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Independent Advisor

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The role of the independent adviser

The proper identification and management of conflicts of interest has always been one of the underlying tenets of the orderly functioning of financial markets. In recent years, however, there have been mounting concerns about conflicts resulting from the increased range of activities undertaken by many investment firms and banks. This was brought into sharp focus in the fallout from the 2008 financial crisis, which placed the integrated 'one-stop shop' investment banking model under particular scrutiny.

Post financial crisis, many companies have chosen to appoint specialist independent corporate finance advisory firms to work alongside the investment bank in the IPO process and once on the market. Independent advisers offer advice on mergers and acquisitions, debt and equity offerings. For example, on an IPO transaction they are focused on advising the management team and managing the logistics of the process, while the bank is responsible for distribution and ensuring that investors buy the company's shares. The main responsibility of an independent adviser includes the identification and management of conflicts of interest between the constituencies involved — for example, issuer, bankers, analysts and investors. They can therefore help a client company procure value from all parties, acting as an independent sounding board on key decisions.

Failings in governance and the road back

The recent financial crisis has revealed some shortcomings in corporate governance and the role of non-executive directors, whose job it is to oversee the execution of company strategy by the executive team. Some non-executive directors have been criticised for failing to fulfil their role of strong independent oversight. Caught in the harsh glare of the spotlight, many have appointed specialist independent corporate finance advisory firms to assist them.

The corporate governance framework in the UK specifically requires a company to be led by an effective board, at least half of which should comprise non-executives deemed to be independent. Directors have a fiduciary duty to act in the best interests of shareholders as a whole and not on behalf of a significant shareholder or stakeholder interest, or indeed just themselves. Furthermore, since the Companies Act 2006, directors of UK companies now have a statutory duty to avoid conflicts of interest.

Against this backdrop, a board cannot afford to be seen to be compromised, and a company's choice of financial adviser(s) is critical. This chapter considers some of the common situations where a board may consider it prudent to take independent financial advice.

The role of advisers in IPOs

Owners of companies seeking an IPO want to maximise the valuation of their business while institutional investors want to buy those shares at the lowest reasonable price possible. An integrated bank appointed as a bookrunner to help sell the shares in an IPO is tasked with achieving the issuer's objectives and that is its primary focus. As those institutional investors are also clients of the same banks, paying them fees for their brokerage and sales and trading services, conflicts may occur despite 'Chinese walls' being in place in the firm.

Independent financial advisers can appear more objective as they don't try to cross-sell other services and usually do not lend money. Therefore, an independent adviser can be perceived as being entirely on the side of the issuer and management on every topic. This allows the adviser to work very closely with the company, almost becoming a member of the internal team. In the past few years, 70 per cent

of all the larger IPOs in western Europe have utilised an independent financial adviser.

Valuation

An adviser's role includes helping to optimise the valuation — not just at IPO, but also in after- market trading given that in most cases the pre-IPO shareholders will retain major stakes going forward. Advisers manage the valuation dialogue so that the issuer has a realistic view of the likely IPO price from the beginning of the process, and this view is then refined and updated as the process moves on. They will also help the issuer negotiate the valuation with the bookrunners and ensure that the valuation feedback received from investors is presented in a clear, frank and accurate manner.

Letting the managers manage

Executing an IPO and being on the market consumes a significant amount of management time, especially since most executives will have had little or no public company experience. By engaging a dedicated equity capital markets advisory team, a company can outsource the project management of an IPO process, enabling the management team to continue running the business with the minimum of distraction.

The bookrunner 'beauty parade'

The independent advisers help the management team select the bookrunner syndicate by compiling a list of possible candidates based on their first- hand knowledge of the market and the research, sales, trading and investment banking capabilities of the major candidate banks. They send out detailed requests for proposals (RFPs) to selected banks and compile matrices to compare responses to key selection criteria, as well as drawing up lists of follow-up questions. They advise on putting together an experienced syndicate, drawing up heads of terms and negotiating the fee structure. They analyse the RFP responses and run 'beauty

parades' where investment banks pitch to become part of the syndicate.

The logic behind this is that independent advisers are able to provide an objective view. The RFP process is usually viewed by the bookrunning candidates as a fair, transparent and level playing field on which to compete. It therefore maximises competitive tension and puts the issuer firmly in control of the negotiation of fees and contractual terms in the mandate letter. Independent advisers will also provide a view to the client as to which lawyers, accountants and third-party experts to appoint. Substantial fee savings can be achieved, with no loss of quality.

