Romanian Financial Markets Reform Project

White Paper:
Comments on the Regulatory Implementation of Mandatory Purchase Transactions

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Scope of Work

The Financial Markets Reform Project was asked by the CNVM to provide a white paper on the implementation of the mandatory purchase transactions in Article 138 of Law 525/2002. Accordingly, we have reviewed the matter of pricing and other issues for mandatory purchase transactions through:

- The Romanian legislation in Law 525/2002 authorizing and amending EO 28/2002 regarding Securities, Financial Investment Services and Regulated Markets,
- European Union directives and analyses covering this matter including the Report of the High Level Group of Company Law Experts on Issues Related to Takeover Bids,
- A submission to CNVM from the National Association of Evaluators in Romania (ANEVAR) with their proposal for dealing with valuing mandatory purchase transactions[1], and
- Interviews with investors and intermediaries.

Recommendations

To assure fairness to all parties and a high level of transparency, we recommended that the **pricing regime** for these transactions should be market based to the extent feasible through a combination of the prices at which the securities have traded and adjustments to net asset book value calculations. The use of net asset book values was mandated in the law. If the price and net asset book value approaches are not feasible, we list some acceptable that are more subjective and less transparent.

The **evaluators** who can participate in this program should be of high caliber and we have specific recommendations assuring the appropriate level of professionalism and experience.

The **roles of the evaluators** should be defined in order to remove uncertainty and add transparency to the process and the second and third evaluators should have 10 days to complete their analyses.

Article 139 should be interpreted in a manner to give **existing 90% shareholders the ability to reduce their holdings in a reasonable time frame**.

The New Romanian Legal Situation - Leaving or Staying On The Market

The Law 525/2002 in Article 138 states that a shareholder or group of shareholders acting in concert controlling more than 90% the voting rights of an issuer

- must make and complete a public offering of the balance of the shares

[1] Proposed Valuation Procedure and Price Setting Method for Public Takeover Offering, sent to CNVM on 22 August 2002.

- within 6 months of a take-over or of the effective date of the emergency ordinance or the law
- in order to transform the issuer into a closed company
- the price shall be determined by an independent evaluator
- using a price determination approved by CNVM in a regulation with emphasis on net asset book value
- with an appeal process open to the minority shareholders.

The original Article 138 was heavily amended in Law 525 without any advance notice. These provisions were never widely discussed by market participants and investors and surprised most observers. Since these provisions only entered the emergency ordinance through the law, we believe that the six month period begins on 4 August when the law was published.

The majority owner does have the alternative under Article 139 of reducing his ownership by 17% within 10 days of registering the holding. This registration reference is unclear as to whether it addresses the registration of the shareholding with the issuer's shareholder registry or the registration with the CNVM of the shareholder's intent to sell. This 17% sale removes the obligation to perform the public offering. The legislation did not create any transitional provisions.

We believe that the registration requirement should be interpreted as filing a registration with the CNVM about the owner's intention to sell the 17% shares. In that case, the majority shareholder has up to six months to register his intention to sell the shares, otherwise the public offer must be completed. Allowing existing holders sufficient time to exercise the right to sell would also protect those investors who bought their shares in good faith but now neither

- have the additional funds required,
- do not want to exit from the Romanian capital markets, nor
- do not want to invest any further in these companies.

The commission should also consider whether ten days is sufficient time for selling a 17% position in a closely held company. The market sale of such a shareholding of most companies in only ten days will severely depress the share prices making the sale option much too expensive to implement by the majority shareholder. Such a confiscatory requirement will discourage investors from participating in the Romanian capital markets. The CNVM should rule on this issue to avoid ambiguity.

Barring our recommended interpretation of Article 139 of the securities law, there are two classes of 90% owners:

1. those who bought their positions prior to passage of the law in good faith and now must comply with changed conditions including the inescapable mandate to offer to purchase the remaining minority shares or sell a large portion of their holdings at ruinous prices and

2. those who will acquire 90% positions in the future knowing that they have the options of either offering to purchase the minority shareholders or, selling 17% of their shares if they do not want to do a public purchase offer.

