lesser extent the ASIC will sometimes discuss some of these issues on an informal basis during the preparation of the expert's report. This provides the regulators with time to review potentially contentious issues without delaying the release of the report, provides comfort for the expert that the methodology and approach will not be challenged by ASIC, and allows the expert to fully explain their approach in a more conciliatory atmosphere. Unfortunately, approaching the regulators is something often objected to by the client for various reasons unrelated to the expert's report.

Independence

I describe above some of the circumstances in which the *Corporations Law* and ASX Listing Rules require the preparation of an expert's report. However, there is a subtle but important distinction between two types of expert reports which may be required.

It is a common misconception that all experts' reports are required to be "independent". This is not the case. For example, s 648 of the *Corporations Law* requires, where the offeror is entitled to not less than 30 per cent of the target's voting shares or there are common directors between the offeror and the target, the target company to send a report by an expert with the Part B Statement. Section 648 does not require an "independent" expert to prepare the report.

Contrast this with s 411, which requires the preparation of "an independent expert's report" in certain Schemes of Arrangement and ASX Listing Rule 10 which requires a report from an "independent" expert.

The implications of this distinction are important:

- where there is no requirement for the expert to be independent, and the expert does not purport to be independent, we would advise that the report not be described as an "independent" expert's report. If the report is described as an "independent" expert's report, it will be required to satisfy all the requirements of "independence" (some of which I describe below). Nevertheless, there are instances where a company prefers to have an independent expert prepare a report regardless of whether or not it is necessary;
- where a report is prepared under s 648, the expert is required by Policy Statement 75 to disclose the existence of any other business relationship with the offeror or the target company or any of their associates which, while not precluding him or her from acting as an expert, would be material to assessing the expert's impartiality. Some of these business relationships may have precluded the expert from being regarded as an "independent" expert. The expert should also disclose any intention to establish future business relationships with the offeror or target;
- no matter whether the report is independent or not, the law may set specific restrictions on the expert. For example, under ss 648 and 703 the expert may not be associated with the offeror or target company, as defined by Div 2 of Pt 1.2 of the *Corporations* Law.

However, it is also important to note Policy Note 43, which states that "The ASC considers it highly desirable that all experts or valuation reports involving the exercise of judgement or opinion should be provided by *independent* experts, whether or not the Law specifically requires that independence".

The *Corporations Law* does not define independence, and I will leave the precise legal implications of independence to the lawyers. However, Practice Note 42 describes various issues to be considered in determining whether or not an expert is independent. For example, the ASIC is likely to consider various factors which indicate a lack of independence, including where (in descending order of seriousness):

- the expert is present at discussions on the development of the proposal;

- the instructions the client gives to the expert to evaluate the facts relevant to writing the report, or indicate how the facts should be evaluated;
- the client has rejected other experts after they have disclosed their likely approach to evaluating the proposal;
- the expert is commissioned to prepare a report before the proposal to be reported on is finalised; or
- the expert begins to write the report before the proposal is finalised.

In relation to independent expert reports, Practice Note 42 suggests that the expert should be independent from the time that the client first approaches him or her to prepare an expert's report until the client publishes the final version of the report for its required purpose. This raises several important issues for the expert during the initial stages of an engagement.

Engagement and Information Gathering

The actions of independent experts during the initial stages of the engagement have come under close scrutiny by the courts, starting with *Phosphate Co-Operative Company of Australia Ltd v Shears (the Pivot* case).[1]

It is interesting to note that in the *Pivot* case the expert was not required to be "independent". However, by naming the report an "independent expert's report", the court ruled that the expert should be required to comply with all the requirements of independence.

Practice Note 42 describes a number of factors the independent expert should consider, most of which is based on the decision in the *Pivot* case. Essentially, the parties must avoid any conduct which could suggest that the client has shopped around for an expert who will give a favourable report based on the client's (or its adviser's) evaluation of the facts. To avoid this (and the appearance of this), the client should give the expert written instructions.

The written instructions should outline:

(a) the reason for the report;
(b) the facts of the proposal; and
(c) data (or the means to obtain the data) relevant to the report.

