Selected Summaries of 2016 Decisions

The Delaware Court of Chancery Selected Business Valuation Case Summaries

Introduction

Duff & Phelps' experts testify on commercial and shareholder disputes across the country as well as in the Delaware Court of Chancery. However, the Delaware Court of Chancery is widely recognized as one of the nation's leading business courts in terms of volume of complex business related cases and as a result has developed significant case law in this area.

The high volume of business cases results in the Court issuing numerous opinions, many of which address business and security valuation and economic damages. In this Court Case Update we focus on five opinions from 2016 to highlight how certain valuation and damages analysis topics are viewed by the Court. We chose these five opinions based on the valuation themes they represent and depth of analysis contained in the Court's opinions.

In our review of the cases herein we have attempted to summarize the salient points related to valuation and damages only. We recommend that interested readers obtain the full Court opinions to gain a complete understanding of all the issues addressed and each judge's position. We have included a hyperlink to each decision below its case caption.

The cases we have summarized include the following:

In re Appraisal of Dell Inc.,
C.A. No. 9322-VCL (Del. Ch., May 31, 2016)
Vice Chancellor Laster
Issues: merger price, DCF vs LBO model, projections, cost of capital
Click here to view the opinion.

In re Appraisal of DFC Global Corp.,
C.A. No. 10107-CB (Del. Ch., July 8, 2016)
Chancellor Bouchard
Issues: merger price, DCF, cost of capital, projections, stock based compensation
Click here to view the opinion.
Click here to view the September 14, 2106 order.

In re ISN Software Corp. Appraisal Litigation,
C.A. No. 8388-VCG (Del. Ch., August 11, 2016)
Vice Chancellor Glasscock
Issues: merger price, DCF, comparability
Click here to view the opinion.

John Douglas Dunmire, et al. v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc.,
C.A. No. 10589-CB (Del. Ch., November 10, 2016)
Chancellor Bouchard
Issues: merger price, market approach, cost of capital
Click here to view the opinion.

Merion Capital L.P. v. Lender Processing Services, Inc.,
C.A. No. 9320-VCL (Del. Ch. December 16, 2016)
Vice Chancellor Laster
Issues: merger price, DCF, cost of capital, projections
Click here to view the opinion.

Case Summaries

In Re: Appraisal of Dell Inc.,
C.A. No. 9322-VCL
(Del. Ch., May 31, 2016)

Click here to view the opinion.

On May 31, 2016, Vice Chancellor Laster issued an opinion in the Dell appraisal matter, concluding that the fair value of Dell's common stock on the closing date of its going-private transaction was $17.62 per share, over 28% higher than the merger price of $13.75 per share.

A large portion of the opinion addressed whether the merger price was an indication of fair value for Dell, with VC Laster stating that the merger price does not "inevitably equate to fair value." VC Laster noted several factors that "may undermine the potential persuasiveness of the deal price as evidence of fair value," including (i) delays between the signing date and the closing date; (ii) that "the deal market is unavoidably less efficient at valuing entire companies (including the value of control) than the stock market is at valuing minority shares;" and (iii) that synergies may exist in the merger price, even for a financial buyer.

VC Laster opined that in this case a combination of factors undercut the relationship between the merger price and fair value, including the buyer's use of an LBO pricing model and the valuation gap between the market price of Dell's common stock and the intrinsic value of the company.

First, VC Laster noted that while a DCF methodology and an LBO model use similar inputs, they solve for different variables. A DCF method results in the present value of a firm, while an LBO model solves for the internal rate of return assuming a present value (i.e., a price). VC Laster opined that the amount a financial sponsor is willing to pay may differ from fair value because of "(i) the financial sponsor's need to achieve IRRs of 20% or more to satisfy its own investors and (ii) limits on the amount of leverage that the company can support and the sponsor can use to finance the deal." As such, the Court concluded that the "outcome of competition between financial sponsors primarily depends on their relative willingness to sacrifice potential IRR. It does not lead to intrinsic value."

Next, VC Laster stated that there was "compelling evidence of a significant valuation gap driven by the market's short-term focus," driven by analysts' short-term focus on quarterly results, and a $14 billion investment in the Company for a transformation that had not yet begun to generate results. The Court highlighted that there is a difference between short-term expectations of market participants and the fair value of the Company on a going concern basis.

In determining the fair value of Dell, the Court relied on a DCF analysis. Both the Petitioners' and Respondent's experts used a DCF analysis to arrive at a fair value for the Company—valuing the Company at $28.61 per share and $12.68 per share, respectively. The difference in value was driven by a number of factors, including (i) the projections; (ii) the long-term growth rate; (iii) the tax rate; and (iv) the cost of capital.