Dealing with the documentation

An IPO process is heavily regulated and document- intensive, with the prospectus in particular often being lengthy and complex. Independent advisers help the issuer to navigate the process and may be asked to assist with management of the prospectus timetable and to liaise with regulators to alleviate time pressures. Potential due diligence 'red flags' and disclosure issues will be raised in advance with the issuer.

Tensions may arise between the bookrunners, which want to maximise disclosure in the prospectus to limit their own risk, and the issuer, which may wish to balance the degree of disclosure in the prospectus with regard to commercially sensitive matters. A good independent adviser will draw upon its experience and judgement to provide a sensible compromise.

The legal documentation, particularly the underwriting agreement, which is the principal agreement governing the relationship between the issuer and the bookrunners, can be a minefield to negotiate. Given the various competing objectives, there is a risk that the respective parties' positions become entrenched.

Naturally, bookrunners will want to negotiate the most favourable terms and will cite market standards and precedent agreements from previous mandates in support of their case. The issuer will also want to negotiate the most favourable terms but may not have the detailed knowledge of market precedent. Key issues in the underwriting agreement are often not purely legal and require detailed knowledge of the issuer's business and commercial judgement. An independent adviser can provide an objective view on current market practice and cite concrete examples from previous deals where, for example, bookrunners may have agreed to compromise in favour of the issuer.

Keeping the show on the road

Once the independent adviser has recommended a group of banks to run the process and the syndicate is in place, it will manage 'behind the scenes' to ensure that the bookrunners remain cohesive and are all working together towards the same goal. Some issuers prefer their independent adviser to act as the key point of contact with the syndicate to free up the issuer to concentrate on the flotation. The focus here is on keeping the syndicate aligned to solve problems before they reach the client. Other issuers prefer to be fully involved with the adviser at their side.

With the syndicate in place, an independent adviser will continue to help the issuer by monitoring how banks are marketing the offering, soliciting and evaluating investor feedback and advising on tactics during the book-building and allocation process.

During the book-building process, an independent adviser will provide assistance with understanding the full range of pricing options available to the issuer and the implications of each scenario — in particular, the potential impact on after-market trading. One of the key objectives of a successful IPO will be the formation of a high-quality

institutional shareholder base that will react rationally to developments in terms of their trading behaviour.

An independent adviser will scrutinise the composition of the allocation proposal and analyse the profiles of the investors — requesting changes, if appropriate, and providing colour on the likely composition of the shareholder base.

Secondary offerings

Post IPO, there are a number of instances where a listed company will wish to continue to receive independent financial advice. Where further 'sell downs' of stock are envisaged, vendors/issuers will turn to independent advisers to project-manage the process, provide guidance on optimal timing and manage the syndicate, pricing and allocation. For these types of transaction, independent advisers can run confidential competitive auctions among bookrunner candidates in order to achieve firm, fixed-price underwriting at an optimal price — and eliminate the risk of leaks.

Issuers wishing to raise further capital by way of a secondary equity raising will often turn to independent equity advisers to advise on the timing and pricing of a rights issue or placing. The advisers will also be consulted on the selection of underwriters, the underwriting fees and the targeting of specific investors.

The level of underwriting fees for rights issues in the UK has been an area for scrutiny in the recent past from investors and for investigation by regulators. Independent advisers can play an important role in helping ensure that the fees appropriately reflect the risks that are being run by the underwriters.

Rights issues require bookrunners/brokers to take firm underwriting risk for a period of at least two weeks. Usually, banks do not welcome this risk unless they are confident that the rights issue will

be strongly supported by shareholders. An independent adviser will work up strategies to reduce the probability of this occurring, including techniques such as broadening the underwriting syndicate to include a more diverse range of banks and spreading the risk into smaller parcels, when conditions suggest this is the best strategy.

In the last few years, approximately 50 per cent of all the larger UK rights issues, placings and open offers have utilised an independent financial adviser.

Mergers and acquisitions

One of the main reasons why clients hire an independent financial adviser in an M&A deal is to seek a fairness opinion. Broadly, a fairness opinion addresses, from a financial point of view, whether a transaction is in the best interests of shareholders. Independent advisers are engaged as they are not aligned to a particular interest (be that a board member, shareholder or other stakeholder) or predisposed to any particular outcome.