We suggest that the expert takes all these into careful consideration when drafting the initial engagement letter. We prefer to receive written instructions from the client and/or to include a detailed

[1] [1989] VR 665; (1988) 6 ACLC 1046; 14 ACLR 323.

description of the requirements for the report and the fee structure in the engagement letter.

Practice Note 42 also provides a number of guides regarding independence which the expert must carefully follow during the initial stages of the engagement. For example:

- the client and the expert should both keep accurate written records of their communications;
- it is appropriate for the client and a prospective expert to discuss matters other than the substance of the report (such as the expert's fee, availability and printing deadlines) before commissioning a report. However, discussion of layout may bring independence into question if the expert highlights positive factors in the report and reduces the prominence of negative factors or disguises them. The expert should not discuss the merits of the proposal or the appraisal method to be employed before the client has commissioned him or her;
- the amount the client pays the expert for the report should not depend on the success of the event or proposal to which the report relates. An expert who is paid a success fee will not be considered independent;
- it may be acceptable for the client to state the desired conclusion of the report. However, the ASIC considers that, if this statement were accompanied by the client's analysis of the facts, it would be contrary to the judgments in the *Pivot* case;
- the client should not presume to determine what data or information is required for the preparation of the report. That is for the expert to do. The client, which is often the best source of information for the expert, should give the expert all the information it is aware of which may relate to the subject of the expert's report, in sufficient detail to enable the expert to determine its relevance;
- the expert should not be bound to provide a report in case the client does not provide the expert with the information (or access to the information) reasonably necessary to enable him or her to prepare the report;
- an expert should avoid discussions with the client on the appraisal method to be used in preparing the report because they "may undermine, or appear to undermine, the independence of the expert".[2] If the expert has discussed the appraisal method or the substance of the draft report made with the client before signing it, he or she must negate any perception of bias. The expert

[2] Page 4.

should make notes during the discussions in order to do this. He or she should also disclose the nature and result of the discussions in the report so that readers can assess the report's independence for themselves. The expert should also keep all drafts of the report so that he or she can demonstrate changes made during its preparation and the reasons for them (to contradict any inference of bias); and

- the expert may need to supply the client with a draft of part of a report that only reviews the facts of the proposal, so that the client can correct any errors of fact. As stated in the *Pivot* decision: "It is one thing to submit to a client or third person acting on behalf of a client a draft of that part of the report which reviews the facts. This may well be perfectly proper and perfectly safe and, indeed, desirable, but to submit a draft of argumentative matter or of reasoning is, I think, asking for trouble."[3] In practice, we prefer to only provide drafts of the report which do not give a final conclusion until the report is signed and completed.

In addition, experts need to be aware of the jurisdiction of shareholders as companies may have joint listings or other tradeable securities such as American Depository Receipts on overseas stock exchanges. In our experience, providing Australia is the target company's home exchange and that the majority of the target company's shares are traded in Australia then adherence to the relevant Australian statutory requirements for experts will generally satisfy the requirements of the international statutory authorities. However, we are not lawyers and recommend that experts retain legal advice as to the reporting requirements of other jurisdictions if applicable.

As a practical matter, we have been involved in the preparation of expert's reports before the transaction has been announced to the market. This is more common in Schemes of Arrangements which are more likely to be negotiated prior to the finalisation of documentation. In such instances, the expert needs to be extremely careful not to be placed in the position where he or she can influence the structure of the deal. The expert needs to adopt the same process as that summarised above in obtaining written instructions on the reason for the report and the facts of the proposal. The expert should report only on the facts of the proposal and should those facts change, the expert should clearly detail in their report the change in those facts.

Many of these risks can be minimised by carefully drafting the engagement letter, and in particular, wording the indemnity section to incorporate these factors. In addition, it is crucial for the expert to

[3] *Phosphate Co-Operative Company of Australia Ltd v Shears* [1989] VR 665; (1988) 6 ACLC 1046; 14 ACLR 323.

maintain comprehensive files of all documents provided either from or to the client, and keep copious notes on all discussions with the client as proof of adherence to these guidelines. Finally, the report should document any changes to the facts.

