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AMF

STRENGTHENING THE INDEPENDENT FINANCIAL VALUATION PROCESS IN CONNECTION WITH TAKEOVER BIDS AND MERGERS OF LISTED COMPANIES

CONTENTS

INTRODUCTION

The recommendations made in this report are a continuation of a study begun several years ago by the COB and the CMF regarding financial valuations and the role played by independent experts in mergers between listed companies.

In view of the missions entrusted to the COB and the CMF, namely to safeguard investments and regulate takeover bids, these institutions have always placed great importance on equal treatment of shareholders and on the information provided to them. In this regard, independent experts who express an opinion on the fairness of the price or parity proposed to shareholders have an increasingly significant function.

In 1977, the COB published recommendations concerning shareholder information and payment for contributions in kind in connection with mergers, spin-offs and split-offs. These recommendations established the principle of a multi-criteria approach – which has since been extended to include other types of operations – and laid down a number of compulsory rules related to the application of these criteria aimed at allowing spinoff auditors (and since then merger auditors) to express a clear opinion on the proposed payment.

Following the adoption in 1993 of the law relative to squeeze-outs, the work of independent experts increased. The fairness opinion became a key element of the information provided to minority shareholders. In 1995, the COB published an article in its monthly review which sought to establish a framework for the work of independent experts and the drafting of the fairness opinion.

In 1996, Mr. Jean-François Lepetit's report dealt with the protection of minority interests in connection with mergers and share price guarantees. At that time, he described the role of auditors and the function of financial valuations with regard to mergers.

Subsequent reports contributed further to this discussion or established a regulatory basis for the work of independent experts. For example, in 2002 the COB published new recommendations aimed at broadening the scope of the independent expert assessment, defining the conditions of the expert's independence and clarifying the multi-criteria analysis.

This framework, though now very well-defined, needed to be reviewed in light of several events which are likely to impact the work of independent experts and financial valuations and demonstrate that further progress in this area is still possible:

- A large number of delistings have occurred in the last two years, at times involving recently-listed companies and under very disputed price conditions.
- The valuation methods used by financial advisors and experts have changed significantly, with some becoming very highly developed.
- The implementation of the IAS/IFRS standards will bring consistency to the financial statements of European companies listed on a regulated market and systematise depreciation tests.
- European Directive 2004/25 of 21 April 2004 on takeover bids, the transposition deadline of which is 20 May 2006, will create a new regulatory framework.
- There has been a great deal of criticism in the United States regarding the conditions under which fairness opinions are established. This criticism has led several professional associations to study the independence and transparency criteria of valuators.

In light of these events, the AMF Board wished to conduct an in-depth analysis of the financial valuation process and, to this end, approved the creation of a working group chaired by Mr. Jean-Michel Naulot.

The role of the working group was to clarify the notion of independent expert assessment and reinforce it. To accomplish this, the group would need to define standards for conducting independent expert assessments, examine cases where an independent expert assessment might be made mandatory, re-examine mechanisms for oversight of this activity by the AMF and study recent changes in valuation methods.

The working group, made up of individuals representing the various parties involved in financial valuations, adopted a work method based on the following principles:

- Consensus-building: all the solutions proposed were approved by the members of the working group.
- A broad approach to the subject: the working group attempted to deal with all problems encountered during independent expert assessments and financial valuations in connection with takeover bids and business mergers.
- Wide latitude in the types of proposals made: certain proposals are mere recommendations while others, if implemented, will require regulations.
- Recognition of the new regulatory framework: the analysis was conducted by incorporating the provisions of the European Directive on takeover bids and the effects of the transition to the new international accounting standards.
- A careful examination of the situation abroad: since the same questions are now being raised in the United Kingdom and the United States, the solutions proposed should, as a rule, be along the same lines as those currently being considered in those countries.

Based on observations of independent expert assessments and financial valuations in both France and English-speaking countries, the working group proposes the definition and application of key principles to reinforce independent expert assessments in connection with takeover bids. The working group recommends that the expert's mission be extended to include several operations not covered by current regulations. It also proposes a change in the approval procedure. Lastly, it makes several recommendations concerning the use of the various financial valuation methods based on the new European and accounting regulatory framework.

Given the role that the independent expert assessment will be required to play in the next few years, the working group considered it urgent to provide a better framework for it, along the lines of the measures taken in recent years to establish a more appropriate framework for the notion of director – and particularly that of independent director – pursuant to the rules of good governance. This will lead to better protection of investors, and especially minority shareholders.

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I. OBSERVATIONS ON THE INDEPENDENT EXPERT ASSESSMENT AND FINANCIAL VALUATION PROCESS

As an introduction to its task, the working group wished to make several observations so as to better define the context of its study and identify areas in which further progress can be made:

1. An independent expert assessment, in the area covered by this report, is an evaluation of the financial conditions proposed in connection with a business merger. It is undertaken by a third party who is independent of the participants in the operation and culminates in a fairness opinion. The aim of the assessment is to inform the target company's Board of Directors and shareholders and, for a takeover bid in France, the AMF Board deciding on the admissibility of the bid, of the fairness of the price proposed by the offeror. The use of an independent expert assessment has already been routine for squeeze-outs since 1993. Moreover, in the last few years listed companies have increasingly and on their own initiative relied on this type of procedure for other operations.

2. The French regulator has, on several occasions, published texts in the form of recommendations, directives and regulations to establish a better framework for independent expert assessments. However, the conditions under which independent expert assessments are conducted are strictly regulated only in the specific cases of squeeze-outs and mergers.

3. With respect to bids, the French regulator has always stressed the importance of the multi-criteria analysis and the price determination factors needed to assess the admissibility of a bid (under the control of the Court of Appeals). This stance taken by the French regulator differs from that of regulators in Great Britain and the United States, where the valuation criteria are verified ex post and by the judge. Thus, for the buy-out offers followed by a squeeze-out (OPR-RO) that occurred in 2003, four valuation methods, on average, were used. For these offers as a whole, a total of seven different valuation methods were counted.[1]

4. The independent expert assessment, however, is limited to an "appraisal", as provided by the regulations, or to a second-level control, and does not entail a full valuation of the company affected by the squeeze-out (Article 237-1 of the AMF's general regulations).

5. In the case of squeeze-outs, the independent expert assessment is organised by the offeror and its financial advisor and not by the target company which it is meant to protect.

6. When a company's Board of Directors uses an independent expert assessment on a voluntary basis, the fairness opinion currently seems to be designed more as a means of legal protection against a possible dispute related to the existence of a conflict of interest or as a way to ensure the success of the bid than as an *inter partes* procedure to benefit the target company's minority shareholders.

7. The independent expert assessment is not mandatory in certain cases where a potential conflict of interest does, in fact, exist (for example, in the case of simplified takeover bids).

[1] Cf. Appendix 5 "Comparative study of the valuation methods used by consultant banks for buy-out offers followed by a squeeze-out occurring in 2003 and 1994".

8. In English-speaking countries, independent expert assessments are also very prevalent.
   In Great Britain, the target company's Board of Directors must use an independent expert assessment[2]. These are conducted mainly by corporate banks.
   In the United States, where independent expert assessments are still not stringently regulated, they are conducted by both investment banks or specialised appraisers. Yet the conditions under which these fairness opinions are sometimes issued are currently the subject of criticism regarding the terms and transparency of payments, the valuators' independence and the multiplicity and subjectivity of the methods and sources used. The National Association of Securities Dealers (NASD) is expected to make proposals in the near future aimed at establishing new rules and will submit these proposals to the SEC.

9. In France, unlike the United States and Great Britain, independent expert assessments are rarely conducted by investment banks but rather by specialised appraisers, except in the case of very large operations. This is due mainly to the fact that, for OPR-ROs, in most cases it is the financial advisor which, acting on behalf of the offeror, proposes the appointment of the independent expert. The firms involved vary greatly in size and activity, and include specialists in independent expert assessments, consulting firms, accounting firms and so on.

10. Factors such as time, the teams assigned and the independent expert's compensation vary to some extent. For OPR-ROs, for instance, which represent only a portion of independent expert assessments and entail, by definition, only small amounts (less than 5% of the target company's capital), an analysis conducted by the AMF staff in 2003 and 2004 revealed significant diversity in the sizes and activities of the firms acting as independent experts[3]. Moreover, resources in terms of budget, time and personnel do not show a clear correlation with the size and complexity of the mission. It was noted that the duration of the assessment, calculated based on the definition used in the study, ranged from several days to several months, with the average being 52 days. The budget estimates reported by the AMF varied from 6,000 to 150,000 euros and the average budget was 35,000 euros. Finally, the teams assigned consisted of one to five people, with an average of two.

11. Transparency of the independent expert assessment process (appointment of the expert, completion of the tasks) could be improved.

12. There is rarely a discrepancy at the end of the process between the expert's findings and those of the offeror's advisor. In certain cases, an expert involved very early on in the process exerts some influence on the work of the offeror's financial advisor. In other cases, an expert intervening not much sooner than the night before the start of the operation will give his hasty support, without there being, from a statistical point of view, any other disagreements between the expert and the offeror.

13. Approval by the AMF is currently based on the review of a file submitted by the expert prior to his work but without any subsequent control, on the basis of records or on the spot, of the quality of the work carried out.

[2] Cf. in particular the provisions of rules 3 and 16 and Appendix 3 of the City Code.