Fairness opinions have no set formula and will be determined by the parameters of the commercial transaction. In the UK, they are sometimes required by regulation (pursuant to the UK Takeover Code and Listing Rules issued by the Financial Services Authority), and occasionally a client may wish to have an opinion from an independent bank to support a board decision on the merits of a particular transaction and create an appropriate audit trail.

In part because of the regulatory backdrop, fairness opinions are less usual in the UK market but are a more common feature of M&A globally, particularly in the US where directors face heightened judicial scrutiny of their business judgement and where the burden of proof is based in part on the structural protections employed by the board. Internationally, there is heightened sensitivity to conflict issues, which can span jurisdictions regardless of legal regime. Companies

and their boards are focused on avoiding litigation and reputational damage by anticipating how facts could potentially be misrepresented with hindsight.

Regulatory environment (UK)

There are certain circumstances where a fairness opinion provided by an independent adviser is a mandatory requirement in the UK.

The UK Takeover Code

The Takeover Code, which governs acquisitions of companies, inter alia, listed in the UK, requires the board of an acquirer or target to receive independent advice from a financial adviser.

- Rule 3.1 of the Takeover Code stipulates that the board of a target company must obtain competent independent advice on any offer, and that the substance of such advice must be made known to its shareholders. Typically, an offer document will contain a statement to the effect that: "The directors of [X], who have been so advised by [Y] bank, consider the terms of the offer to be fair and reasonable"

- Rule 3.2 states that a board must also obtain competent independent advice when the offer is a reverse takeover or where the directors are faced with a conflict of interest

- Rule 15 holds that when an offer is made for a company with outstanding convertible securities, the acquirer must make an appropriate offer or proposal to the holders of such convertibles, to ensure that their interests are safeguarded. The board of the offeror must obtain competent independent advice on the offer or proposal

- Rule 16 states where there is a 'special deal' for certain shareholders (management, for example), the Takeover Panel will require, as a condition to its consent to such a deal, that the independent adviser to the offeree publicly states that in its opinion the arrangements are fair and reasonable

- Under Appendix 1 on a 'whitewash' transaction where the procedure for making a mandatory offer under the Code is waived by target shareholders, the relevant circular must contain a statement from a competent independent adviser regarding the transaction, the controlling position that it will create and the effect it will have on shareholders generally.

In all the above scenarios, the independence of the financial adviser will be rigorously assessed by the Takeover Panel. The onus will be on the adviser to establish that it meets the Panel's criteria.

Listing Rules

Where a listed company enters into a transaction with a 'related party', as defined in Chapter 11 of the UK Listing Rules, a statement must be made in the shareholder circular that the transaction is fair and reasonable so far as the shareholders of the company are concerned, and that the directors have been so advised by an independent adviser acceptable to the Financial Services Authority.

In the case of a related-party transaction that involves the acquisition or disposal of an asset where any percentage ratio is 25 per cent or more, and for which appropriate financial information is not available, an independent valuation must be prepared. Typically, an independent adviser will undertake the required work, present its conclusions to the board and put its name to the relevant disclosure in the shareholder circular.

Voluntary circumstances

A client may request an independent bank to give a fairness opinion on a voluntary basis. In these circumstances, the bank will undertake detailed valuation work and analysis and provide the client with its conclusions — usually in the form of a relatively short-form letter that sets out the principal decisions made regarding the data,

methodologies and analyses, including any qualifications or assumptions made.

Examples of where a voluntary fairness opinion from an independent bank may be sought include the following scenarios involving actual or potential conflicts of interest:

- the chief executive wants to bid for the company
- the controlling shareholder wants to take a company private (delist)
- a private equity firm wants to take a company private and offer roles to management
- a significant shareholder wishes the company to buy a private company that the shareholder owns
- a parent company wishes to demerge a public company subsidiary, after paying a special dividend to the parent
- an acquirer wants to offer different consideration to different constituencies (not permitted under the Takeover Code in the UK but may apply to private companies or in different jurisdictions)
- situation-specific conflicts — for example, where the government is a long-term owner or a reference/majority shareholder and is selling its stake or preparing to float.

Conclusion

As we have seen, conflicts of interest have been a major driver in the global trend towards using independent advisers. Senior executives and boards are demanding higher standards around conflict management, and at the same time the regulators and the market as a whole are turning the spotlight on the record of non-executives for impartiality and strong oversight.

Some companies feel they can make their own judgements, but more and more are choosing to appoint an independent adviser to help steer a course through the twists and turns of a transaction.

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