The choice of projections was the primary driver of the different values calculated by the experts. Three sets of projections were provided by Boston Consulting Group ("BCG") to the special committee (the "Committee") in January 2013. BCG was hired by the Committee to create a set of independent forecasts to help the Committee consider potential transactions. The three projections were:

- BCG Base Case;
- BCG 25% Case (incorporating 25% realization of $3.3B in cost-savings); and
- BCG 75% Case (incorporating 75% realization of $3.3B in cost-savings).

Another set of projections was presented to the banks financing the merger in September 2013 (the "Bank Case").

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The Petitioners' expert equally weighted the BCG 25% Case and the BCG 75% Case, effectively creating a BCG 50% Case, and then weighted this equally with the Bank Case. The Petitioners' expert also incorporated an additional $1 billion in cost savings to the Bank Case.

The Respondent's expert adjusted both the BCG 25% Case and the Bank Case. The primary adjustment was to the BCG 25% Case, which was created in January 2013 and was never updated. The Respondent's expert made adjustments to account for the fact that the Company's actual performance was worse than projected, and to account for lower rates of PC shipments.

The Court noted that while it is generally skeptical of litigation-driven adjustments to management projections, the Respondent's expert persuasively justified his changes. The Court concluded that there were two sets of reliable forecasts, with the adjusted BCG 25% case "likely somewhat conservative," and the adjusted Bank Case "likely somewhat optimistic."

The second area in which the experts differed was the long term growth rate for the terminal period. The Petitioners' expert used a growth rate of 1% and the Respondent's expert used a growth rate of 2%. VC Laster noted the Court's use of inflation as a floor for terminal value and stated that a growth rate of 2% is "arguably too low." VC Laster noted that a 3% rate "could be more appropriate" given "the Company's status as a mature Company whose growth rate should fall somewhere above inflation and close to GDP." The Court ultimately used a growth rate of 2%.

The third area in which the experts disagreed was the tax rate to apply to Dell's cash flows. The Court adopted the rate used by the Petitioners' expert of 21%, based in part on valuation models prepared by the Company's financial advisors. The Respondent's expert used two rates: 17.8% for the projection period, based on the report of a tax expert, and 35.8% for the terminal period, based on the marginal tax rate. VC Laster noted that "the Company has not paid taxes at the marginal rate since at least 2000," due, in part, to the Company's "ability to defer payment of domestic taxes on income earned overseas."

Finally, the experts disagreed on most of the components of the weighted average cost of capital. The Court ultimately used the following inputs:

- **Cost of Debt:** the long-term rate on BBB rated bonds, given the Company's downgrade by S&P from "A" to "BBB" in May 2013.
- **Capital Structure:** 75% equity, representing the midpoint of Dell's pre-announcement capital structure and the average capital structure for the 2 years leading up to the announcement.
- **Beta:** 1.31, based on the Company's own historical 2-year weekly beta. The Court in this case stated that "a beta specific to the Company is more targeted than a blended beta calculated from peer companies, particularly when both experts opined that the Company had few peers."
- **Equity Risk Premium:** Supply-side ERP of 6.11%.

Using the inputs noted above, as well as certain adjustments to cash, the Court averaged the DCF result of $16.43 per share using the adjusted BCG 25% Case projections, and the DCF result of $18.81 per share using the adjusted Bank Case projections, to arrive at a fair value of $17.62 per share.

As of this publication, this matter is currently under appeal.

Case Summaries

In re Appraisal of DFC Global Corp.,
C.A. No. 10107-CB
(Del. Ch., July 8, 2016)

Click here to view the opinion.
Click here to view the September 14, 2106 order.

In June 2014, Lone Star Fund VIII (U.S.), L.P. ("Lone Star"), a private equity fund, purchased all outstanding shares of DFC Global Corporation ("DFC") for $9.50 per share (the "Transaction"). Amidst allegations that DFC was sold below its fair value due to "significant company turmoil and regulatory uncertainty," Petitioners brought an appraisal action. On July 8, 2016, the Court issued an opinion which concluded on the use of "a blend of three imperfect [valuation] techniques," to arrive at a fair value conclusion of $10.21 per share. After both sides filed motions for reargument requesting reconsideration of certain aspects of the Court's application of the discounted cash flow method, the Court issued an order on September 14, 2016, concluding on a fair value of $10.30 per share.