[3] Cf. Appendix 4: Analysis of the conditions applicable to independent experts involved in buy-out offers followed by a squeeze-out launched in 2003 and 2004.

14. The competitiveness of the Paris stock exchange and the restructuring needs of the economy require that the regulations, while protecting investors, and particularly minority shareholders, not be unnecessarily stringent or drawn out so as to ensure the proper flow of operations.

II. BASIC PRINCIPLES OF THE INDEPENDENT EXPERT ASSESSMENT

Based on the above observations, the first task assumed by the working group was to define a set of basic principles common to all operations for which an independent expert is appointed, whether or not the expert assessment was required by the AMF general regulations.

These principles would apply not only to the various stages of the expert's mission, but also to his tasks and report. The working group also deemed it necessary to review the responsibilities of the target company's Board of Directors and to reinforce its role.

2.1. Establish the framework for the expert's involvement

a) Under what circumstances must an independent expert be involved?

The working group believes that an independent expert must be appointed whenever there is a potential conflict of interest among the decision-making bodies of a company involved in a takeover bid or financial transaction.

b) Who appoints the independent expert?

The target company's Board of Directors[4] should appoint the independent expert, whose responsibility will be to:

- Support the decision-making process based on the reasoned opinion that he is required to present to the market regarding the operation;
- Help the minority shareholder make a decision;
- Provide an initial assessment before the AMF exercises its control in the operations for which it is reviewing the admissibility of the proposed bid.

The offeror's Board of Directors may also appoint an independent expert in order to inform its minority shareholders with regard to a take over bid if it believes that there may be a conflict of interest among its own decision-making bodies. The same principles established for conducting an independent expert assessment of the target company would apply in this case.

c) Who is the independent expert?

The independent expert should be guided by the following minimum principles:

- Adhere to a code of ethics;

[4] These principles were established with reference to corporations managed by a Board of Directors, which continues to be the most common form used by listed companies in France. Corporations managed by a Supervisory Board and an Executive Committee and partnerships limited by shares should transpose them as appropriate.

- Sign an attestation of independence;
- Have prior recognised professional experience in the financial markets and in valuation;
- Have the means to fulfil his mission (dedicated team, access to databases, etc.);
- Have sufficient time to carry out the mission;
- Be subject to a fairness opinion committee (cf. definition in section IV, paragraph 4.3 below);
- Be paid a fixed sum based on the size and complexity of the operation;
- Be insured against possible risks incurred in connection with the expert assessment.

d) What does the independent expert's report contain?

The expert's assessment should support the duly reasoned decision made by the target company's Board of Directors concerning the bid price and help the minority shareholders make their decision.

The independent expert assessment should therefore include a valuation of the target company. Thus, the independent expert's report should consist of at least five sections:

- A description of the context of the operation;
- A valuation of the target company or of the assets concerned, including all the methodologies described in section V of this report;
- A critical analysis of the work carried out by the offeror's financial advisor;
- A description of the procedures followed;
- The fairness opinion or recommendation to the target company's Board of Directors in case of disagreement.

e) How should the expert proceed?

In order to best complete his mission, the expert should proceed as follows:

- Discuss the financial statements and business plan with the target company's management teams;
- Discuss the terms of the bid with the financial advisors and conduct a critical analysis of the hypotheses presented;
- Draft the report with emphasis on any points of disagreement with the offeror and its financial advisors;
- Present the report to the target company's Board of Directors;
- Publish the report in support of the reasoned opinion of the target company's Board of Directors as part of an offering circular. In the case of a single offering circular, the report should be given a significant and even equivalent place to that of the valuation conducted by the offeror's advisor. For reasons of confidentiality, the published report could, however, differ somewhat from the report submitted to the Board of Directors.

2.2. Make the target company's Board of Directors responsible for the procedures

The working group believes that the target company's Board of Directors is greatly responsible for ensuring that the independent expert assessment is properly conducted.

The Board of Directors is responsible for:

- Protecting the interests of all shareholders.

- Appointing, where appropriate, a board of independent directors capable of overseeing the expert's mission.
- Choosing an expert whose qualifications, resources and professional reputation are consistent with the mission.
- Appointing this person as early as possible.
- Defining the expert's mission.
- Taking all necessary measures to support the expert assessment, which should be overseen, if applicable, by an ad hoc board of independent directors, if one exists. These measures, which must, of course, be suited to the size and complexity of the transaction, include the following steps:
    - Following standard procedures, approve the company's business plan and deliver it to the expert.
    - Together with the expert, determine the time needed to study the file.
    - Together with the expert, decide on the latter's payment, which should be in line with the complexity of the valuation, the available resources and the expert's qualifications and reputation.
    - Ensure that the expert conducts the assessment properly and follows all necessary procedures.
    - Ensure that the quality of the information provided by management and the audit committee is satisfactory.
    - Review the expert's report and discuss it at a meeting of the Board of Directors in the presence of the expert before reaching an opinion on the bid.
    - Once the opinion on the bid has been made public, answer questions from the minority shareholders in the presence of the independent expert if they require further information.

The Board of Directors must also ensure that the operation is kept strictly confidential.

2.3. Ensure greater transparency regarding the actions taken by the Board of Directors and the expert

In order to improve transparency regarding the role of the Board of Directors and the expert's work, the working group believes that certain information should be made public.

The following information concerning the target company's Board of Directors must be included in the offering circular :

- Actions taken by it with respect to the operation;
- An explanation of the choice of expert, based in particular on criteria such as qualifications, independence and suitability of the resources to the stated objective;
- The amount of the payment made to the expert.

The following procedural information regarding the expert and his mission must be included in the report and the offering circular :

- A presentation of the expert (description of his organisation, his most recent assignments and the resources that were available to him);

- The schedule of the assessment and the analysis methods used (including, in particular, the specific work schedule and a detailed description of the actions taken during the mission);
- The personnel involved in the assessment (along with the experience and qualifications of the various participants);
- The creation of a fairness opinion committee;
- The payment specified in the mandate;
- Indication of the process and information sources used;
- Attestation of independence;
- Existence of a code of ethics and, if applicable, membership in an association having a code of professional conduct.

2.4. Ensure the expert's independence with respect to the offeror, target company and financial advisors

It is important to have experts who are competent, have resources consistent with the mission entrusted to them, can vouch for their reputation by their signature and are insured against possible legal action.

The Board of Directors must ensure adherence to the following general principles:

- The expert must be independent with respect to the offeror and its financial advisors.
- The expert must not have a significant interest in the success of the operation.
- All conditions must be met to allow the expert to give an objective, impartial opinion on the operation.

The expert must provide a statement of strict independence with respect to the offeror, the target company and their advisors. Both the reality and the perception of this independence must be assessed. In order for an expert to be independent in reality, he must be able to give an impartial opinion, both subjectively and objectively, on all matters related to his mission. The perception of independence refers to the opinion that a reasonable and reasonably well-informed investor might have of the expert's ability to give an objective, impartial opinion on all matters related to the mission.

Following are some examples of circumstances that would prevent the signing of an attestation of independence:

(i) The existence of a legal or financial relationship that could potentially create a dependence, or any other factor that could result in a conflict of interest with the offeror (including its subsidiaries) and/or its advisor, or with the target company and/or its advisor. If such a relationship were to exist without likely creating a dependence, the expert would be required to state this in the attestation of independence and demonstrate the non-significant nature of the relationship or the existence of an appropriate "Chinese wall"-like organisation ensuring the expert's independence in carrying out his mission.

(ii) The existence of a pecuniary interest, other than the published mandate, in carrying out the planned operation.

(iii) The existence of a consulting project carried out with the offeror, including its subsidiaries, during the two years prior to the bid, unless this consulting project is not likely to create a dependence. In this case, the project must be clearly indicated in the attestation of independence.

The fact that a financial institution which carried out several consulting projects for the target company is appointed as an expert for the target company should not be prohibited, unless the offeror and the target company are members of an integrated group, and provided that the general principles outlined above are complied with.

(iv) The existence of a claim or debt between the offeror, including its subsidiaries, and the expert which is likely to create an economic dependence. If a debt exists that does not create an economic dependence, the independent expert must nevertheless state this in the statement of independence and show that an appropriate "Chinese wall"-like organisation exists which ensures the expert's independence in carrying out his mission.

The statutory auditors of the offeror or one of its affiliates, of the target company or one of its affiliates, or of the directors paid in connection with the transaction may not be designated as authors of the fairness opinion.

To ensure independence, the fixed-sum payment shall be due irrespective of the outcome of the financial transaction.

The expert's independence will be further ensured by the publication of his payment, as recommended in paragraph 2.3.

Lastly, the expert's involvement in several transactions for the same company or the same bank should not result in the creation of a dependence.

2.5. Standardise the timeframes for appointing the independent expert

The independent expert should have at least 20 days, except under special circumstances, to prepare his report once the target company's Board of Directors has ensured that he has received, upon his appointment, the information needed to conduct the valuation.

In all the cases referred to above, the independent expert's report should be made public when the bid is filed.

There may, however, be two exceptions to this rule:

- If the bid is initiated by a new shareholder;
- If, due to special circumstances, the Board of Directors considers it necessary to postpone the appointment of the independent expert.

In both cases, publication of the expert assessment could be postponed for up to 20 days following the filing of the bid, which would move back the date of admissibility by the AMF Board by the same amount of time.