The second group comes to its position in a voluntary manner while the first has been caught in a change in the law. Laws change all the time, but usually there are transitional provisions to protect the rights of persons with pre-existing situations. Thus, the alternative interpretation of Article 139 would meet a fairness test. However, it would represent a forceful sale of legally owned assets which violates many principals of market economics. Usually, forced sales are associated with an overwhelming public interest. **The public interest in protecting investors who knowingly participated as minority shareholders is ambiguous.**

Most of the minority investors actively purchased their shares either on the market or through privatization. If the 90% investor purchased his shares through privatization, the minorities were informed about their position before at the time they took action. Where the majority owner purchased the shares on the market, he would have needed to do a public purchase offer which would have been open to the minorities. In the broad majority of cases, the minority owner knew he was buying shares in a 10% situation or has had opportunities to sell. The balance between protecting the rights of minority and majority shareholders is tenuous for these examples in Romania. In more developed and mature markets, the case for protecting minority shareholders is much stronger.

International comparisons

The Report of The High Level Group of Company Law Experts on Issues Related to Takeover Bids (HLG)[2] prepared for the European Union discusses purchases where the **majority owner are allowed to compel** minority owners to sell (squeeze-outs) and where the **minority owners can compel** the majority owner to buy (sell-outs). In neither case is party in control of the transaction required to act. Majority shareholders are not required to enter into squeeze-outs and minority investors are not required to initiate sell-outs.

The European Union company law and directives do not regulate either type of transactions.

The HLG analysis of the diverse **usage in member countries** shows that most countries **allow** majority owners to institute squeeze-outs for public companies, sometimes in conjunctions with takeover bids. The ownership threshold for the majority party for squeeze-outs is usually 90% or higher. When the threshold shares were purchased in a takeover, the squeeze-out price cannot be lower than the takeover price.

[2] Published in Brussels, 10 January 2002, URL: http://europa.eu.int/comm/internal_market/en/company/company/news/hlg01-2002.pdf. Squeeze-outs provisions among member countries are discussed on pages 54 to 57; sell-outs on pages 58 to 60.

When the 90% shares were acquired through other types of transactions, the most frequent situation is that experts appointed by the court should establish the purchase price. The criteria for the price setting are not generally clearly stated, but some countries refer to prices on the market and to actual purchase prices paid by the majority investor.

Germany has a squeeze-out provision under which a company with 95% ownership can request the shareholders' general assembly to buy out the minority shareholders. The consideration decision should be based on the company's asset value and earning power, but be a minimum of the average stock exchange price in the three months prior to the offering.

Austrian law allows the majority investors to conduct a squeeze-out of minority shareholders when the majority shareholder owns 90% of the shares. The squeeze-out price is determined by the board of directors of the issuing company. Each shareholder has the right, within one month of the transaction, to petition the court to determine the fairness of the consideration. The court's decision must be based on the determination of a permanent committee made up of judges, certified public accountants and members of the Federal Employee's Chamber and the Austrian Economic Chamber. The valuation must be based on the capitalized value of the company's anticipated earnings and the intrinsic value of certain assets. Recent market prices and discounted cash flows are not considered.

French majority investors may initiate a squeeze out when they own 95% of the voting rights. When the squeeze-out follows a public purchase offer, the squeeze-out price is equal to or larger than the initial cash tender offer.

Belgium also has a squeeze-out that can be invoked when the majority shareholder owns more than 95% of the shares. Upon request from the minority shareholders, the securities commission may send its comments to the company. If these comments are not taken into account, the commission may not approve the prospectus. There does not appear to be any criteria for determining the amount of the consideration.

Canada allows these transactions upon the approval of the majority of the minority shareholders. Thus, the minority shareholders are able to influence the pricing decisions.

In all these cases, the squeeze-out is a voluntary decision by the majority shareholder.

About half of the EU member countries provide a sell-out right. The majority of them provide for the sell-out right regardless of how the threshold shares were acquired. The price is most often established by experts appointed by the court or the securities regulator. Some countries state that the price on a recent takeover should be taken into account.

Most of the member countries with these rights contemplate that the threshold shares were acquired in takeovers where the acquiring investors knowingly initiated transactions that would trigger the squeeze-out and/or sell-out.

The Romanian Context

Article 138 of Law 525/2002 represents a sell-out in that the 90% investor must offer to buy the shares. The minorities are not required to sell as is the case with a squeeze-out, but after the offering the issuing company can be withdrawn from trading on a stock market and closed by the majority owner. Some minority shareholders will prefer to remain owners of shares in such a closed company when they believe that the company's prospects are bright. For most minority investors, the likelihood of the absence of a trading market will motivate then to sell on the offering.

