

Independent Advice for Directors in an Acquisition Scenario

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Emerging practice focuses on need for more objective scrutiny

It's decision time...

You're a director of a public company, and you and your fellow directors have just heard a presentation from senior management recommending the acquisition of a significant competitor. The target is currently owned by a private-equity shop that had taken the target private three years ago. The business combination will propel your company to the No. 1 market-share position in Canada, and provide a significant platform in the U.S. It's a competitive bid process with final priced bids due in 10 days. Management is clearly very excited and is recommending the deal, as are the principal deal advisers, a reputable investment banking firm retained by management.

The pro-forma financials look good. The deal should drive a one-time revenue increase of almost 50%. And while EBITDA margins are somewhat lower than those of your own firm, the target company has been consistently profitable. The proposed pricing is eight times current run-rate EBITDA, but the deal team points out that this is really only six times next year's EBITDA if planned increases in profitability materialize.

At the board, however, you're not quite ready to commit to the deal. Most of the discussion has focused on the benefits of the transaction: revenue synergies, cost take-out and combined market presence. While the target is smaller than your company, the transaction is transformational and will require taking on significant debt, which is being underwritten by the financial adviser. You can't help feeling that "deal momentum" has become a factor driving management forward. Some of your unresolved concerns include:

- The assumptions underlying an optimistic target forecast;
- The higher debt load arising from the transaction;

- The rigour and independence of the financial analysis and due diligence in support of the deal.

As an independent director, it's your job to remain objective and make your decisions in the best interests of the corporation. The question is: Are you getting complete and fully objective material from the deal team? While no one's integrity is in doubt, if the deal proceeds, there is a large contingent fee payable to your investment bank. And in addition to making a splashy acquisition, management clearly looks forward to running a bigger, more prestigious company.

Should directors seek independent advice?

The most public manifestation of this desire for more independent scrutiny has emerged in the context of the board, or the special committee of the board, retaining a fully independent financial adviser to prepare a fairness opinion regarding the transaction. Directors have considered this approach for many years, recognizing that the contingent fees paid to the financial advisers, as well as fees associated with associated debt and equity financings, have the potential to reduce the actual or apparent independence of the financial adviser's fairness opinion. The Ontario Securities Commission's Reasons for Decision in the proposed 2009 merger of HudBay Minerals and Lundin Mining, which argued that the receipt of a fairness opinion from an adviser with a contingent fee arrangement did not assist directors in demonstrating due care in complying with their fiduciary duties, put the public spotlight on this issue. Two years later, additional fairness opinions for non-arm's-length transactions are still not the norm, although it has become more common practice for transactions negotiated exclusively between parties – i.e., without a market test.

It is interesting to note that in the case of a proposed merger between public companies earlier this year, the special committees of both boards retained independent advisers to prepare independent fairness opinions. Senior M&A lawyers at several of Canada's leading firms all report that the level of focus on the independent fairness opinion for certain transactions has intensified substantially in recent years.

Are there other issues for which independent directors can or should take independent advice? There is an emerging view that when the subject matter of the decision lies outside the experience or expertise of the directors, and the impact is potentially material, directors are well within their rights to request, additional support in exercising their fiduciary duties.

Some examples:

- Where the financial model is central to the decision, outside experts can be retained to review the model's functional integrity. Financial models developed under deal-deadline pressure are often imperfect, and a few small errors can have significant impact;

- Independent financial advisers may be requested to run alternative scenarios or to "stress-test" assumptions around debt service;
- HR experts can assess cultural fit and advise on effective change management;
- Outside due-diligence specialists can critically assess assumptions around post-deal synergies and the plans for achieving them;
- Accounting expertise may assist in advising on how the transaction will look on the acquirer's financial statements. Purchase price allocation, M&A tax accounting, and goodwill impairment are complex issues, and sometimes lead to unintended disclosure implications.

None of this is to say that boards should run a parallel due-diligence process. In most cases the interests of directors and management are aligned, and it is primarily management's responsibility to take appropriate advice in support of its recommendation to the board. Experts retained by management should be prepared to deliver their advice and reports to board members and to respond to their questions.

In certain rare circumstances, directors' confidence may be enhanced by commissioning further work directly from a totally objective party, and directors should not hesitate to ask for this support when needed. Whether advice is sought directly by the board or, more customarily, through management, it is the responsibility of the board to exercise its independent judgment in the best interests of the corporation, regardless of "deal momentum."

Where to Turn

There are numerous financial advisers and consultants available on short notice to provide expert input on a transaction. Depending on requirements, these may include the integrated accounting/advisory firms, international strategy houses, or any number of boutiques. Rather than responding to a fire-drill exercise with a few days to go, boards should work with management to identify, commission and review transaction-support requirements early in the process.

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