III. SCOPE OF THE INDEPENDENT EXPERT'S WORK

The working group believes that the rules for applying independent expert assessments must, depending on the types of operations, be based on three objectives:

① To encourage the target company's Board of Directors to use an independent expert assessment when it has any uncertainty about the existence of a conflict of interest related to a merger;

② To extend the scope of mandatory expert assessments to include bids that entail an underlying conflict of interest;

③ To ensure that, in certain cases, the independent expert assessment is not a mere formality:

- *consecutive bids*: the expert assessment should occur as early as possible;
- *mergers*: the transposition of the European Directive on takeover bids should encourage market operations in case of mergers.

3.1. Obligations of the Board of Directors

A merger between two companies is a major undertaking which must, in accordance with the principles of good governance, be based on a duly reasoned decision by the Board of Directors. The decision made by the target company's Board of Directors is an essential act which binds the directors, whose role is to protect each shareholder's interests.

When making its decision, the Board of Directors must elicit the opinions of experts and consultants who, of course, do not relieve it from any of its legal or moral obligations. The aim of the Board of Directors should be to assess the bid price which, though not the only factor, is a key element of the opinion it is required to give the shareholders.

The working group believes that the Board of Directors should use an independent expert assessment prior to making its official decision if it is uncertain about the existence of a possible conflict of interest or if it requires further understanding of the bid or operation in question or its conditions or impact, particularly for minority shareholders.

The working group also believes that the term "fairness opinion" should be limited to attestations issued in accordance with the abovementioned AMF standards. Thus, the Board of Directors could issue a "fairness opinion" only if the independent expert assessment was carried out in accordance with the AMF standards. In this case, the text of the opinion and the payment specified in the mandate would therefore be published.

Of course, any opinion which does not comply with the AMF standards could be published without it being called a "fairness opinion".

This would eliminate the dichotomy between an independent expert assessment and a fairness opinion, except in the case of a fairness opinion issued by the merger auditors at the request of the Commercial Court.

3.2. Cases where an independent expert assessment would be mandatory

The working group recommends that an independent expert assessment be required in the five cases below where a potential conflict of interest exists, as well as in certain atypical operations:

a) Isolated or consecutive OPR-RO

A squeeze-out, an operation that results in the expropriation of minority shareholders, would require, as it currently does, an independent expert assessment with two differences:

- The independent expert assessment would no longer consist of an "appraisal" but rather a full undertaking that includes a valuation subject to the standards defined in this report.
- For a consecutive OPR-RO, when it is announced as such, the independent expert assessment would occur at the time of the initial bid, and the expert would confirm only at the time of the OPR-RO that the parameters had not changed.

In consideration of these regulations, which provide greater protection of minority shareholders' interests, the working group recommends that the OPR-RO threshold be reduced from 95% to 90%, as is authorised by the European Directive on takeover bids and is already the case in Great Britain. This easing of the threshold would facilitate economic restructuring operations, which are sometimes hindered by the presence of a fund wishing to block the operation. It would also keep the shareholder from becoming gradually caught in a dangerous situation of having no liquidity. In addition, it would encourage companies to opt for a market bid before conducting a merger between two listed companies (cf. paragraph 3.2.e) ii) below). Nonetheless, this debate over lowering the OPR-RO threshold must take into account the specific characteristics of listing on the Paris stock exchange (overall consistency with the ability to have reduced float at the time of listing, with the implementation of buyback programmes, etc.).

b) Voluntary simplified takeover bid/share exchange offer (OPAS/OPES)

When the bid is made by a shareholder who already controls the company (voluntary bid), the working group believes there is an underlying conflict of interest which gives reason for an automatic independent expert assessment.

c) In certain cases, a share buyback offer (OPRA) and simplified takeover bid (OPAS) by a company of its own securities

When a company launches an OPRA or OPAS of its own securities, there may be a conflict of interest if the controlling shareholder (or one of several acting in concert) does not bring his or her own securities to the bid. In this case, an independent expert assessment is required. As a special case, the assessment would consist not of a valuation but rather an independent opinion on the bid conditions for both the shareholder participating in the bid and for the shareholder not participating in it.

d) In certain cases, a reserved capital increase, depending on its terms and conditions

Reserved capital increases which include a discount on the quoted market price and allow a shareholder or group of shareholders acting in concert to obtain a significant interest in the company would result in an independent expert assessment.

e) Merger-absorption

Two complementary avenues were explored to improve the financial valuation process in the case of a merger-absorption.

(i) Use of an independent expert assessment

The working group believes that any merger between two listed companies – excluding those following a voluntary bid on a non-controlled company (as in the case of Sanofi/Aventis) – should result in an independent valuation.

Indeed, to the extent that there are minority interests in the controlled company and, based on the rule of parallelism of forms with other mergers, it is important that the Board of Directors be able to make a reasoned decision on the basis of an independent valuation.

It should be recalled that pursuant to French law special auditors are appointed by the Commercial Court in order to :

- assess the value of contributions in kind (Art. L.225-147 of the Commercial Code);
- determine the fairness of the share-for-share exchange basis (Art. L.236-10 of the Commercial Code);

with the understanding that the fairness opinion given by the special auditors is issued to the Boards of Directors of both the controlling and the controlled companies.

The working group believes that special auditors, when determining the share-for-share basis, should apply the recommendations of this report and, in particular, conduct a valuation of the companies concerned while remaining faithful to the specific requirements of their mission. When the merger follows a takeover bid, the merger auditor(s) should be appointed at the time of the initial bid.

If the structure of their mission, the nature of the procedures and the content of their opinion were to fulfil all the principles laid out in this report, their mission would have the effect of an independent expert assessment. A study should be undertaken parallel to this to improve the merger auditor appointment process.

(ii) Choice of market bid

Some regulators go a step further by taking measures that allow minority shareholders to approve the proposed merger:

- In the United States, the measures vary greatly from one company to another and at times from one state to another. In most cases, the target company's board of independent directors requires that a majority of the minority shareholders vote in favour of the merger as a condition precedent to proceeding with the merger, while in some jurisdiction the majority shareholder is prohibited from voting at the target company's shareholders' meeting.

- In Great Britain, any shareholder who is party to the operation and holds at least 10% of the voting rights of the absorbed company is prohibited from voting at this company's shareholders' meeting. At the time of the meeting, the merger must be approved by more than 50% of the votes cast. In addition, all mergers are preceded by a bid with a threshold of 90% in most cases. The bid may be followed by a squeeze-out if the threshold condition is met. The bid is made in cash if the offeror purchased securities during the previous year.

In France, the merger must be approved by two-thirds of the votes cast at the shareholders' meeting; however, the majority shareholder participates in the voting.

Moreover, the merger does not necessarily result in a bid since it may be subject to an exemption pursuant to the AMF's general regulations (Article 234-8 3 of the general regulations for compulsory bids and Article 236-6 2 for share buyback offers).

Jean-François Lepetit, in an effort to give greater consideration to the interests of minority shareholders, stated as early as 1996 in his report that "*shareholders controlling an absorbed company who propose an early exit to minority shareholders are taking a welcome step."*

In fact, the decision to proceed with a merger without first making a takeover bid is often based on the desire to not make a cash offer at the time of the squeeze-out, as a merger involves an exchange of securities.

The working group believes, however, that the transposition of the European Directive on takeover bids could, in the future, encourage companies interested in a merger to opt more often for takeover bids.

According to this Directive, Member States must include in their stock market regulations the option to proceed with a squeeze-out paid in securities at the time of a consecutive operation: *"Member States shall ensure that a fair price is guaranteed. That price shall take the same form as the consideration offered in the bid or shall be in cash. Member States may provide that cash shall be offered at least as an alternative."* (Art 15.5).

On this latter point, it is of course preferable that the transposition of the Directive not provide the obligation of a cash option at the time of a consecutive squeeze-out.

This means that a company initiating a merger would have the option to pay for the squeeze-out either in cash, in securities or a combination of the two. It should therefore no longer be wary of takeover bids and, as a result, should seek the exemption less frequently.

The fact that the OPR-RO threshold would at the same time be lowered to 90% (cf. paragraph 3.2.a) would further encourage the offeror to carry out its proposed merger via a market operation.

Thus, in accordance with the principles of good governance, the working group is hopeful that the transposition of the Directive will make market operations appear increasingly as an alternative way to carry out a proposed merger between listed companies.

Two additional observations have been made:

- The expenses incurred by the shareholder through an OPR-RO paid in securities or a combination of securities and cash must be the same as those for an OPR-RO paid in cash.

- The liquidity of the securities offered should be sufficient.

f) Atypical cases

To the five previous cases, we should add certain operations which, by their nature, do not necessarily call for an independent expert assessment but may, nevertheless, require one under certain circumstances.

This could apply to a standing market offer[5] carried out under atypical conditions (for example, bid at a price below the weighted average of the previous two months' prices) in order to help shareholders make a well-informed choice between retaining their securities or selling them at the expense of liquidity.

An expert assessment might also be required if there existed operations related to the bid that could have a significant impact on the price and would therefore possibly undermine the principle of equal treatment of shareholders. Special care must therefore be taken when management obtains significant advantages in connection with the bid.

Lastly, an expert assessment might also be required if the acquisition was paid for with complex debt financial instruments (equity notes, convertible bonds, stock warrants, etc.).