We found very little literature on sell-outs which are equivalent to the provisions of the Romanian securities law. **The provisions in the laws of other countries dealing with squeeze-outs are not relevant for sell-outs** since majority investors in those countries usually voluntarily entered into the transactions leading to the sell-out. Existing 90% shareholders covered by Law 525 accumulated their positions without any expectation of being required to perform a sell-out. Future buyers of 90% positions will, of course, be forewarned and may decide to rise to the threshold fully informed. **The lack of public debate before this provision was passed also mitigates against overly strict enforcement of this article initially.**

Pricing

The securities law requires that the price for the public offering should be established by an independent evaluator based on the price determination method specified by CNVM regulations. The price determination method must take into consideration the net asset book value on the issuer's balance sheet and unspecified other accounting elements. The commission has full flexibility to determine the price determination method as long as the net asset book value is part of the methodology. The commission also appears to have the ability to determine which parties should be the independent evaluator. In this section we will discuss valuation techniques. The next section will include a discussion of the independent evaluators and the scope of their work.

Market Pricing Method

We believe that in a market economy, **a market price generated when there is active trading between willing and uncoerced buyers and sellers who are free to buy and sell is the best measure of share values.** The HLG report also mentions that member countries use the price in a takeover bid or the average price paid by the majority owner as one of the considerations in determining the price for a squeeze-out. Most of the companies with a 90% owner will have low market activity since there are few shares available for public trading.

Certainly, majority and minority investors have engaged in abusive activities that have hurt the value of shares of specific companies and the reputation and value of the Romanian capital markets. However, **we do not believe that mandatory purchase obligations mandated for all majority shareholders should be used to punish past wrongs.** Specific transgressions should be addressed specifically, not with a shotgun aimed indiscriminately. The fact is that today's values represent investors' perception of current value. Minority investors who participate in these sell-outs will be able to invest in other depressed issues. They should not be rewarded with prices that do not represent today's reality.

An indicator we recommend for determining whether an issue has an active trading market is whether the issue has registered trades for at least 150 days in the past twelve months and whether the total value of those trades exceeds the equivalent of 100,000 USD[3]. When an issue meets this standard, the average price weighted by the value of the trades should be a primary determinant of the public offering price since a large number of buyers and sellers decided the market price was fair.

A recent (within the past six months) successful takeover bid price is also an important determinant. If a large number of shareholders participated in the public offering, they thought the price offered was fair. This price could be adjusted by subsequent changes in the price of the major market price index for the exchange where the issue was traded when that index has risen since the offering. Since an important principle of valuing these squeeze-outs is fairness to minority shareholders, we would only adjust the takeover price for increases in the market index, not declines. The presence of this adjustment also motivates the majority shareholder to perform the squeeze-out offering promptly.

When both a market trading price and a takeover price can be calculated under our definitions, the higher one should be used in the purchase price setting methodology.

Adjusted Net Asset Book Value Method

The law specifies that the price determination method must give consideration to net asset book value. **In most developed markets there is only a tenuous connection between book value per share and share prices.** Many companies in the heavy industrial sector have low profitability, high asset values and low prices relative to net asset book value, others, particularly service companies, how high profitability, minimal asset values and high prices relative to net asset book value. Furthermore, there are times in market cycles when the overall level of prices are high or low relative to net asset book value.

[3] We have determined that there were 34 companies excluding the SIFs traded on BVB that were traded on more than 65% of the days the market was open and had annual trading volume over 100,000 USD. The SIFs were not included since they would not be considered for this mandatory purchase offerings. We were not able to obtain such information on RASDAQ trading.

Usage of net asset book value must reflect the sector of the company and the current state of the market. The minority investors who decide to sell out of their investment positions can readily invest in other securities in the Romanian market at the current prices. With many issues trading at prices significantly less than net asset book value, they can buy other depressed issues. The same principal will work at a time when market conditions have changed and most issues sell above net asset book value.

The validity of **any comparison based valuation method is enhanced by larger numbers of comparable assets.** We recommend that the comparable list should include all the issues that meet the requirements of market activity and sector conformity, but should encompass at least five issues. If there are not enough suitable comparable companies, the evaluator should not use the net asset book value method since there is such a wide disparity between book values and market prices. This disparity is present in both Romania and more developed markets.

Net asset book value per share should be adjusted by the average of the price to net asset book value ratio (PBV) for comparable companies that are actively traded as defined in the Market Pricing section above. For example, if the issue being evaluated is in a specific sector, the evaluator can determine the relative PBV ratio by dividing the current market price by the most recently published net asset value for each of the other issues in this sector.

