KPMG

Our ref ASIC CP 326 Submission Paper

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Australian Securities and Investments Commission
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Via Email: 444GA.Submissions@asic.gov.au

Draft

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Dear Mr Kouts,

KPMG Response to Consultation Paper 326 - Chapter 6 relief for share transfers using s444GA of the Corporations Act

We are pleased to have the opportunity to respond to Consultation paper - *CP 326 Chapter 6 relief for share transferrs using s444GA of the Corporations Act* (**CP326**) published by ASIC on 16 January 2020.

Attachment A to this letter provides KPMG's responses to questions raised in the Consultation Paper.

Many of the insights and recommendations in this submission are drawn from KPMG Corporate Finance's practical experience in preparing independent expert reports (IERs) for Oroton and Ten Network as well as our general experience in preparing IERs and maintaining independence.

We would be pleased to discuss this submission further with you. Should you wish to do so please contact Jeff Cook or Ian Jedlin.

Yours sincerely

[redacted]

Jeff Cook

[redacted]

Ian Jedlin

Appendix 1: Responses to questions

B1: Requirement for IER and explanatory materials

Proposal B1: We propose to include guidance in RG 6 about when we will grant relief to facilitate a s444GA transfer, namely where:

(a) an IER is prepared in accordance with RG 111; and

(b) the IER and explanatory materials are made available to shareholders before the s444GA hearing.

Feedback

B1Q1: *Do you agree that ASIC should require an IER to be prepared in accordance with RG 111 and that the IER and explanatory materials should be provided to shareholders before the hearing? If not, why not?*

KPMG response: We agree that ASIC should require an IER to be prepared in accordance with RG 111 and that the IER and explanatory materials should be provided to shareholders before the court hearing.

Shareholders must be provided with sufficient information on which to decide whether or not to object. The nature of that information should be consistent with that provided to them in other circumstances in which they are being asked to dispose of their shares – i.e, an IER prepared in accordance with RG 111. The IER and other materials must be provided to shareholders prior to the hearing to ensure they have sufficient opportunity to consider the information and determine whether to object.

From a corporate governance perspective, the directors of a company which is a going concern have a fiduciary duty to the shareholders. ASIC requires an IER where there are potential conflicts of interest and the shareholders may be unfairly prejudiced (e.g. control transactions where there are common directors or bidder has a 30% interest in the target and in compulsory acquisitions) in order to protect the interests of shareholders. Similarly, for a company that is in administration, there are no directors and the administrators, once appointed, are deemed officers of the company with fiduciary responsibilities to the company, rather than creditors or shareholders directly. As such, it is appropriate that an IER is prepared in order to ensure that the interests of shareholders are represented.

For most companies, a distressed valuation utilising a discounted cash flow or market approach will better suit the circumstances of the company. For these companies, reliance on a liquidation value in an administrator's report would potentially understate the value of the equity in the company and as such, the relevant shareholders' interests.

Furthermore, the IER provides additional information that assists shareholders in understanding why their shares are being expropriated without any consideration.

B1Q2: *Are there situations where you consider the IER might be unnecessary? If so, please outline the circumstances.*

KPMG response: There are limited circumstances in which an IER might be 'unnecessary'.

These may include:

Where a majority of information is duplicated. The balances owing to creditors resulting from the administration will be identical between the administrator's report and the IER and the administrator is clearly the appropriate party to provide this information.

An administrator's report includes the valuation of a company on an appropriate liquidation basis. This will generally not include a valuation of the company on a distressed basis (which is the situation faced by shareholders) i.e. assuming the sale of the business as a whole either utilising a discounted cash flow or market approach. As such it also does not include key information relating to those cash flows or earnings (e.g. industry drivers) as well as appropriate valuation metrics (discount rate, comparable company multiples, etc).

There are some instances where the liquidation value as presented in the administrator's report would be the most the appropriate premise of value (such as in the case of a land or fixed asset rich company). In those cases, shareholders could be provided with just an administrator's report and their assessment of liquidation value.

Countering these arguments is that an administrator is not a completely independent party. Even if they are independent of mind, they are not independent in appearance. As such, from a shareholders' perspective, there may be a reduced level of confidence. This may increase the likelihood of shareholders objecting.

