THE TAKEOVER PANEL

ADEPTON AND WILLIAMS HUDSON

In this matter Williams Hudson Limited, by their merchant bank advisers Morgan Grenfell & Co. Ltd., have brought before the City Panel a ruling given by the Panel Executive during the course of a transaction in which Adepton Ltd., whose merchant bank advisers are Wm. Brandt's Sons & Co. Ltd., was seeking to take over the ordinary share capital of Williams Hudson. It is the well understood practice of the City Panel that Executive rulings are of an informal and provisional nature: in the vast majority of cases no reason arises to question them but they are always given on the basis that they are subject to reference to the full Panel. When occasion arises for such a reference although, as in the present case, only one specific ruling may have been in question, the whole transaction may be taken under review by the Panel and the matter will be considered by them at large.

In the present case a number of issues were raised by the parties and in view of their nature and of the somewhat tangled web involved, it is necessary to say something about the companies concerned in the transaction. Adepton, the offeror company, previously and under the name of Kings Motors (Oxford) Ltd. engaged solely in the motor trade, is a quoted company whose authorised capital is £2 million of which £972,000 was issued. A majority of the shares in this company is now owned by Argo Caribbean Group Ltd. Argo is stated to be a private investment company resident in the Bahamas and controlled by the trustees of a settlement by Mr. David Rowland. After the acquisition of Adepton by Argo the activities of the former company were extended to the wider fields of property and finance. The Directors' profit forecast (for the 15 months to 31st March 1971) of £80,000 assumed that there would in that period be no contribution to profits from these new activities.

The main asset of Adepton is, however, its controlling interest in The Consolidated Signal Company Ltd. which it acquired by a bid made subsequently to the acquisition of the controlling interest in Adepton by Argo. Consolidated Signal is in turn a quoted company whose principal asset is an 11% interest in Westinghouse Brake and Signal Company Ltd. The interest in Consolidated was acquired by an offer by Adepton of an 8½% convertible unsecured loan stock 1990/95. The combined net assets of Adepton and Consolidated, taking investments at book value, were stated in the offer document to be £1,012,000. The investments were, however, stated to have had a market value of £1,630,000 against a book value of £437,000 and on that basis the net assets of the group were £2,205,000 less any minority interest in the increased value and provision for tax. As at 20th February 1971 Adepton and its subsidiaries had mortgages of £70,500 and secured bank overdrafts of £125,350; since that date, moreover, the company had incurred a guarantee liability of £1,200,000. In addition and on completion of the 100% take-over of Consolidated Signal further 8½% convertible unsecured loan stock 1990/95 to a maximum of £1,184,665 fell to be allotted.

Hudson is a quoted holding company whose subsidiaries engage in transportation on sea and land and various other activities. It has an issued share capital of £3,054,000. Its profits before taxation and minority interests for the year ended 31st March 1970 were £824,000. The Chairman has stated that those for 1971 would be unlikely to equal the profits of the previous year but he forecast profits of £1,000,000 for 1972. The net tangible assets were stated by Adepton to be £8,814,000.

On 21st July 1970 Argo commenced to buy Hudson shares in the market. Although at first they also made some sales, during August of that year they reported that they had acquired over 10% of the share capital in issue. Purchases continued and by 28th January Argo had a total holding of 14.46% of Hudson's issued share capital. We were assured that there were no subsequent transactions by Argo, Adepton or their associates after that date and prior to the offer.

Against this general background Adepton on 5th March this year at 10. 00 a.m. orally informed Hudson of the terms (although not until a little later, and then only after a complaint by Morgan Grenfell, of the full conversion terms) of an offer which they were about to make for the whole of the ordinary share capital of Hudson. This offer they announced publicly immediately thereafter; it was on the ticker tape at 11. 07 a.m. The offer involved the issue of a further convertible unsecured loan stock 1990/95, this time at a coupon of 9¼% but with a conversion rate of 75p - slightly less favourable than the conversion rate of the 8½% Stock (72½p). Assuming complete acceptance of the offer by Hudson's shareholders on the original terms this would have involved the issue of up to £8,332,800 of further stock, giving a total eventual liability in respect of the two stocks of some £9,500,000 and an initial interest commitment of some £850,000 annually. The Trust Deeds by which the stocks were to be constituted contained no restrictions on further borrowings nor on the disposal of assets by Adepton.