If the average PBV ratio for the selected comparable companies in the sector is 0.70 and the net asset book value of the company being evaluated is 3000 ROL, the adjusted net asset value for evaluation purposes should be 2100 ROL (0.70 X 3000). This valuation method is consistent with the terms of the law and with the market comparison method

Another issue with use of net asset book value is the type of accounting used by both the subject company and the comparable companies. In the near future many Romanian companies will be changing to IAS for reporting their financial position. Since IAS net asset book values will be significantly different than under RAS for many companies, the evaluator should use net asset book values reported under the same standard for all companies included in his analysis. The adoption of IAS will be phased in over the next few years. If the evaluator is analyzing a company on IAS where most of the comparables are on RAS, he should try to obtain financial statements prepared under RAS for the subject company to have the broadest range of comparables.

We recommend that the CNVM adopt this adjusted net asset book value method as one of the valuation techniques that must be used by independent evaluators. To work properly, the evaluator must use companies that are actively traded as defined and have economic characteristics that are similar to the subject company.

Asset Based Method

The asset based method, also mentioned by ANEVAR calculates a net asset value after the values of the assets and liabilities, tangible and intangible) have been revalued at their current market or fair value. This method requires a great deal of judgment and estimating. As a result, it can be very subjective with different valuators estimating very different values, particularly for intangible assets. The valuation of very valuable corporate assets such as brand names is very difficult unless the valuator want to simply consider the market price of the shares as the best independent valuation of such assets when they are important for a particular company. For many companies this valuation method will not be transparent and easily understood. This method is also very expensive when the company has numerous assets in different locations throughout the country.

ANEVAR recommended the use of this method only for companies without IAS based statements, without audited financial statements or without an unqualified auditor's opinion.

The asset based method will be useful for some companies in Romania that primarily have physical assets and should be included is the list of acceptable valuation techniques. However, usage should be limited to appropriate situations or when superior methods are not applicable.

Discounted Cash Flow Method

The discounted cash flow (DCF) method, another well accepted valuation method, values **the future earning and cash flow generation capability of the company** under the theory that companies are not worth more than their ability to earn money for their investors. Future earnings are reduced by an interest rate factor to reflect the lower value of future cash receipts than current cash. The interest rate factor is calculated by considering both the market interest rates for long term bonds with a risk element specific to the company under review. Thus, a highly risky company would have a greater risk adjustment than one with little risk. In this case, the risk refers to both the financial volatility of the company and the valuator's confidence in his estimates of future cash flows.

The three critical elements in the DCF method are these estimates of future cash flows, the current market interest rate for long term bonds and the confidence factor. At least five years of cash flows must normally be estimated. In our experience this method is difficult to apply in mature economies. In a transition economy with high inflation, five year estimates are highly suspect. The great advantage of DCF is the ability to include all available information in the valuation exercise. The valuator can consider the impact on expected new products or future competitive developments. The major flaw of DCF is that the valuator either will have to depend on information provided by the company[4] or he will need to make his own forecasts in a vacuum.

[4] As long as the purchase price is to be paid by person controlling the company, the company will have an incentive to provide pessimistic assumptions about future business developments to reduce the price evaluation. In addition, the various assumptions used by the first evaluator will be subject to criticism by the subsequent evaluators.

We do not recommend this method for usage by the valuators working on mandatory public purchase offers unless other methods are not applicable.

Other Valuation Methods

The **replacement cost** method attempts to determine what it would cost to replace the company's various assets. The theory behind this method is that an investor would not buy the company outright if he could buy the capacity (technical and financial) to produce the products with similar quality and production costs for a lower price. Cash and receivables are easy to estimate. The productive capacity is much more difficult since the investor replacing the capacity may use different technologies to produce the same products. This method is very useful for valuing companies, but like the approaches above, it is very speculative.

The **liquidation value** method determines the company's value assuming the sale of all assets and winding down the company. This method will not be very useful for valuing public takeovers since these companies are judged to have a value as a business which is generally greater than the sum of the assets.

Valuation Recommendation

We recommend that the CNVM specify the usage of the market pricing method and the adjusted net asset book value method we have described above.

When there are strong price signals as determined by active trading volume, the weighted average price for the past twelve months should be used. In the case of a recent, successful takeover bid, that price should also be considered. In either case, we recommend that the valuator be required to use the higher of the two prices.