B1Q3: *Do you consider that the administrator's report to creditors could be used instead of an IER? If so, on what basis? If not, why not?*

KPMG response: Only in exceptional circumstances as noted above should the administrator's report be relied upon to fulfil the purpose of the IER. The administrator's report to creditors should form part of the materials provided to shareholders. The nature of such a report is that it is prepared for the creditors, and not for shareholders. In order to ensure shareholders are provided with all the information they need to make their decision, it would be necessary for such a report to also address the information needs of the shareholders. Shareholders should generally be entitled to receive a report prepared independently i.e. in accordance with RG 112. Furthermore, we note that a liquidation value is not necessarily the same as a distressed value where a company's value is better represented in its cash flows rather than by the assets on the balance sheet.

B2: Basis of valuation in IER

Proposal B2: If we proceed with Proposal B1, we propose that the IER should be prepared solely on a liquidation basis where the only alternative is liquidation. Where the valuation shows no likely return for shareholders on this basis, we will normally grant relief, subject to the IER and explanatory materials being provided to shareholders and the Court granting leave.

Feedback

B2Q1: *Do you agree with our proposal that an IER should only be prepared on a liquidation basis? If not, why not?*

KPMG response: We disagree that an IER should only be prepared on a liquidation basis but rather that an expert should also consider a 'distressed valuation'.

Liquidation value

In forming this view it is fundamental to consider the meaning of 'liquidation value'. This is because what is meant by 'liquidation value' will determine the basis of value that an expert adopts. We consider that 'liquidation value' is generally considered to be a 'break up' value, assuming all assets are sold. It is defined in the International Valuation Standards[1] as:

> *"the amount that would be realised when an asset or group of assets are sold on a piecemeal basis. Liquidation Value should take into account the costs of getting the assets into saleable condition as well as those of the disposal activity. Liquidation value can be determined under two different premises of value:*
>
> *(a) An orderly transaction with a typical marketing period, or*
> *(b) A forced transaction with a shortened marketing period."*

Potentially what flows from this definition is that an expert will focus on what is meant by 'a piecemeal basis' and look to the value of the underlying individual assets.

Distressed value

In undertaking our reports for both Ten Network and Oroton Group we did not adopt this approach and considered a 'distressed valuation' in order to assess the possible value in the event of a liquidation (we assumed that as the businesses did not have significant tangible assets for which material value could be realised they would be sold as going concerns but with potential acquirers seeking higher levels of return to reflect the increased risk).. This approach recognised that secured creditors would fund ongoing trading to the extent necessary to effect the sale of the business as a whole on an orderly but distressed basis as this would maximise the outcome from their perspective. In our view, this reflects the reality of many situations (i.e. the company is not yet in liquidation).

This approach allows for consideration of the value, not on a piecemeal basis, but by considering the business as a whole and in particular that which may be derived by adopting an income approach using discounted cash flows. It also allows the independent expert to recognise that an acquirer would seek a higher level of return to reflect the increased risk.

B2Q2: *Should an independent expert consider, when performing a liquidation valuation, potential recoveries from voidable transactions and other matters as a result of the administrator's investigations? If not, why not?*

[1] Published by the International Valuation Standards Council, effective 31 January 2020.

KPMG response: They should be included in liquidation value where there are reasonable grounds associated with those recoveries. Where reasonable grounds do not exist, we consider that they should not be included.

B2Q3: *Do you consider that a 'going concern' valuation of the business is relevant or useful for a company in administration? If so, why?*

KPMG response: 'Going concern' is commonly applied to the preparation of financial statements and is defined as the assumption that the entity "will continue its operations for the foreseeable future….When the use of the going concern basis of accounting is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business."[2]

That is, 'going concern' value assumes the company has sufficient funds to pursue its operations for the foreseeable future. This definition is not appropriate for a company in administration as the company is by definition unable to discharge its liabilities in the normal course of business.

We consider that a 'going concern' value is not appropriate since fair value principles (i.e. the seller cannot be considered to be 'not anxious') that underlie 'going concern' value no longer apply and have the potential to imply value that does not exist for shareholders. As such, 'Going concern' may be confusing to shareholders as it misrepresents reality.

There is also complexity as to the ongoing forecast assumptions and difficulty in establishing a reasonable basis since the company is not a going concern (re RG 111.74).

Rather, an acquirer would take into consideration:

(i) the distressed nature of the business (e.g. through a higher discount rate), and

(ii) other creditors (other than debt) that are crystallised as a result of the administration (and, therefore, should be deduced from the value of the business).

In preparing our IERs for Ten Network and Oroton, we valued the business operations on a 'going concern' basis (i.e. enterprise value), then deducted all borrowings and creditors' claims that crystallised as a result of the administration from the value of the operating business. We had to make various assumptions that did not reflect the reality of the businesses at that time, as the businesses were unable to discharge their liabilities in the normal course of business, and as such the value to shareholders.