Assuming that the 9¼% loan stock had a value of par, the Adepton offer put a value of £8,332,800 on Hudson.

Immediately after announcing the offer, but before posting the offer document, which was dated Saturday, 6th March, Adepton commenced what was contended by Morgan Grenfell to be aggressive buying of Hudson shares on the market. The price of the shares went up from a middle market quotation of 80p at which it had stood on 4th March to 90p on Friday 12th. Adepton continued to buy until the 15th and withdrew after the close of business on that day by which time, so we were told, they had both used their available resources and acquired slightly more Hudson shares than they had intended. This, including those already held by Argo, constituted just under 41% of the Hudson shares in issue. It is to be emphasised that Adepton were never in the market to buy all the shares of Hudson: had they been, no problem might have arisen. The quotation was suspended seven days after the last purchases by Adepton.

The period immediately preceding the announcement of the Adepton offer was one in which postal services had been disrupted by the strike. The strike was, however, concluded and the Post Office announced that 1st class mail services would be resumed on Monday, 8th March but stated that they could not for some days be relied upon to give the normal delivery. The Adepton offer was in some cases delivered by courier and in others entrusted to the Post Office. It is, however, clear that some shareholders did not receive the offer document until 12th March or even later. Adepton complied with the normal Code requirement of reporting purchases publicly but they did not, nor under the existing rules of the Code were they obliged to, inform shareholders generally that they were standing in the market to buy.

Hudson, who had published on the afternoon of 5th March a general advice to shareholders not to accept the offer, circulated a reply to it dated 13th March.

In these general circumstances Morgan Grenfell contended that the whole of the transaction was inequitable to Hudson's shareholders and in particular that they had been under "duress" to sell in the market because of the inadequacy of the paper offer, that the information in the offer document was inaccurate and also quite inadequate to enable the Hudson shareholders or the market to assess the cover for the convertible unsecured loan stock or the net resources of the intended group, that it was circulated to shareholders too late and that in view of the aggressive market purchasing shareholders were not all receiving similar treatment. They contended that the 9¼% convertible loan stock would in fact be "worthless on the market" and therefore should have been accompanied by a cash alternative. They supported this contention with the evidence of a manager of a large Pension Fund and a Broker. Reference was made to General Principles 3 and 8 of the City Code and to Rules 14, 29 and 31. The Director General in reply said that the City Code had up to that point been complied with and that no obligation to provide a cash alternative arose unless it appeared that Adepton's offer or revised offer was not equal in value to the average price of the market purchases according to Rule 31. The representatives of Brandts on behalf of Adepton also argued that the Code had been in all respects adhered to and that the Panel at the Executive level had been kept informed of the steps being taken.

Adepton had always accepted the obligation under Rule 31 to increase the amount of their paper offer so as to match the amount which they had paid to shareholders in cash for the shares which they had purchased in the market during the period from the commencement of the offer until 15th March, the weighted average price of these purchases amounting to 88. 7p.

It was pointed out to Adepton by the full Panel that apart from other problems which the case presented, there would clearly be difficulty in reasonably estimating the price which ought to be attached to their proposed 9¼% loan stock which, contrary to the contention of Morgan Grenfell, they had valued at par since, amongst other matters, it was not known how much of it would be in issue. After further discussion the Panel adjourned their further consideration of the questions involved in order to enable the parties to prepare pro forma consolidated accounts. These were presented together with a revised offer when the full Panel met again on 25th March.

The revised offer no longer relied upon the suggested 9¼% loan stock. Instead it was proposed that for every 6 Hudson ordinary shares, they would offer 5 Adepton ordinary shares and £2.40 8½% convertible loan stock 1990/95, being a further tranche of the loan stock already in issue. They contended that having regard to the price at which their ordinary shares and the 8½% loan stock had been quoted on the market prior to the suspension of the quotation, this would at least equal the weighted average price of 88. 7p which they had paid for the Hudson shares on the market. As a matter of arithmetic this would be so if the loan stock was taken at 83.4% of par and the Adepton ordinary shares did not drop below their earlier price of around 66½p.

The question raised by Morgan Grenfell was, however, whether it could be demonstrated that the paper offered was in a currency such as to make the offer comparable in value to the cash paid.