Reliance on Technical Experts

To assist in the valuations usually included in expert reports, merchant bankers often engage a technical specialist to assist in specialist areas of valuation. The most common example is the use of mining specialists to assist in valuing mining and exploration assets. This is consistent with ASIC Practice Note 43, which envisages the appointment by experts of technical specialists when valuing specific assets.

The expert must be satisfied that the technical specialist:

- is competent and uses assumptions and methodologies which seem reasonable; and
- is clearly briefed.

There are no set rules defining the roles to be undertaken by the technical experts. In relation to mining valuations, we generally prefer the technical specialist to review the company's resources and costs of production and prepare a cash flow model which forecasts net cash flows from mining operations. We generally take responsibility for the calculation of an appropriate discount rate to apply in their cash flow model, the forecast of any corporate overhead costs and the subsequent adjustment for other assets and liabilities outside the operations which are not valued by the model.

In addition, we have used technical experts to assist in valuation issues which are particularly controversial to mitigate risk and ensure the report is as comprehensive as possible. For example, in our recent expert's report for Great Central Mines we engaged two professors of finance to assist in our determination of an appropriate discount rate.

There are no prescribed rules for deciding whether to disclose or publish all or parts of specialists' reports. The ASIC recommends that where an expert refers to or relies upon information from a specialist's report the expert's report should reproduce the material information from the specialist's report (but not necessarily the entire report). In practice, we judge whether to include the full report or not based on the confidentiality of the data, the size of the report and whether the report will add to shareholder understanding.

Basis of Assessment — "Fair and Reasonable"

As described above under the heading "When is an Expert Report Required?" there are various sections of the *Corporations Law* and ASX Listing Rules which require an expert's report. However, these sections have differing definitions of what the expert is required to report on to shareholders.

It is most common for the expert to be required to assess whether a transaction is "fair and reasonable" for shareholders. Neither the *Corporations Law* nor the ASX Listing Rules defines what constitutes "fair and reasonable" for the purposes of an expert's report.

Typically, in determining the basis for our assessment we have regard to common practice among independent experts and of the ASIC Policy Statements. The views of ASIC as to the meaning of "fair and reasonable" is expressed in Policy Statements 74 and 75. However, these two Policy Statements have different definitions.

Policy Statement 75 relates to experts' reports required pursuant to *Corporations Law* ss 411, 648 and 703. This Policy Statement states that "fair and reasonable" should be taken as a reference to "in the best interest".

Policy Statement 75 treats "fair" and "reasonable" as distinct concepts:

- an offer is defined as "fair" if the value of the offer price or consideration is equal to or greater than the value of the securities subject to the offer. It requires the comparison of values to be made assuming 100 per cent ownership of the target company; and
- an offer is defined as "reasonable" if it is fair. However, an offer may also be reasonable if, despite not being fair, after considering other significant factors, and in such circumstances it may be in interest of shareholders to accept the offer in the absence of any higher bid before the close of the offer.

In contrast, Policy Statement 74, which applies to s 623 reports, states that "what is fair and reasonable for non-associated shareholders should be judged in all the circumstances of the proposal", which implies treating the term as a single concept. This Policy Statement states that:

> "The report must compare the likely advantages and disadvantages for the non-associated shareholders if the proposal is agreed to, with the advantages and disadvantages to those shareholders if it is not. Comparing the value of the shares to be acquired under the

proposal and the value of the consideration to be paid is only one element of this assessment."

In practice, we generally find that irrespective of whether fair and reasonable is to be treated as one concept or two distinct concepts, the primary focus of the assessment is on the comparison of the consideration received from the offer against that foregone. Shareholders are primarily concerned with issues surrounding price and after that "other reasonable" factors are considered.

Valuation Approach

A fundamental step in forming an opinion on the fairness and/or reasonableness of an offer is an assessment of the fair market value of the target company's equity or assets. Fair market value is commonly defined as:

> *The price that would be negotiated in an open and unrestricted market between a knowledgeable, willing but not anxious buyer and a knowledgeable, willing but not anxious seller acting at arms-length.*

There are abundant valuation methodologies one could use to value a company, several of the more common methods are:

- the value derived by applying appropriate multiples to maintainable income statement measures;
- the value implied from recent comparable company transactions;
- the amount that would be distributed to the owners assuming an orderly realisation of assets and liabilities;
- the value based on market trading in the company's securities; and
- the present value of projected future net cash flows.