The adjusted net asset book value method should be used except in cases where the valuator cannot justify any other actively traded companies as comparables. When there is a useable price, the market price and the net asset value should each be weighted by 50%. Without a useable price, the net asset value will have the entire weight.

When neither a price factor nor the adjusted net asset value technique is appropriate, the valuator should use a combination of the unadjusted net asset value method, the asset based method and the discounted cash flow method. The valuation derived from each method should be given a one-third weight in the pricing for the tender offer. If the valuator decided that one or two of these three methods would not be appropriate in a specific situation, then the remaining method or methods would receive all the weight.

Who Are The Evaluators

The securities law does not define the independent evaluators beyond stating that an evaluator must determine the offering price. We believe that the people authorized to perform these sophisticated business and financial evaluations should have demonstrated training and experience. Clearly, the credibility of this program and the CNVM will rest on the competence and performance of these people. The commission needs to protect investors (majority and minority) and the reputation of commission and the Romanian capital markets from the activities of incompetent evaluators. There are many fine evaluators licensed in Romania through the ANEVAR program. Over 1000 people have passed the association's rigorous tests. However, many of them do not have extensive experience performing these types on analyses. We believe there should be two types of professionals recognized by CNVM for these valuations:

1. Licensed members of ANEVAR with at least three years of business evaluation experience working for major consulting firms which firms have performed at least 20 business evaluations within the past three years, or
2. People who have passed the first level of the Chartered Financial Analysts (CFA) program sponsored by the Association of Investment Management and Research and have at least three years of experience working in an investment capacity for regulated Financial Investment Service Companies and/or as business evaluators as defined in #1 above.

During the past five years, more than 40 Romanians have passed at least the CFA Level One examination including the results of the 2002 examination. Of those, fourteen have passed the final Level Three examination. We believe that the combination of Level One and three years of experience will be sufficient for the level of analysis called for by our other proposals.

Each valuator should be required to submit his credentials to CNVM before conducting an evaluation for mandatory public purchase offers. The CNVM should approve the credentials within five business days. Once an evaluator is approved he can perform subsequent evaluations without submitting his credentials or becoming approved. The CNVM should have the ability to cancel its approval for a specific evaluator for cause.

The Evaluation Process

The securities law describes a three step process:

1. an evaluator establishes the initial purchase price
2. if the holders of 5% of the company shares decide to challenge the evaluation, they must within ten days hire a new evaluator to establish a second price
3. if the second price is within 20% of the initial price, the actual purchase price shall be the arithmetic average of the two prices
4. if the second price is more than 20% higher than the initial price, a third evaluator shall be chosen and paid by both parties to mediate between the first two evaluations.

It is not clear whether the majority shareholder or the company selects and pays the initial evaluator and participates in the choice and compensation of the third evaluator. The CNVM should clear up this ambiguity and we recommend that the majority investor should be the correct party. The company does not benefit from these transactions and is merely a bystander.

We also believe that the second evaluator should be empowered to check on the work of the first evaluator and issue a fairness opinion. If they cannot issue a fairness opinion in good faith, they should issue a statement explaining in detail why they thought the first evaluation was faulty and how it should be rectified. For example, the second evaluator may judge that inappropriate companies were used for comparisons under the adjusted net asset book value method. If the second evaluator does issue such a statement, he should then compute alternative evaluations.

If the third evaluator is necessary, his role should be to decide which of the first two evaluations were more appropriate or to decide on a price between them.

The second and third evaluators should be given access to all the information and worksheets used by their predecessors. In addition, they should have a specified amount of time to complete their analyses since the majority shareholder has a limited amount of time to complete the mandatory purchase offer. We recommend that each of these two fairness opinions should be released to the challenger and the majority shareholder within 10 business days.

Conclusion

We believe that our recommendations will facilitate the implementation of Article 138 of Law 525/2002 and a clarification of Article 139 in a manner fair to both majority and minority investors.

- Pricing will be market based to the extent feasible. Otherwise, more subjective methods will be used.
- The competence of the evaluators participating in this program will be sufficiently high to reduce concerns about their ability to perform this type of analysis.
- The roles of the three sets of evaluators will be clear to all concerned and the second and third evaluators should have 10 days to complete their analyses.
- A regulation clarifying Article 139 that will provide existing 90% shareholders sufficient time to sell their holdings will also enhance the fairness of the application of Article 138.

The Financial Markets Reform Project is ready and willing to discuss the details of our recommendations at the convenience of the CNVM.