The pro forma consolidated accounts were based on various assumptions as to the equity holding in Hudson which Adepton might acquire. They were of course based on the original Adepton offer of 9¼% loan stock which the accountants assumed to have a par value. Summarising the effect of the accounts, subject to this important qualification, it is sufficient here to say that if Adepton only acquired 50% plus one share in Hudson the net result, whether of Adepton alone or

Adepton and Hudson combined, would have shown a loss. This would also have been the position on the acquisition of 75% minus one share. If, however, Adepton acquired 75% or more of the Hudson ordinary shares group relief for taxation purposes would become available to Adepton and at 75% the combined deficiency would be only £4,000. Assuming the best position, namely the acquisition of 100% of the Hudson shares, the surplus available for the equity shareholders, assuming nothing was put to reserve, would have been £95,000 of which the preference dividends would have absorbed about £14,000.

The offer which the Panel was eventually called upon to consider consisted in a combination of shares and loan stock which had previously enjoyed a market quotation. The acquisition of at least 75% of the Hudson shares would, however, remain a matter of great importance. The Panel asked whether Adepton would undertake not to make their offer unconditional until they had obtained that proportion but Adepton was not prepared so to undertake.

The Panel heard evidence from experienced stockbrokers in regard to the value of this revised offer. Adepton's brokers, Laurie, Milbank & Co., considered that the assumed prices on which the offer was based were extremely realistic. They pointed out that the asset value of the Adepton shares would be greatly increased on the acquisition of Hudson and they thought that the management of Hudson would be greatly improved on its acquisition by Adepton owing to the great skills in the management of assets possessed by Mr. David Rowland who would control it. These brokers said that in their opinion it would be normal to value the Adepton shares and stock after the further issues involved by reference to their earlier market prices.

Morgan Grenfell invited the Panel to hear evidence from Mr. G. W. Mackworth-Young of brokers Rowe and Pitman. He took an entirely different view and thought the earlier argument was fallaciously based on the premise of comparing like with like. But Adepton combined with Hudson was in no way like what Adepton had been before and the market would regard it as a very different business. Asset value was, he thought, a most unreliable guide fo forecasting a market price for these shares: the essential thing was earnings and the multiple which the market might put upon them. Adepton's figures showed that about £300,000 would be available for distribution after tax on the basis of 100% acceptance. Mr. Mackworth-Young said that it would be wrong to assume a P/E ratio greater than the average rating then ruling in the market, namely around 12, whereas the offer assumed a P/E ratio of 23.2. Mr. Mackworth-Young did not think that Mr. Rowland's control would be considered a factor by the market in the case of management of an enterprise such as Hudsons. He could not value the package at higher than, say, 65p per Hudson share.

The full Panel has given careful consideration to the whole of the relevant facts, evidence and argument in this case, by no means all of which had been put before the Panel Executive. Eventually, indeed, they had to consider a revised offer which had not been submitted to the Executive at all and the decision which the Panel now gives relates to that offer.

The Panel feels bound to say at the outset, however, that the technique of take-over purchases pursued in this case and for which there had been several other and unchallenged examples in recent months - unchallenged that is to say before the Panel - has caused them some anxiety. Under General Principle 8 all shareholders of the same class are required to be treated similarly. This General Principle runs through and covers the interpretation of the whole Code. Whilst the General Principles prevail, they cannot override the express Rules of the Code in regard to particular matters and in such cases can only be resorted to if those express Rules cannot themselves be applied to a particular case. Although practice notes from time to time broaden the Code down from precedent to precedent as is done in the case of the ordinary law of the land, the Panel has no power at all to alter its provisions. This is entirely a matter for the Panel's constituent bodies.

We proceed first to examine the announcement of the original offer and the purchases made on the market immediately thereafter and during the following ten days. The combined effect of Rules 29 and 31 of the Code is that purchases may be made on the market as soon as an offer has been announced and it is the Panel's existing practice to require the offeror company to make the benefit of any heavy buying programme available to all and sundry for a reasonable period of time. The purchases may commence, as they did in this case, before the Directors of the offeree company have had any opportunity at all of advising shareholders whether to accept or reject the offer or sell in the market and may be brought to an end before all shareholders have received the offer document, still less the offeree board's reply. In the light of the experience there has been since the commencement of the Code's administration, we cannot pretend that this position is satisfactory in a case where the offer is wholly or partly in paper. It has hitherto been accepted that having put out a bid, whether in paper or in cash and paper, an offeror should be free to buy in the market provided that if he buys at more than the price or value he has offered in his formal bid he gives all shareholders an increased offer (in paper or cash) equivalent to the average higher price paid. If, however, the offeror is offering only his paper, the position may be very different if, as in this case, the offeror company is much smaller or less well established than the one which it seeks to take over and if the quality of the paper is under heavy attack. It is true that the offeror must stand in the market for at least the reasonable time required under the Panel's existing practice (in this case five days) and that, theoretically, all shareholders have a similar chance to sell. In. practice this similarity may be more theoretical than real.