IV. CODE OF PROFESSIONAL CONDUCT AND OVERSIGHT OF THE INDEPENDENT EXPERT'S WORK

4.1. Code of professional conduct

Professional associations whose members have recognised experience in the field of valuation (SFAF - French Society of Financial Analysts, SFEV - French Society of Valuators, etc.) would develop a code of professional conduct defining the principles that independent experts must follow in their mission and the resources that they must have in order to comply with them.

These codes should include *at a minimum* basic principles of behaviour (integrity, competence, independence, conflict of interest, fraternity, discretion, etc.) and organisation (acceptance of a mission, fulfilment of a mission, available human and physical resources, use of experts and external databases, etc.). They should identify prohibited and high-risk situations, as well as safeguards.

4.2. Code of ethics

Independent experts and independent expert firms – excluding investment services providers which already have their own rules – should periodically adopt a code of ethics which adapts the above principles to their own structure and indicates the resources available to them to carry out their mission.

[5] A standing market offer ("garantie de cours") is a mandatory bid carried out by an investor after acquiring control of a listed company.

4.3. Internal control procedures: fairness opinion committees

The working group believes that, much like the practice implemented in other countries and in some cases in France, an independent expert assessment should include internal control procedures to ensure the quality of the work carried out.

The following rules could apply:

a) Investment services providers (ISP)

The procedure that currently exists at certain establishments was defined by the working group as follows:

At investment banks, a specialised or non-specialised committee ensures that valuations are conducted efficiently and monitors the quality of these projects and the management of risks related to preparing and publishing fairness opinions.

This committee gives its consent prior to the signing of a mandate and the delivery of any document to a client (valuation report, fairness opinion, etc.) and decides on possible conflicts of interest.

This committee is made up of professionals from the field, managers of the investment bank and a compliance officer. It meets as often as necessary and at least twice: prior to the signing of the engagement letter and prior to the issuance of the valuation document and attestation. The valuation report must be sent to the committee with sufficient lead time. The committee's decision is recorded in minutes and a favourable opinion signifies approval to send the document to the client.

b) Non-ISP independent experts

Independent experts should also take the initiative to establish *inter partes* procedures for reviewing their work. These reviews could be organised at the firms or through a professional association.

Independent experts should use the procedure implemented by ISPs as a model, particularly as regards the diversity and independence of the committee charged with giving an opinion on the method and conclusions of the expert's work.

In the future, the independent expert should not be the only person concerned with the report. He should be able to receive opinions from those not involved in the valuation while remaining free to arrive at his own conclusions, and this in strict compliance with the rules of confidentiality.

4.4. Replacement of the approval of independent experts by an *a posteriori* AMF review

At present, experts are approved through a quick, formal review of a file submitted to the AMF. The file contains the expert's presentation, the timetable of the valuation, the proposed analysis methods, the personnel assigned to the valuation, the budget and an attestation of independence.

The working group believes that it would be more appropriate to replace the AMF's *ex ante* approval of the expert by the principle of procedural transparency and an *a posteriori* review of independent expert

assessments under the conditions described below. Moreover, the independent expert should fulfil the following two conditions:

- Adopt a code of ethics (cf. section 4.2);
- Implement procedures that conform or are similar to internal control procedures (cf. section 4.3).

Lastly, the AMF could certify professional associations of independent experts that have adopted a code of ethics and implemented transparent member selection criteria and procedures in order to ensure that their members perform their work in accordance with the rules of professional conduct and the professional standards imposed by their respective associations. Independent experts belonging to a professional association certified by the AMF would be considered as having some form of internal control.

The elimination of an *ex ante* review should be arranged in collaboration with the experts, who should be given a period of time to transition to this new system.

4.5. Definition of the ex post review of independent expert assessments

The new procedure would entail an ex post review by the AMF to ensure the expert's compliance with the rules of transparency and with the methodology used to conduct valuations.

The ex post reviews would cover the following main points:

- Accuracy of the attestation of independence;
- Compliance with the code of ethics and the internal procedures applicable to the expert;
- Review of the methodology used and actions taken;
- Review of the qualification level and number of internal or external employees involved in the expert assessment;
- Verification of the file (retention of the files, professional liability insurance), which implies keeping the file for a minimum of 10 years;
- Review of the reports and, in particular, their conclusions, as well as the procedures and work carried out.

The AMF could establish a scale of penalties that includes such measures as warnings, temporary or permanent denial of the right to practice, etc., based on the severity of the offences.

V. VALUATION METHODS

As an introduction to this section, the working group would like to make four comments:

- Unlike the previous sections, the main purpose of this section is not to establish rules but rather to make reasonable recommendations based on experience to ensure that methods are not used for a subjective purpose.
- These recommendations are intended primarily for independent experts (corporate banks and independent firms) – and not financial advisors – which must adhere to certain standards in a particularly important profession given the manner in which their work is applied by the Board of

Directors that appointed them, the shareholders whose interests they protect and the AMF Board which decides on the admissibility of the bid.

- This analysis of the valuation methods is particularly appropriate in view of the fact that independent experts will now be required to routinely conduct a valuation before presenting their conclusions.
- These recommendations must be in line with the European Directive on takeover bids. They must also take into account the transition to the new IFRS standards, which place special emphasis on fair value.

5.1. Regulatory changes that could impact valuations

a) Framework of the European Directive on takeover bids

In France, all proposed takeover bids, whether voluntary or mandatory, are subject to admissibility by the AMF, which assesses the price or share-for-share basis "based on generally-accepted objective valuation criteria and the characteristics of the target company" (Art. 231-23 of the general regulations).

Although the European Directive of 21 April 2004 on takeover bids does not call for admissibility or a multi-criteria analysis, paragraph 2.b of Article 3 entitled "General Principles" states that: " Member States may lay down additional conditions and provisions more stringent than those of this Directive for the regulation of bids".

The Directive must therefore be interpreted as a minimum harmonisation directive which allows each regulatory authority to propose in its general regulations specific measures aimed at protecting minority shareholders.

The only measures imposed by the Directive are as follows:

- For a mandatory bid (Art. 5), regulatory authorities must ensure compliance with the "equitable price", which is defined as the highest price paid for the same securities by the offeror during a period, as determined by the Member States, of at least six months to not more than 12 months preceding the bid (a price increase is imposed if any securities are purchased at a higher price during the bid).
  The Member States may, however, authorise their regulatory authorities to accept an increase or decrease in this price based on clearly-defined circumstances and criteria, such as if the highest price was set through an agreement between the purchaser and a seller, in case of price manipulation, if the market price was impacted by extraordinary events or to rescue a failing company.
- For an isolated or consecutive squeeze-out (Art. 15), the principle of "fair price" must be applied. If the squeeze-out follows a voluntary bid, the price of the bid is presumed to be fair if, through acceptance of the bid, the offeror acquired at least 90% of the securities carrying voting rights. If the squeeze-out follows a mandatory bid, the price of the bid is presumed to be fair if it is equal to the equitable price defined in Article 5 of the Directive.

b) Entry into force of the IAS/IFRS standards

Regulation No. 1606/2002 of the European Parliament and Council requires that issuers of securities admitted to trading on a regulated market as of 31 December 2005 prepare their consolidated financial

statements in accordance with the international accounting standards adopted through a European Commission regulation. Following the entry into force of this regulation, listed companies will need to change their asset valuation accounting methods, which will consequently impact the amount of their shareholders' equity.

In accordance with IAS standard 36, following impairment tests and if applicable, the carrying amount of an asset must be reduced to the recoverable amount.

The recoverable amount is defined as the highest of:

- the fair value of the asset: market value less costs to sell,
- and its value in use: value of the future cash flows expected to be derived from the asset discounted according to a stringent methodology.

5.2. Working group's suggestions regarding these changes

a) Continued use of multi-criteria analysis

In view of the fact that Article 3 "General Principles" gives Member States broad latitude in defining bid admissibility conditions, the working group recommends that the Directive be transposed while maintaining the principle of multi-criteria analysis, which is the best way to help the target company's Board of Directors and minority shareholders make an informed decision.

b) Expansion of the notion of minimum price

Currently, the notion of minimum price exists in French stock market regulations only with regard to voluntary simplified takeover bids and, of course, standing market offer. In the case of voluntary simplified takeover bids, this price is equal to the average share price, weighted by transaction volumes, during the 60 trading days preceding the notice of filing of the proposed bid (or of its announcement). It may be advantageous to extend this stipulation to include OPR-ROs (particularly isolated or consecutive OPROs with voluntary simplified takeover bids), while specifying that the absence of the security's market liquidity could weaken this criterion in certain cases. Insofar as the rules for setting the price of an OPR-RO can, because of the squeeze-out, hardly be less stringent than those applicable to simplified takeover bids, the AMF has applied this price on many occasions.

Moreover, the aforementioned Article 5 implies the addition of a reference to transactions carried out by the offeror in the period preceding the bid as a minimum price for mandatory bids. This is already the case, from a regulatory standpoint, in Great Britain and, in actual fact, in France, since the multi-criteria analysis makes reference to recent transactions.

The notion of minimum price should therefore be extended to include mandatory bids and even voluntary bids, based on the highest price paid by the offeror during the 12 months preceding the bid or during the bid, in accordance with the Directive.

In view of the application of the new IAS/IFRS standards, the working group also explored the advisability of adding net book value to the notion of minimum price in cases where a company that already controls an asset decides to assume full control of it. This would apply to voluntary simplified takeover bids and isolated or consecutive OPR-ROs (with a voluntary simplified takeover bid).