Mining companies are generally valued based on the present value of projected future net cash flows, because of the predictability of future cash flows over the useful life of the assets. In applying this methodology, we generally seek assistance from specialists as discussed above.

In addition to discounted cash flow value methodology, we often value listed companies using market evidence based on the market price of shares as a second methodology. This is because in the case of a portfolio shareholding in a listed company with good liquidity in its shares and with a well informed market, the market price at which the company's shares trade on the stock exchange is acknowledged

as a good indicator of fair market value. There are some obvious problems with this for small mining companies, and the analysis needs to be interpreted with caution.

Gold premium's impact on DCF

As noted, the most common methodology for valuing mining assets is by calculating the present value of projected net future cash flows through the application of discounted cash flow (DCF) methodology.

The DCF approach has a strong theoretical basis. However, there has been significant debate concerning its relevance to valuing gold mining assets in recent years. In particular, valuers of gold mining assets, including stockbrokers and experts, have frequently observed an ASX traded share price which values a gold mining company at a premium to its value calculated using the traditional DCF methodology. For example, this was discussed in the court hearings over Goldfields Limited's takeover bid for Pancontinental Mining Limited in 1995. Furthermore, the Valmin Code specifically refers to the need to capture this market premium in valuing assets.

This premium to DCF has become known as the "gold premium". This should not be confused with the "control premium", discussed later. There are numerous explanations given for the "gold premium"; most of which appear to us to involve smoke and mirrors. For example, some analysts believe the gold premium reflects:

- the inherent value gold has as a financial asset. However, we believe any inherent value of gold should be reflected in gold prices;
- the exploration and development potential of assets. However, this should be captured within the expected future cash flows of a gold mine or in a valuation of exploration potential;
- potential future increases in the gold price. However, we believe expected future cash flows should reflect these expected increases;
- a failure to recognise the value of flexibility in an optimal extraction policy. For example, the owner of a gold mine has an option to extract gold, not an obligation to do so. Most valuers do not value this option; and
- the speculative investor that is "punting" on a large gold discovery.

Whatever the rationalisation, valuers of gold assets typically calculate an average observable gold premium and use this to adjust

their DCF valuation to a market tradeable value. The average observable gold premium is generally calculated by the difference between a sample of published stockbroker DCF valuations for gold companies and the appropriate ASX share price. In practice, the observable gold premium can fluctuate wildly in a relatively short period of time.

Although there is still some debate concerning the optimal methodology for valuing gold companies, we are not aware of an alternative methodology developed on a sufficiently rigorous theoretical basis to justify the replacement of traditional DCF methodology. In any case, we note that the majority of stockbroking analysts who follow the gold mining stocks use DCF methodology, and also consider whether a gold premium is applicable.

Discount rate and beta

There has been significant debate surrounding the use of different discount rates in DCF valuations of mining companies in recent years. The most controversial variable in the determination of a discount rate is beta.

The beta co-efficient relates the systematic risk of the specific company to the risk of the market as a whole. Thus, the beta attaching to an investment which is considered more risky than the market as a whole is greater than 1.0.

We are aware of valuations of gold companies in particular which have used betas ranging from 0 to 2.0. This wide range primarily reflects the use of different market indexes on which to regress company returns to determine beta. Betas estimated against the All Ordinaries Index have historically been in the range from 1.0 to 2.0, while betas calculated against an international index have historically been below 1.0. The use of the All Ordinaries Index presupposes that Australian investors are the marginal price setting investors.

Generally, commodity industries are international industry with prices set by international markets. Therefore, the share market value of companies is primarily driven by international investors, assuming the company is large enough to attract international investors. Therefore, the most appropriate beta to use in the determination of cost of equity should be calculated with reference to comparable international industry standards, and based on an industry average gearing ratio. That is, investors should be viewed as international investors, investing in an international industry. As a result, it is most appropriate to calculate a beta based on the correlation of returns against an international market index.