Knowledgeable shareholders who are close to the market have most of the relevant information available to them and have an immediate opportunity to jump at the chance of selling for cash: the less attractive the formal offer to the shareholders, the quicker those who are able to form an independent opinion may be expected to sell in the market for cash. The small shareholder, however - and it was the purpose of the City Working Party who devised the Code to protect the interest of all shareholders - who receives the written offer in paper apparently at an amount in excess of what he had previously believed the value of his shares to be, will often have no professional advisers and it may hardly occur to him that a sophisticated offeror in the City will be buying his company's shares at a higher price even than the value of the paper they have offered him. Nor indeed may he realise in time that they are buying for cash at all. Perhaps he will write to his broker (if he has one) for advice, having been told in the offer document that he has 21 days within which to make up his mind. Perhaps he will write to his Bank Manager. The Bank Manager in turn will, as we understand is the practice, consult the Bank's brokers. But by the time the small shareholder has received his advice, the offeror may well have withdrawn from the market and the market price of the share will have fallen accordingly. Moreover, the offeror's technique will involve, as it did in the present case, his acquiring only what he regards as a controlling interest in the company and although he is required to stand in the market for several days, he will certainly not be anxious to purchase further shares for cash once that controlling interest has been obtained.

It seems to us illusory to suppose that this technique does not in practice give a signficant advantage to those closest to the market. Moreover, it may result, as in this case, in effective control passing to the offeror before the ordinary small shareholders who need advice have had any chance of seeing the defence which their Board may wish to put forward against the offer or of considering the advice of their companies' Directors or indeed of getting the full information which the City Code requires under General Principle 3. In addition, the use of this technique makes it very difficult for anyone to mount a competing and possibly a better offer; control will have been acquired before there is an opportunity for this to be done.

Whilst, however, there are dangers and disadvantages in this kind of strategy, used in this case in good faith and certainly not for the first time, it by no means follows that the technique involves a breach of the existing Rules of the Code or that the Panel is empowered to put an end to it.

Our conclusion on this part of the case (and it is by no means the only matter in the case) is that, apart from the consequences to which reference will be made later, Adepton were not in any breach of the Rules by the manner in which they made purchases in the market. The market was under no greater pressure in this case than may arise in any case where, after making a general offer in paper, offerors purchase on the market. In this context it is perhaps significant that during the time Adepton stood in the market to buy, they in fact acquired only about 27% of the issued shares. It may, however, be that our constituent bodies will wish to consider whether the Rules of the Code should be altered to secure a greater degree of equity as between all shareholders. The aim would be to consider how the Code could best be amended to impose suitable and practical limitations on the existing freedom of an offeror for paper to conduct a market raid on the shares of the offeree in the opening stages of his bid. We believe that it should be possible to reconcile the principle of a free market with the principle that the offeree shareholders should all be treated similarly and should have reasonable time and sufficient information to form a judgement on the offer.

We now proceed to consider the criticisms of the offer document itself. It contained a statement that "so far as is known to Adepton there had been no material change in the financial position of Hudson since the date of its last accounts". This statement was (albeit unintentionally) misleading. In fact Hudson had committed itself to purchase two tankers of a value of some £19 million and the fact of the debt incurred to finance these purchases was highly significant in regard to the income cover available for the total indebtedness including the loan stock which Adepton were proposing to issue. Brandts knew of the transaction but had been advised that it was not necessary to refer to it. It was contended by Morgan Grenfell that it would be quite impossible for shareholders or the market to assess the true value of the offer without having something in the nature of a pro forma group balance sheet and profit and loss account of the two companies. There is some force in this argument and we think it would be good practice in similar cases in future if something of this kind could be included in the offer document. The Panel has not, however, previously called for this information and we therefore upheld the rulings given by the Panel Executive in regard to the procedure followed in the conduct of this offer.