However, the working group felt that, in such a case, the net book value should be a strong reference without the need to rely on the notion of minimum price.

The working group also believed that the revalued net assets published by a holding company would be a stronger reference than a minimum price in case of a buyback offer by the holding company of its own securities.

5.3. Valuation methods and references: the working group's recommendations

The working group's aim was to define several basic guiding principles to support independent experts in the valuation process. Compliance with these principles should enable them to conduct their valuations according to acceptable professional standards and avoid the danger of opacity or subjectivity. The working group, however, did not wish to give an overly-detailed description that would be unreasonable and might restrict the expert's freedom to complete his file, as this freedom is a key element of any independent expert assessment.

The multi-criteria approach followed by independent experts entails the application of valuation methods and the review of valuation references. A distinction should be made between valuation methods and valuation references.

There are two types of valuation methods:

- **Market approaches**: these consist in assessing a company by reference to comparable companies whose market value are known, either because they are listed or because they were subjects of a recent transaction, which characteristics were publicly disclosed. These methods should be applied even more frequently for two reasons: the growth in cross-border transactions and the implementation of a single set of accounting standards to approximately 7,000 listed companies in Europe.

- **Income approaches**: these consist in determining the company's value based on its expected future risk and return (discounted cash flows, discounted dividends and, in some cases, adjusted net assets).
  The discounted cash flow (DCF) method, in particular, is an important step forward in a multi-criteria analysis as it is based on the company's future outlook and allows a critical analysis of its business plan. This method, which was only used in one-half of all valuations 10 years ago, is now used in a vast majority of cases. The working group recommends that it be applied even more routinely in all situations involving minority shareholders, regardless of the type of bid.

Valuation references supplement the valuator's analysis by checking it against certain value indicators:

- the assets book value ,
- the company's share price,
- significant transactions on the securities included in the valuation,
- analysts' target share prices.

A review of these references is crucial. The decision to exclude any reference to historical share prices or an average share price must be made carefully and substantiated by specific arguments when the company is listed on a regulated market, as this reference is presumed to be legitimate.

Each valuation is specific and it is up to the independent expert, depending on the available relevant information, to determine which method(s) is (are) best suited to the case at hand. The expert must, however, adopt a multi-criteria approach that allows him to:

- Apply, where relevant, the two types of methods defined above;
- Check the results obtained against the available references;
- Clearly describe the process that drove him to exclude or favour one method or reference over another.

Contextual elements are often essential to the expert's reflection to determine the fairness of a transaction. An understanding and an analysis of the context are an integral part of his reasoning and will quite often influence the choice of method used. If the expert's opinion is made available to the public, he must also give an pedagogical explanation of this opinion. This entire process takes time since the expert's opinion is shaped gradually as the various leads are collected during the analysis.

When carrying out his work, the expert must adhere to the following principles:

- **critical examination,**
- **transparency,**
- **consistency and relevance.**

(i) Critical examination

This principle leads the expert to consider with a critical eye all data provided by management or external sources. The expert must consider the reasonableness of the business plan, which must be the same as that prepared and approved by the company's management. It is up to the expert to ask management, which is solely responsible for making forecasts, to change its forecasts if they seem unrealistic given the information obtained by the expert. The expert must also ensure that he is informed of any recent changes made by management to the business plan and must be advised of the reasons for this change.

(ii) Transparency

The expert must provide the Board of Directors with a detailed report of his work and conclusions. The public report must contain enough information to enable readers to understand the expert's reasoning and the main assumptions made.
The sources of the data and information used by the expert must be clearly indicated and any discrepancies between the various sources must be mentioned.

The choice or exclusion of a valuation method or reference must be explained.

When applying the comparables method, the expert must explain the choice of the sample and the adjustments made to ensure the consistency of the data used.

When using the income approach, the expert must:

- Present the key elements of the business plan in general terms (average growth during the period, average return on invested capital, etc.);
- Indicate how specific (normally included in business plans) and systematic (based on the discount rate) risks were handled;
- Present detailed assumptions used to calculate the terminal value;
- Routinely present and explain sensitivity tests based on the central assumption.

(iii) Consistency and relevance

When applying a valuation method, the expert must ensure the consistency of the parameters among themselves and with the external sources and information available to him. Where relevant, he must also ensure that this data is consistent with data from valuations conducted previously.

For the market approach method:

- The selected companies must be sufficiently similar in terms of risk, return and growth.
- The multiples must take into account the characteristics of the company and of the comparables being valued.
- The sample of comparables must consist of companies whose securities are considered liquid enough by the expert.
- The comparable transactions method must be used with a sample of recent transactions, particularly as the market valuation may have changed considerably over the previous two years.

For the income approach method:

- The business plan must use a long enough period to reduce the weight of the terminal value in the total value.
- The risk free rate must match the length of the business plan and the financial projections.
- The terminal value year must reflect the company's competitive position at that time.
- A risk must be taken into account only once, i.e. either in the business plan or in the discount rate.
- The perpetual growth rate must be consistent with the long-term growth rate used for the national economy.
- The cash flows used for the terminal value must reflect a normative situation.

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CONCLUSION

The working group has made 25 specific recommendations in this report aimed at establishing a framework for the expert's work and ensuring his independence and the quality of his work, thereby improving information and providing greater protection of minority shareholders in connection with financial operations.

These 25 recommendations can be summarized as follows:

1. The profession of independent expert, corporate financial advisor or independent appraiser should adhere to specific standards (ethics, independence, work methods).

2. The independent expert assessment should be requested by the target company and not by the offeror.

3. The responsibilities of the target company's Board of Directors must be clearly stated to ensure that the independent expert assessment is conducted properly (choice of expert, payment, procedures, reasoned opinion of the Board of Directors).

4. The independent expert assessment should be based on a full undertaking that includes a valuation and not simply on an appraisal of the work carried out by the offeror's consultant bank.

5. Procedural transparency vis-à-vis the market must be ensured for both the Board of Directors and the expert.

6. To ensure independence, situations where the appointment of the expert would be prohibited must be provided for, particularly as a result of relations with the offeror and its consultants, a significant interest in the operation or the absence of conditions under which an objective opinion on the operation could be issued.

7. Except under special circumstances, the expert should be appointed as early as possible and complete his report before the bid is announced so that it can have a bearing on the price established.

8. The expert should have at least 20 days to carry out his work.

9. The expert should present his report to the target company's Board of Directors before the latter issues its reasoned opinion on the bid.

10. The payment made to the expert should be based on the complexity of the valuation, the resources available to him, his qualifications and his reputation, and should be published.

11. The target company's Board of Directors should use an independent expert assessment if it is uncertain about the existence of a possible conflict of interest or if it requires further understanding of the bid.

12. The term "fairness opinion" should be limited to attestations issued in accordance with the AMF standards. All fairness opinions should therefore be published, along with the payment made

to the expert. Of course, any other type of opinion on a bid which does not comply with the AMF standards could also be published, but without being called a "fairness opinion".

13. The scope of the independent expert assessment, which is currently limited to squeeze-outs, should be expanded to include voluntary simplified takeover bids, share buybacks offers, reserved capital increases, mergers-absorptions and certain types of atypical bids.

14. For consecutive bids, the expert assessment should automatically occur when the initial bid is made.

15. A market bid could be encouraged in connection with the merger thanks to the option to pay for the squeeze-out in securities (without the obligation to offer a cash alternative).

16. The squeeze-out threshold could be lowered to 90% to facilitate operations and to keep the shareholder from becoming caught in a situation of having no liquidity, provided this threshold is in line with the Paris stock market regulations in effect.

17. Experts should have a code of ethics and professional associations recognised in the valuation field should adopt a code of professional conduct.

18. Each expert assessment should be subject to mandatory quality control via fairness opinion committees established by the independent experts or by a professional association.

19. The ex ante approval of the expert by the AMF should be replaced by an*ex post* review following a transition period.

20. Professional associations having recognised experience in the valuation field could be certified by the AMF.

21. The principle of multi-criteria analysis with regard to the admissibility of bids should be reaffirmed when the Directive on takeover bids is transposed.

22. The notion of minimum price should be expanded to include several new cases: 60 trading day average for OPR-ROs, highest price paid by the offeror during the previous year for mandatory and voluntary bids, and net book value and revalued net assets considered a “strong reference” for voluntary OPR-ROs and simplified takeover bids.

23. The discounted cash flow (DCF) valuation method should be applied to all bids where the target company is controlled.

24. The business plans used in the valuation methods should always be those prepared by the target company’s management, and may be modified after discussion with the independent expert.

25. The assumptions and sources used in the valuation methods should be explained in much greater detail.

The working group's aim in proposing these measures is to bolster transparency, particularly as regards the procedures followed and the methods applied, and to broaden the responsibilities of the expert and the target company's Board of Directors.

Transparency and accountability are as much a question of behaviour as of regulation, and can therefore have an immediate impact.

For those measures of a regulatory nature, the working group recommends that the necessary steps be taken relatively quickly, with the understanding that the proposals concerning the transposition of the Directive on takeover bids will need to be included in the schedule of transposition projects.

Lastly, the working group recommends that the AMF remain especially vigilant to ensure that the entire future system is clear and understandable in the interest of all those concerned, and particularly minority shareholders. The regulations, Directives, positions and recommendations published prior to these new measures should therefore be repealed.