The capital structure of each comparable company needs to be assessed since the calculated beta (leveraged beta) reflects the financial leverage of each company's capital structure. Should the capital structures of the comparable companies vary significantly from the optimal capital structure, the comparable company betas need to be un-levered (representing a company with no debt) and then re-levered at the optimal capital structure. The formulas for this process are found in most corporate finance textbooks.

Control premium

Valuations based on market evidence reflect the value of a portfolio shareholding in a company, where share prices reflect trading in small parcels of shares rather than whole companies. Valuers generally add a premium for control to the portfolio price when valuing a company as a whole or a controlling interest in a company.

The determination of the appropriate control premium is one of the more contentious issues in any public company valuation. Our recent analysis reveals that between 1995 and 1999 takeover premiums for Australian gold companies ranged from 8.6 per cent to 127.6 per cent. This is a range that any Texan would feel proud to live on! However, there is no observable reason explaining this range. A great deal of subjectivity and opinion is required to determine an appropriate control premium from this disparate set of results for a particular company.

A control premium is generally regarded as the premium paid by a significant shareholder:

- for the benefits that the significant shareholding may have compared with a portfolio shareholding. For example, a large shareholder may be able to, inter alia, influence the operations, including the payment of dividends, and may be able to extract synergistic benefits; and
- due to the different views of the target shareholders in relation to value. For example, shareholders will hold a broad spectrum of views relating to the value of company assets, based on their views of exploration potential, quality of management, the future prospects and their individual taxation implications. In order to gain the shareholding required for compulsory acquisition, and to secure the acceptances of the most optimistic investors, a price may need to be offered which is at a premium to current market price.

The premium for control is typically measured by the observed premium paid for a listed company in a takeover. However, as indicated by our analysis of gold company control premiums and analysis of other industries, the level of premium for control is not consistent across companies. The size of the premium will depend on the bidders and shareholders assessment of two factors above. Moreover, the ultimate size of the premium in a takeover will depend on the relative bargaining strengths of the target's shareholders with the acquirer.

In addition, the breakdown of the premium between the two factors above cannot be objectively quantified. As a result, the most appropriate premium to apply in each circumstance is a matter of judgment.

As an illustration of the difficulties in determining the appropriate control premium, we discuss below our recent analysis of the control premium applicable in our expert report for Great Central Mines for their response to the Yandal Gold bid.

CASE STUDY ON CONTROL PREMIUMS — GREAT CENTRAL MINES

On 11 January 1999, Yandal Gold Pty Limited (Yandal Gold) announced its intention to make a takeover offer for all of the issued shares in GCM (the Offer) for $1.50 cash per share.

Yandal Gold is a company owned 50.1 per cent by Edensor Nominees Pty Limited (Edensor), the trustee for the Gutnick Family Trust, and 49.9 per cent by Normandy Mining Limited (Normandy). In its Offer document, Yandal Gold disclosed that it was entitled to approximately 40.4 per cent of GCM pre offer.

We prepared an expert report pursuant to s 648 of the *Corporations Law*. While our primary methodology for valuing GCM is by calculating the present value of GCM's future net cash flows using DCF methodology, as a secondary methodology, and for comparative purposes, we reviewed the ASX share traded price for GCM, and concluded a value for GCM shares immediately before the takeover offer. To this we added the control premium to determine a fair price for GCM.

The premium for control is typically measured by the observed premium paid for a listed company in a takeover. We analysed the takeover premia of recent takeovers of Australian gold mining

companies, based on a comparison of share prices one week before the announcement of the takeover offer.

The results of our analysis was a range from 8.6 per cent to 127.6 per cent for takeover premia offered in successful takeover offers. However, excluding the Plutonic takeover by Homestake (a premium of approximately 127.6 per cent and twice that of the next highest premium), the upper end of the range is 61.3 per cent. The simple average (excluding Plutonic) is 33.7 per cent, with a median of 26.0 per cent. The simple average including Plutonic is 40.4 per cent, with a median of 31.6 per cent.