In the particular circumstances of this case, however, we feel that the real crux of the matter is the applicability of Rule 31. Rule 31 provides that in the case where the offer involves a further issue of already quoted securities the value of such securities shall normally be calculated for the purpose of ascertaining what increased price shall be paid by reference to the average of the mean of the daily quotation of the securities during the offer period. (Where, as in this case, a revised offer introducing the quoted securities for the first time is announced during the offer period, the price of the securities before the announcement of the revised terms may not be relevant to the averaging process.) It is true that there have been a number of occasions in the past in which a smaller company has made an offer to take over a larger one. No such extreme case as the present one has been brought before the Panel and it certainly cannot be considered normal. The normality with which Rule 31 is concerned is not the take-over transaction itself, but the valuation of the additional issue of securities involved in the offer. Where, as is perhaps the more general case, a large company is acquiring a much smaller one, Rule 31 provides a fair guide, for although the market price of an offeror's securities will often fall back on the announcement of the bid, the additional stock to be issued will represent a small percentage increase on that already in issue and asset and earning cover may not be significantly affected. In the present case the position is different. Adepton is seeking to acquire a company very much bigger than itself and the amount of additional shares and loan stock which the transaction involves is a multiple of that already in issue. The asset and earning cover will not depend on those of Adepton which formed the basis of the price of the Adepton securities prior to the offer; and the extent to which the Hudson earnings can be relied upon will depend upon the percentage of shares which Adepton may acquire. We were impressed by the evidence of Mr. Mackworth-Young already referred to and we conclude that reference to the market prices of Adepton shares and stock during the offer period would not be a normal way of calculating the value of the additional securities and would in fact be likely to result in figures bearing little resemblance to those which the securities would command when the transaction was concluded. The Rules of the Code do not in these circumstances require us to place a value on the Adepton securities and we see great difficulty in anyone arriving at a reasonable estimate. It is not known what additional amount of stock and shares would require to be issued: this depends upon the number of acceptances the offer might be expected to attract. It was demonstrated to us in this case that the degree of interest cover varied materially with the level of acceptances and that a level of acceptances of at least 75% was necessary for the interest liability to be covered even once on a pro forma basis. Adepton were not prepared, however, to undertake not to make their offer unconditional until that percentage had been obtained. There were other considerations. Thus, there was a wide difference of opinion as to the price earnings ratio which it would be appropriate to attribute to the new shares. Again, the opening price if and when the additional securities come to be quoted, would depend upon the expected balance between buyers and sellers. Morgan Grenfell made it clear that they could not advise Hudson shareholders to remain minority shareholders under the new management nor to hold Adepton paper. It might follow that a great deal of the paper would come on to the market as soon as dealings began and this possibility would certainly affect the opening price.

The parties, no doubt realising the difficulties, as we do, were unwilling unreservedly to accept our decision on valuation. Obviously it is a matter of great difficulty to form a judgement on an opening price and, in all the circumstances, we do not think that the procedures of Rule 31 are reasonably and safely applicable here. This is not a case of changing the existing rules in the middle of the bid: the existing rules did not fit the circumstances of the case. We are, therefore, thrown back upon General Principle 8 which is indeed of paramount importance and which requires similarity of treatment. Our conclusion is that in order to achieve this the Adepton offer should be underwritten for cash. We merely add that if Adepton, its advisers and brokers, are correct in their confident assertion that their paper would be in great demand and the offer likely to be accepted by most of the Hudson shareholders underwriting will not impose a severe burden. But burden or not, compliance with the Code requires, in this particular case, a cash alternative if shareholders are to be equitably and similarly, although not identically, treated.

Whilst the present case stands entirely on its own facts, those who make offers in paper in future and follow their offer with massive purchases in the market would do well to assure themselves, in the light of all the circumstances relating to the two companies and their consolidation, that the paper will have an undoubted market value capable of reasonable estimation.

The City Panel expects that its decision will be promptly implemented and no question arises at this stage, therefore, of the imposition of any penalty or censure. The decision is accordingly not subject to appeal, decisions of the Panel on procedure and interpretation being final.

2nd April 1971.