If going concern value is to be applied in the case of 444GA transactions, it would be appropriate for RG 111 to clarify the definition of going concern value in the case of an administration in accordance with the above.

B2Q4: *If you agree with the previous question, should ASIC refuse relief where the going concern value shows the shares have some value?*

[2] Source: para 2, "Auditing Standard ASA 570: Going Concern", December 2015

KPMG response: n/a

B2Q5: *Are there other factors that we should take into account when considering whether to grant relief?*

KPMG response: n/a

B3: Who should prepare the IER?

Proposal B3: If we proceed with Proposal B1, we propose that the IER should be prepared consistent with the principles in RG 112. In our view, this would preclude the administrator (or another member of the administrator's firm or party associated with their firm) being the independent expert.

Feedback

B3Q1: *Do you agree with this view? If not, why not?*

KPMG response: Yes, we agree that an IER should be prepared consistent with the principles in RG 112. One of the advantages of having an IER prepared consistent with the principles of RG 112 is that it would be prepared independently of the administrator. The administrator has taken charge of the company and is primarily focused on achieving the best possible return to creditors. The administrator is not, therefore, in a position to independently prepare a report for use by the shareholders. Further, the decision shareholders have to make is whether to object to a course of action being proposed by the administrator. To assist with the making of that decision, shareholders should receive a report prepared by a party other than the administrator.

B3Q2: *Do you agree that the concepts of independence should be based on RG 112? If not, what other standards should be applied?*

KPMG response: To maintain consistency between an IER prepared in the context of a 444GA transaction and those prepared in other control transactions, the concepts of independence set out in RG112 should be applied. It would not, therefore, be helpful to the market or to shareholders to introduce different concepts of independence for an IER prepared in these circumstances.

B3Q3: *Do you believe that another member of the administrator's firm or party associated with the administrator's firm (or their advisory/consulting arm), who has not been involved in the administration, should be allowed to prepare an 'independent expert' report? If so, why? If not, why not?*

KPMG response: The independent expert should not be from the same firm as the administrator as this represents a conflict of interest. Some firms have the scale, policies and processes to manage elements of the potential conflict. For instance, KPMG's independent experts are members of a different business unit to its administrators, and it would be able to establish separate teams and implement ethical dividers between those two teams. However, as noted above, the decision shareholders have to make is whether to object to a course of action being proposed by the administrator. If the individual preparing the IER is from the same firm as the administrator, in our view, there are no safeguards which could be applied which could ensure independence of mind and it is unlikely there would be independence in appearance. This reduces the credibility of the IER and may increase the likelihood of shareholders objecting.

Other observations

Currently RG 111 has sections pertaining to control transactions, demergers and demutualisations, sale of securities under item 7 of s611, compulsory acquisitions and buyouts and related party transactions.

It would be helpful for the independent expert if RG 111 was amended to include guidance regarding s444GA transactions. This would possibly include:

- What is meant by 'liquidation value' similar to that for fair value under RG 111.11
- What opinion is required from the expert (as per RG 111.10 for fair and reasonable)
- Any amendments to valuation approaches that should be considered re RG 111.69
- Relevant matters an expert should consider similar to what is provided for other transactions i.e. the impact of a distressed seller, crystallisation of creditors as a result of the administration
- How an expert may consider forecast financial information given the requirement for a reasonable basis

Financial implications, competition, compliance

It is conceivable that there are circumstances where the benefits of not requiring an IER could outweigh the advantages of requiring an IER. A requirement to have an IER prepared will increase the cost to the company, and may delay the proposed transfer of the shares (although we note that the commissioning of an IER is already market practice in many transactions). Both may, in some circumstances, result in the company being forced into liquidation when it otherwise would not. Perhaps ASIC could consider a requirement for relief to be obtained from the requirement to have an IER prepared, but such relief should only be granted in exceptional circumstances.

We have considered the impact of the above with respect to financial implications, competition and compliance and note as follows:

Financial implications

It is recognised that in certain circumstances the requirement for an IER may increase costs noting however that market practice is moving in this direction already given the different skills required to prepare such a report as well as the benefits of having an independent party consider the value of the business.

Competition

We do not consider there is any material impact on competition. Currently only limited organisations have the ability to prepare both an administrator's report and an IER. Separation of the roles as such is likely to have little impact.

Compliance

We consider this will be improved. It reduces the likelihood of parties without the necessary experience seeking to opine on such transactions and provides shareholders with improved information upon which to consider their interests.