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APPENDICES

APPENDIX 1

Composition of the working group on financial valuation

Chairman

Mr. Jean-Michel Naulot (member of the AMF Board)

Members

Mr. Jean-François Biard (BNP Paribas)
Mr. Franck Ceddaha (Oddo Corporate Finance)
Mr. Jean-Pierre Colle (RSM Salustro Reydel)
Mr. François Kayat (CSFB)
Mr. Ross Mc Innes, Mrs. Sylvie Lucot (Thales)
Mr. Jean-Louis Mullenbach (Bellot Mullenbach & Associés)
Mrs. Colette Neuville (ADAM)
Mr. Maurice Nussenbaum (Sorgem Evaluation, Université Paris 9 Dauphine)
Mr. Bertrand Peyrelongue (Calyon)
Mr. Fabrice Remon (Deminor)
Mr. Jean-Florent Rerolle (Houlihan Lokey Howard & Zukin, Chairman of the Société Française des Evaluateurs)
Mr. Thierry Vassogne (Linklaters)
Mr. Jean-Noël Vieille (Aurel Leven Gestion, Chairman of the SFAF valuation commission)
Mr. Alain Marcheteau (SNECMA)

Also in attendance at the meetings

Mr. Hubert Reynier (AMF, Managing Director, Regulation Policy and International Affairs Division)
Mrs. Anne Demartini (AMF, Regulation Policy and International Affairs Division)
Mrs. Patricia Choquet (AMF, Legal Affairs Division)
Mrs. Michaëla d'Orazio d'Hollande (AMF, Legal Affairs Division)
Mr. Bertrand Durupt (AMF, Corporate Finance Division)
Miss Elodie Froidure (AMF, Corporate Finance Division)
Mr. Jean-François Sablier (AMF, Corporate Accounting and Auditing Division)
Mr. Olivier Gayral (AMF, Corporate Accounting and Auditing Division)

Recording secretaries

Mrs. Maryline Dutreuil-Boulignac (AMF, Regulation Policy and International Affairs Division)
Mr. Le Quang Tran Van (AMF, Regulation Policy and International Affairs Division)

APPENDIX 2

Engagement letter sent by Mr. Michel Prada, Chairman of the AMF, to Mr. Jean-Michel Naulot on 4 November 2004

"Dear Sir:

Because of the traditional role it plays in safeguarding investments, the French regulator has always placed great importance on financial valuations. Several AMF publications deal with this topic in connection with mergers between listed companies and, in particular, the valuation methods that must be used. These publications include regulations, directives, recommendations, working group reports and so on. The regulator has placed special emphasis on the need for routine independent expert assessments in the case of squeeze-outs, and recently established professional criteria for the approval of firms providing this type of service.

Although the quality of the work performed by valuators or independent experts and the information provided in the offering circulars relative to bids and mergers has continued to improve over the last decade, there is still some room for progress. In France today, there are no generally-accepted standards regarding the financial valuation process, the scope of the expert's analysis and the characteristics of the subsequent report. Moreover, members of the profession are currently conducting studies and taking actions on these topics.

In an effort to bring new light to the regulator's study of this topic, assess the issues related to better protecting investors in external growth operations and ensure long-term improvement in the quality of information, the AMF Board wishes to conduct an in-depth analysis of the financial valuation process in conjunction with members of the business community. In this respect, I have been assigned the task of forming a working group comprised of individuals with expertise in this field and would like to request your participation as Chairman of the group.

Given the magnitude of the subject, the AMF would like to focus first on a specific aspect of the valuation process, namely the independent expert assessment. This will require, among other things:

- Clarifying the notion of independent expert assessment by studying, in particular, to what extent a dichotomy should be made between this notion and that of fairness opinion and what is expected of experts in terms of qualifications, professional conduct, diligence, methodology and transparency, identifying the types of professionals authorised to conduct expert assessments based on specific situations, and redefining the AMF's procedure for approving and reviewing experts;

- Analysing cases where the presentation of an independent expert assessment might be mandatory (other than OPROs) in order to protect the rights of minority shareholders when they are required to give an opinion on a bid initiated by a shareholder who already controls the company;

- Studying recent changes in the valuation methods used in independent expert assessments in order to determine which are the most objective and therefore update the AMF's publications on this topic.

All these efforts will require an analysis based not only on national laws and regulations but also on the experiences of foreign countries and the best international standards.

The working group will be asked to recommend all changes to regulations and business practices that it considers necessary. These recommendations will then be the subject of a public consultation during the first half of 2005. It is understood that the working group's mission could subsequently be extended to cover such topics as whether it is advisable for the AMF to also establish a framework for the valuation of companies in initial public offerings .

I hope you will be interested in this project and look forward to receiving your reply.

Sincerely,"

APPENDIX 3

List of individuals interviewed and consulted by the working group

In the course of this project, the working group consulted and interviewed a number of professionals and experts in the financial valuation field. Through their comments and input, these individuals contributed greatly to the working group's study. The Chairman of the working group therefore wishes to thank them for their availability and for their interest in the group's mission.

Individuals interviewed by the working group

Mrs. Christine Morin-Postel
Independent administrator (3i Group plc, Pilkington plc, Alcan, Royal Dutch Shell, Arlington)

Mr. Henri Brandford-Griffith
Cabinet Brandford-Griffith & Pasturel

Individuals consulted

Mr. Olivier Diaz
Cabinet Darrois, Villey, Maillot & Brochier

Mr. Jean-Pierre Martel
Cabinet Rambaud Martel

Mr. Christian Hirsch
Financière de Courcelles

Mr. Bruno Husson
DCB Fairness

Mr. Bertrand Jacquillat
Associés en Finance

Mr. Jean-Charles de Lasteyrie
Ricol, Lasteyrie & Associés

Mr. Dominique Ledouble
Cabinet CDL

Mr. Pierre Loeper
Prorevise

Mr. Foucauld de Tinguy du Pouët
Détroyat & Associés

WARNING

The studies presented in Appendices 4 and 5 pertain exclusively to fairness opinions issued in the most regulated context – and therefore the context best known to the AMF – namely, squeeze-outs.

These are, for the most part, small transactions (less than 5% of capital).

The information presented in Appendix 4 therefore does not reflect the conditions applicable to assessments by financial advisors (budget, time, personnel).

Appendix 5 describes the valuation methods used in connection with the OPR-ROs carried out in 2003 and 1994. This Appendix should under no circumstances be construed as a recommendation to apply these methods.

APPENDIX 4

Analysis of the conditions applicable to independent experts involved in buy-out offers followed by a squeeze-out launched in 2003 et 2004

(Sources: AMF)

This study concerns all buy-out offers followed by a squeeze-out (OPR-RO) launched in 2003 and 2004, which totalled 71 (36 in 2003 and 35 in 2004).

During this period, 28% of the bids studied involved less than 1% of the target company's capital, 47% between 1 and 4%, and 25% more than 4%.

In 2003, 40% of OPR-ROs were isolated and 60% followed a voluntary bid or standing market offer (consecutive OPR-RO). In 2004, 30% of OPR-ROs were isolated and 70% were consecutive. Most OPR-ROs during this period, therefore, followed a voluntary bid or standing market offer.

Although some 20 experts were involved in these operations during the two-year period, 77% of the assessments were conducted by seven experts.

For these OPR-ROs, the following items were reviewed based on the application for approval submitted by the expert to the AMF. Some files did not contain all this information:

- Duration of the independent expert assessment calculated based on the number of days from the date of approval of the expert by the AMF to the date of signature of the attestation;
- The independent expert's budget estimate;
- The personnel allocated to the independent expert assessment.

I. Breakdown by independent expert

The breakdown by market share of the seven main experts is as follows:

Expert A = 19%
Expert B = 13%
Expert C = 12%
Expert D = 12%
Expert E = 10%
Expert F = 7%
Expert G = 4%

The other experts were involved in only one or two operations.

The types of business in which the experts are engaged varies. Some are firms specialising in independent expert assessments and/or financial valuations, while others are auditing and consulting firms.

No banks were involved in these operations.

II. Duration of the mission

It is difficult to assess the actual duration of an expert assessment. The following information should therefore be considered with caution, as it is calculated based on conventions used for the purpose of the study.

The duration of the assessment was calculated based on the number of days from the date of approval of the expert to the date of signature of the report. This does not always reflect the actual amount of time for the expert's work and should, therefore, be viewed in conjunction with the hourly estimate.

It is clear that the duration of the mission varies greatly, and can range from a few days to several months. For six bids, the mission lasted less than 10 days. Thus, the durations vary from two to 155 days, with the average being 52 days.

The number of hours estimated[6] by the experts also varies considerably from one operation to another, ranging from 10 to 320 hours, with an average of 132 hours.

III. The independent experts' budget estimate

The expert provides his budget estimate for the assessments to the AMF in his application for approval. The estimates provided to the AMF vary from €6,000 to €150,000.

In the two years covered by the study, the independent experts' average estimate (excluding tax and misc. expenses) was €35,193.

The correlation between the size of the bid and the expert's estimate is not always obvious, and other factors such as the complexity of the file, special circumstances surrounding the operation and the expert's billing policy are also taken into account.