In determining the appropriate premium for control to apply to GCM's market traded share price in relation to the Offer, we considered the following:

- Edensor and Normandy currently hold 40.4 per cent of the total GCM shares on issue. In addition, nominees of Edensor and Normandy represent three out of the five directors on GCM's Board of Directors. Normandy also has representation on a number of GCM's technical, operational and financial management committees;
- the extent to which Yandal Gold can extract synergistic benefits by integrating GCM into its own operations is limited, other than through administrative cost savings by de-listing the company. Yandal Gold stated in its Part A Statement that it would operate GCM in the same manner if the takeover Offer is successful;
- GCM is already benefiting from some of the synergies which come from Normandy through the Technical Services Agreement; and
- given the existing shareholding entitlement of Yandal Gold, Edensor and Normandy, it is unlikely another takeover offer for GCM will emerge in the foreseeable future. This could reduce the relative bargaining strength of GCM's shareholders in extracting a higher premium from Yandal Gold.

In relation to the first point above, it follows that where a fair price is to be determined by adding a premium for control to a market price, a premium for control which is lower than average should be applied whenever a prior stake has lead to a higher pre-offer market price (and the average control premium has been determined on a non-inflated pre-bid share price). In other words, if GCM's pre-bid price was inflated because of Yandal's shareholding, either GCM's pre-bid price should be reduced to the level it would be if Yandal did not own any shares in GCM, or the control premium should be lower than the average.

We explain further below why we could expect a higher pre-offer price in the case of Yandal's shareholding in GCM. Note that the impact of Yandal's pre-bid shareholding in GCM should not be confused with the increase in GCM's pre-bid share price as a result of speculation of a takeover offer.

As previously discussed, there are a number of explanations of observed control premia:

- to pay for synergistic benefits that are captured in whole or in part by the target shareholders; and/or
- to acquire the shares of those target shareholders who are particularly optimistic about the future of the target company.

In relation to the first bullet point and specific to GCM, since GCM already benefited from its relationships with Yandal, Normandy and Edensor before the offer, it follows that this synergistic benefit was already reflected in the pre-offer price range. If one wished to add a control premium to reflect these synergistic benefits one would need to add that premium to what the share price would have been in the absence of Yandal already having control. The alternative is to apply a control premium which is lower than the average premium calculated where there is no pre-bid shareholding.

Further, it could be argued from the above that given the majority of synergistic benefits would already have been incorporated into the pre-bid price, the control premium should be negligible or zero in relation to synergistic benefits.

In relation to the second bullet point above, a prior holding of 40.4 per cent does not reduce the price necessary to acquire the stock of the shareholder at that 90th percentile of optimism. To first acquire a 40.4 per cent holding one must acquire the stock of all shareholders at or below the 40.4th percentile of optimism. The market price is higher as a result. To then acquire a further 49.6 per cent of the shares in a subsequent bid, one must still pay the price necessary to acquire the stock of the shareholder at that 90th percentile of optimism. The price paid is still the same as that that would be paid absent the stake acquired in the first step. But the premium relative to the price preceding the second step is smaller.

Let P_0 denote the original price, P_1 denote the price after acquiring the 40.4 per cent stake, and P_2 denote the price after acquiring a further 49.6 per cent. The effective premium paid in the two-step process is $(0.404/0.9)\ (P_1 - P_0) + (0.496/0.9)\ (P_2 - P_0) < P_2 - P_0$. But the price received by the shareholders in the second round is the still fair price of P_2, which is the valuation of the shareholder at the 90th percentile of optimism.

The correct premium for control to add to the pre-second step market price in the Yandal case is appropriately smaller than the average premium where there is no prior holding. Once again, this is not because of a reduced likelihood of subsequent competing offers, but is because of the fact the existence of the prior holding effectively informs the market of the high likelihood of the subsequent Yandal offer, an offer that did in fact arise. Hence the market price will have been higher than it would have been in the absence of the prior holding. Adding a smaller premium to a larger price is necessary to obtain the fair price one would have obtained in the absence of the prior holding.

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