For example, in an OPR-RO involving roughly 3.5% of the target company's capital for a total of 17.5 million euros, the expert's budget estimate was only €45,000, while the same expert estimated a cost of €75,000 for another OPR-RO involving slightly less than 0.5% of the target company's capital for a total of 2.8 million euros.

In 2003 and 2004, the budget estimates for the expert assessments represented, on average, 16.5% of the total cost of the OPR-RO. It should be noted, however, that of the 71 operations examined, only 15 information memoranda indicated the amount of these costs. The range was between 1% and 92% of total costs depending on the size of the bid.

IV. Personnel allocated to the expert assessment

The team assigned to the project seldom exceeded four people. For two of the bids, one of which involved an amount of more than 150 million euros and the other approximately 2 million euros, the team consisted

[6] Based on the hourly estimates provided by the firms at the time of their application for approval and for the operations for which information is available (i.e. 56). Where the estimates were given in number of days, the days were converted to hours on the basis of an eight-hour day.

of five people. An average team is made up of two people. For the same expert, the members of the team are normally the same from one operation to another.

Conclusions

For the OPR-ROs launched in 2003 and 2004, the field of activity, size and budget estimates of the independent expert firms varied widely. Given the observations made and in the absence of more detailed statistical analyses, it is not possible to show a correlation between the budget and the amount or size of the bid.

The same is true for the amount of time spent by the expert on the various operations. The teams assigned to the project vary slightly both in the number of people and in the team members.

Summary Table

	Maximum	Minimum	Average
Number of assignments per expert	13	1	4
Maximum bid amount (in K€)[1]	1,019,060	45	46,322
Duration of the assignment (in days)[2]	155	5	52
Number of hours estimated[3]	320	10	132
Budget proposed by the expert (in K€)[4]	150	6	35
Number of employees per mission	5	1	2

Summary of statistical data for the main expert firms involved

Averages calculated for the seven main experts (except for the number of operations)

Firms	Number of operations	Average bid amount[1] in K€	Average duration of the assignments (in days)[2]	Average number of hours estimated[3]	Average budget[4] K€	Average number of team members
A	13	98,870	41	60	39	3
B	9	80,776	66	176	35	3
C	8	25,068	38	188	44	4
D	8	7,115	69	111	19	2
E	7	127,983	47	256	71	4
F	5	552	45	58	18	2
G	3	576	56	76	16	1

[1] Maximum number of shares offered x price of the bid.

[2] Difference, in number of days, between the approval date of the expert (letter to the CMF) and the date of signature of the expert report.

[3] Based on the hourly estimates provided by the firms at the time of their application for approval. Where the estimates were given in number of days, the days were converted to hours on the basis of an eight-hour day.

[4] Budget estimate excluding tax and expenses.

APPENDIX 5

Comparative study of the valuation methods used by financial advisors for buy-out offers followed by a squeeze-out launched in 2003 and 1994

The following study examines the valuation methods used by financial advisors in 2003 and 1994 in connection with buy-out offers followed by a squeeze-out (OPR-RO). It was compiled based on the offering circulars published on the *Autorité des Marchés Financiers* website and the valuation reports available from the *AMF's Corporate Finance Division*[7]. The valuation methods used in 2003 were compared with the methods used by experts for similar operations in 1994 in an effort to draw conclusions about possible changes noted in this area over the past 10 years.

The information presented in this study illustrates, in part, the observations made by the working group in its report and should not be construed as guidelines for financial valuations.

I. Context of the OPR-ROs in 2003

The buy-out offers followed by a squeeze-out that occurred in 2003 can be classified as follows:

- The OPR-RO was part of an acquisition. It was the result either of block trading followed by a standing market offer or simplified takeover bid, or of a takeover bid or exchange offer.
- The OPR-RO was "spontaneous" and not part of an acquisition, but was carried out for other reasons (group reorganisation, delisting of a company whose free float was very low, etc.).

II. Valuators' preliminary work

In all cases, it was noted that the financial advisors had performed the following tasks prior to conducting the valuation:

- A strategic analysis of the target company (forces that shape the company's market, the company's place in its market, production systems, distribution networks).
- An analysis of the company's financial characteristics. This aspect of their work focused on issues such as the company's profitability and funding and investment policy. The banks paid close attention to changes in turnover and the impact of the business cycle. In general, these analyses examined trends over a three-year period.

At this stage, the financial advisors rarely performed a comparative analysis, which consists of comparing the company's key balances and ratios to those of companies in the same sector.

These preliminary analyses accounted for a significant share of the valuators' work. Of the 50 or so pages that generally made up the valuation reports, the first two-thirds consisted of these analyses.

[7] In 2003, 36 OPR-ROs were filed with the AMF. Thirty-five information memoranda were available on the AMF website.

III. Valuation methods used

1. Multi-criteria approach

For the vast majority of OPR-ROs occurring in 2003, the valuators used a multi-criteria approach, as provided by the AMF's general regulations. They used an average of four methods in their valuation and routinely substantiated their choice.

For some operations, a single method was used. These involved failing businesses or companies forced out of business.

On the other hand, up to eight valuation methods were used for certain bids without the valuator fully substantiating his reasons.

2. Valuation methods used

Seven methods or references were commonly used by valuators for the OPR-ROs that occurred in 2003: transaction multiples, comparable method, discounted cash flows (DCF), dividend yield and reference to Net Book Value (NBV), Revalued Net Assets (RNA) or share price.

In 80% of these cases, two methods (discounted cash flows and trading comparables) and one reference (share price) were used.

Two approaches were used in 50% of the cases, namely transaction multiples and revalued net assets.

Net book value was used in only 15% of the cases and discounting of dividends was used in only one operation.

In more than one-half of the operations, the valuator used another method, including reference to transactions on the security (used 14 times), the Bates method (used four times) and the Gélinier method (used one time).

3. Valuation of a group of companies

Since the company being valued rarely engaged in a single business activity, valuators generally considered two approaches:

- Global approach: the consultant bank valued the company without making a distinction between its businesses.
- "Sum of the parts" approach: the consultant bank valued each of the company's businesses separately and then totalled the results to obtain an overall valuation.

Thus, for one of the OPR-ROs occurring in 2003, the valuator made the following distinction: fully consolidated companies were valued using the discounted cash flows and Bates methods, while equity-accounted companies were valued at their book value. In another operation, where the company being valued had begun to transfer its business activities, the company's value was obtained by adding the value of its "core business" activities based on a multi-criteria approach (DCF and comparable method)

and the value of "other activities" provided by management during discussions with the potential purchasers.

4. Income methods

4.1. DCF method

a) The most commonly used method

The DCF method was the method used most frequently by the valuators. It was used in all the OPR-ROs occurring in 2003, with the exception of operations where the company being valued was either forced out of business or in serious financial trouble.

b) Advantage of the DCF method according to the valuators

In the valuators' opinion, the advantage of the DCF method lies in the fact that it is based on the company's internal data (forecasts, target margins, etc.) and therefore reflects management's perception of the group. It avoids problems stemming from the lack of comparability of companies used to calculate multiples and provides an interesting perspective on the target company's share price in that it is based on private information, whereas the markets provide only public information.

c) Three parameters need to be determined

The DCF method requires an approximation of three variables: projected cash flows, discount rate and terminal value.

(i) Projected cash flows

Type of cash flows taken into account by valuators

The cash flows used by the valuators for the OPR-ROs occurring in 2003 were free cash flows, which measure cash flows generated by economic assets, also called debt-free cash flow.

Creation of a cash flow timetable over a specific period

The valuators used the business plan prepared by the company's management to develop the cash flow projections. The business plan, which the valuators used in their analysis as it was presented to them, covered a two to five-year period. In some cases, where the valuators considered the business plan too ambitious, their beta calculation took the risk related to these forecasts into account. For example, one valuator fixed the company's beta at 1.5, higher than the estimated sector beta of 0.7.

In all cases, a link period between the end of the business plan and the terminal value period was established by the banks based on parameters defined along with management of the company being valued and/or the offeror.

The valuators did not take into account synergies resulting from the delisting of the company being valued. In fact, in the case of one "spontaneous" OPR-RO, the synergies had already been realised.

It was noted that the average length of the cash flow timetable was seven years and that there seems to be a trend toward extending this period.

(ii) Calculation of the terminal value

The terminal value corresponds to the company's value beyond explicit financial forecasts. On average, it represented two-thirds of the company's value and was as high as 80% for several OPR-ROs occurring in 2003.

Approaches used

The valuators used two approaches:

- Estimated exit value based on a market method (EBITDA, income and equity multiples). This approach is used in less than 10% of all cases.
- Calculation based on an income approach by a perpetual discounted cash flow (approach used in 90% of the cases).

For some operations, the perpetual growth rate was higher than the growth rate of the economy.

In one operation, the valuator created a third 10-year period, after the business plan and the link period, to determine the terminal value.

Terminal value reasonableness test

For some operations, the calculation of the terminal value based on a perpetual growth rate was compared to the market method and vice versa.

(iii) Discount rate: weighted average cost of capital

For the discount rate, the valuators used the weighted average cost of capital (WACC), which is an average of the cost of capital used to run the business, i.e. shareholders' equity and net financial debt.

The rate used by the valuators for the OPR-ROs occurring in 2003 was between 7 and 18%, based on the risk level of the company being valued.

In one operation, the valuator used an approach based on geographic area and obtained a weighted average cost of capital for each region.

The valuators relied on two main methods for calculating the weighted average cost of capital.

The most commonly used was the indirect method. This method seldom enabled the valuators to obtain the market value of the company's shareholders' equity.

The valuators then used two methodologies to calculate the beta of equity:

- calculation of a historical beta
- calculation of a normative beta.

When considering risk specific to the company by measuring the company's risk against that of the sector average, the financial advisors occasionally used a size and/or illiquidity premium.

In the vast majority of cases, the valuators used historical betas calculated based on financial data. They employed a sector sample sometimes identical to that created for the market methods and applied a weekly or monthly frequency.

The zero-risk interest rate used by the valuators corresponds to the effective rate of long-term government loans. In almost all cases, these were 10-year fungible government bonds. In one operation, the valuators used the 30-year US T-Bond.

To determine the risk premium, the valuators usually solicited the services of an independent firm which calculated either historical or projected premiums.

d) Sensitivity analyses

In most cases, the valuators conducted a sensitivity analysis of the result obtained at the perpetual growth rate and/or at the weighted average cost of capital.

According to them, the analyses were justified by the fact that the DCF method measures the impact on the valuations of an upward or downward variation in the forward assumptions and financial parameters used. These sensitivity analyses show, for the variables studied, the main risk areas or opportunities to which the company being valued is subject.

To arrive at the equity value based on the company value, obtained using the DCF method, the valuators subtracted the company's net debt.

The valuators rarely indicated the analyses used to ensure the coherence of the results.

4.2. Yield

This method is based on the discounting of projected dividend flows. It was generally rejected because of the difficulty in forecasting these types of future flows.

The yield method was used for one operation. The valuator explained that the target company was owned equally by the offerors and that the dividend flows were calculated based on assumptions derived from the memorandum of understanding between the two companies.

5. Comparable approach

5.1. Trading multiples method

The trading multiples method was the most commonly used method after the DCF method.

However, this method was sometimes rejected by the valuators because it does not take into account the turnaround of the company being valued or anticipated revenues from the various development projects underway.

For certain operations, the valuators occasionally relied on a consensus among analysts to establish the financial projections of the sample companies and those of the company being valued.

a) Sample of comparable companies

The valuators used one or more samples of comparable companies, which included 2 to 40 similar companies, the average being 6.5.

The main criteria used to create the sample were business activity, geographic location, revenue growth and size.

In general, the valuators indicated the share price used (one-month average, three-month average) to calculate the market capitalisation of the comparable companies. They did not conduct a detailed analysis of the share price (float, liquidity, etc.).

b) Multiples chosen

In most cases, EV/EBITDA multiples were used, along with EV/sales, EV/operating profit, EV/EBITA multiples and PER. Other alternative multiples included EV/R&D and EV/net assets.

The choice of multiples is not always specified. However, a parallel can be drawn between the sector of the company being valued and the multiples chosen. Thus, the banks used the same multiples when valuing companies from the banking or mass distribution sectors.

(i) Net income multiples

For an operation involving a banking institution, the valuator considered banks to be valued traditionally by reference to their net income and equity. His analysis therefore focused on net income multiples (PER and price-equity ratio). This approach is substantiated by previous operations. For an OPR-RO involving the securities of an institution in the same sector, the valuator had used the same multiples.

(ii) Sales multiple

This entails valuing the company on the basis of a sales multiplier.

The multiple, referred to as EV/sales, is one of the most commonly used multiples for valuing distribution organisations.

This multiple, however, does not take profitability into account.

It should be noted that the sales multiple was also used to value securities of companies in the new technologies sector.

(iii) EBITDA multiple

When this multiple is used, the valuator's analysis is based on operating income before depreciation and focuses on earnings before interest, taxes, depreciation and amortisation (EBITDA). This indicator shows profit from operations and disregards the company's investment policy and changes in inventory.

The valuators used this multiple, which does not take depreciation policies into account, to value companies in the telecommunications sector that launched OPR-ROs in 2003.

It was also used by a valuator in an operation involving the securities of a distribution company. The valuator felt that this multiple was the closest to operational cash flow and that the result obtained was the least distorted by accounting practices.

(iv) PER multiple

The PER multiple takes into account the company's development financing policy. Serious distortions may result from significant differences between the net financial debt levels.

This multiple was used in 30% of the OPR-ROs occurring in 2003.

(v) Other multiples

Market capitalisation multiples (Capi/revenue, Capi/NBI). These multiples are used to avoid the bias of approximating the net cash flow of the sample companies.

Free cash flow capitalisation rate. This multiple is useful for the valuation of heavily indebted companies. It was used in 2003 to value a mobile telephony company.

d) Discounts

In one operation, the valuator applied a 30% discount to the multiples of the sample of comparables to allow for the significantly smaller size of the target company compared with that of the sample companies. The valuator justified this based on a growing relationship between the companies' capitalisation and their EBITA multiple.

5.2. Comparable transactions

The sample used was created based on available information regarding recent transactions in the same sector (transfer of control, merger, etc.).

When the purchaser's price is used, the multiple may include a control premium paid to obtain control of the target company, which sets a value on a portion of the expected synergies. This deterred some valuators from using this method in connection with the OPR-ROs launched in 2003.

6. Comparison of bid price to share price

Reference to the share price is a relevant valuation criterion when using the multi-criteria approach. The valuator used this criterion in all the cases studied. By taking into account the security's liquidity, the float and whether or not the issuer is tracked by a research department, he was able to determine whether or not historical share prices should be used. In most cases, he found them to be irrevelant.

7. Asset method

The asset method entails valuing the company's various assets and commitments separately and arriving at an algebraic sum. It includes reference to net book value and the revalued net assets method.

7.1. Net Book Value

Almost all the bids launched in 2003 offered a price that was higher than the net book value per share. Only in one OPR-RO was a lower price offered.

Generally speaking, the reference to net book value was not used by the valuators for the OPR-ROs occurring in 2003. In their opinion, it did not reflect the current or future earning power of a company or group of companies and did not take into account the market values of the main assets needed for operation.

It was, however, used in one operation on the grounds that, although it "does not take into account the growth prospects (of the target company) and the profitability of its operations, (it) is nonetheless an objective valuation reference which must be understood as a minimum value for the company".

7.2. Revalued Net Assets

Revalued assets were tangible or intangible assets (brand, equity interests). In most cases, the valuator relied on an expert to assess the tax consequences of the revaluation.

This method was used by the valuators in one-half of the OPR-ROs occurring in 2003. The valuators considered the revalued net assets method to be appropriate for holding companies, financial institutions and real estate firms.

8. Other methods

Two alternative methods were used by the valuators:

- The Bates model was used for four OPR-ROs in 2003, three of which were handled by the same valuator.
- Reference to other operations on the target company's security.

Lastly, in an operation launched in 2003, the *Conseil des Marchés Financiers* made reference to the target company's book value in the offeror's financial statements insofar as it was "supported by a valuation carried out by the offeror under the supervision of the auditors". The fact that this value was taken into account did not undermine the offered price. This method was not used by the valuators.

9. Summary of the valuations

For each of the methods chosen, the valuators used a range of results and presented a median value.

The price offered to shareholders was in the high range of the valuations and, for the most part, corresponded to the highest value.

IV. Comparisons with 1994

In 1994, there were 13 buy-out offers followed by a squeeze-out[8].

1. Valuation methods used

The asset-based approach (net book value and revalued net assets) and comparable were used in nearly all cases (10 out of 13).

Also used were the DCF method (7 out of 13 cases), share prices (5 out of 13 cases), transaction multiples (5 out of 13 cases) and dividends (3 out of 13 cases). The valuators also used the Bates method and reference to a previous operation on the security.

2. Multiples method

Sample

In most cases, a single sample was used with an average of six companies.

The sample was based on the business activity, growth and margin of the comparable companies.

Multiples used

The most commonly used multiples were PER, EBITDA and sales. The “other multiples” category included the net assets multiple.

3. Historical share price

The valuators used weighted share price averages (12, 6 and 3 months) and, in general, the closing price. In most cases, the price offered for the OPR-RO was above the lowest average.

4. DCF method

Length of the cash flow timetable

The length of the business plan used in the valuation varied between four and 10 years. On average, the valuators used a cash flow projection of five to six years.

Discount rate used

In almost all cases, the valuators specified the calculation of the discount rate (weighted average cost of capital) which they fixed at 8.1% to 13.3%.

The valuation reports seldom mentioned the cost of equity and the cost of debt on which the WACC calculation was based. When they were indicated, they ranged from 10.3% to 13.3% and from 8.05% to

[8] All these operations were analysed based on the information memoranda published on the AMF website and the valuation reports available from the *Direction des Emetteurs*.

8.4%, respectively. In most cases, the zero-risk rate was that of the 10-year fungible government bond. The market risk premium was between 2.4% and 4%.

Calculation of terminal value

The terminal value was calculated using a perpetual growth rate.

In nearly one-half of the cases, the valuators conducted a sensitivity analysis of the result obtained at the perpetual growth rate and/or at the weighted average cost of capital.

Conclusion

The following observations can be made regarding the valuation methods used between 1994 and 2003:

- ✓ There is evidence of increased use of the DCF method and longer cash flow timetables.
- ✓ The use of asset-based approaches (NBV, RNA) decreased.
- ✓ The trading comparables method continues to be widely used. However, there has been some change in the multiples used: the net assets multiple is now used less often than the operating profit multiple.