In the appraisal of DFC, the Court deemed it appropriate to use three equally-weighted valuation techniques to arrive at a fair value conclusion: a discounted cash flow model, a multiples-based comparable company analysis, and the Transaction price. The majority of the value discussion in the opinion focuses on the inputs to the discounted cash flow analysis.

The two experts differed in their discounted cash flow analyses in the following six areas: (i) beta; (ii) size premium; (iii) tax rate; (iv) net working capital; (v) cash flows beyond management's projection period; and (vi) stock based compensation.

First, in estimating beta, Petitioners' expert used two-year weekly raw betas from Bloomberg for DFC and 9 peer companies, and estimated three betas, based on: (i) DFC's observed beta; (ii) all 9 peer companies; and (iii) the 6 U.S.-based peer companies. Petitioners' expert used these betas to construct a range of betas, and selected betas within that range for various capital structure scenarios. Respondent's expert took the midpoint of two methodologies: (i) five-year weekly smoothed betas based on 6 peer companies; and (ii) Barra betas. The Court ultimately used five-year smoothed betas for DFC and the 6 overlapping peer companies. The Court addressed a number of issues in concluding on the appropriate beta. Following is a list of the Court's discussion regarding the primary differences between the experts regarding beta:

- **Barra Betas:** The Court rejected the use of Barra betas, citing Golden Telecom, noting that neither Respondent's expert "nor any published research has demonstrated the predictive effectiveness of Barra betas." Additionally, the Court stated that "[t]here is no benefit to using a second beta methodology without confidence in the methodology itself."

- **Beta Peer Group:** The Court utilized the 6 peers used in Respondent's expert's estimate, all of which were included in Petitioners' expert's estimate. In addition, the Court used DFC's observed beta, equally weighted with the peers, citing Golden Telecom.

- **Measurement Period:** The Petitioners' expert chose a relatively short two-year period to reflect the "regulatory uncertainty in the market." However, the Court ruled that the uncertainty in the market did not meet the criteria provided by authoritative literature to justify the shorter time frame, and thus adopted the Respondent's expert's use of a five-year period.

- **Beta Smoothing:** The Court adopted the Respondent's expert's use of smoothed betas primarily due to this method's "forward-looking" tendency, and thus its ability to provide a "forward-looking" weighted average cost of capital.

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- **Beta Unlevering Method:** The Court rejected the Petitioners' expert's use of the Fernández formula to unlever the betas of DFC's peer group. The Court noted that the formula was "not commonly used in estimating a public company's weighted average cost of capital," stating that while the "Fernández formula has merits that may warrant its use in an appropriate case…here, the limits in available data, namely the lack of observed or even estimated debt betas for each individual company in the peer group, negate the benefit that the formula could provide." For these reasons, the Court adopted the Respondent's expert's use of the Hamada formula, a "widely accepted, readily understood" method.

Second, the Court used a size premium of 3.52%, based on the 10w decile in the Duff & Phelps 2014 Valuation Handbook. The Court used DFC's market capitalization as of April 1, 2014, the day before the Transaction was announced, adjusted downward to incorporate the reduced earnings guidance that was announced the following day, at the same time as the Transaction. DFC's market capitalization as of April 1, 2014, of $346 million "rested on a knife's edge between the 9th and 10th deciles." The Court stated that "all else equal, the announced drop in projected earnings would have caused such a decline in DFC's unaffected stock price…[and] DFC's market capitalization would have fallen into the 10th decile." The Court noted the large range of market caps included in the 10th decile and determined that the 10w subdecile is appropriate.

Third, the Court used a tax rate of 32%, the rate DFC management provided to the fairness opinion provider to calculate the WACC, rather than a custom estimated tax rate due to "disagreement surrounding the appropriate actual tax rate based on DFC's debts…[and] uncertainty regarding the tax rates in the jurisdictions of the company's future obligations."

Fourth, in determining the appropriate level of net working capital ("NWC"), the Court adopted the Petitioners' expert's method of utilizing management's financial projections, rather than the Respondent's expert's method of calculating historical NWC as a percentage of total revenue. In the original opinion, the Court mistakenly utilized the working capital projections based on the Respondent's expert's methodology. In the September 14, 2016 order, the Court corrected the working capital projections to utilize management's financial projections. Similarly, the Court found it appropriate to use management's excess cash projections, however it noted that an estimated cash balance closest to the time of the Transaction should have been used.

Fifth, the Court utilized a 2-stage model using management's projections for 2014-2017 and a terminal value using the Gordon growth model. The Respondent's expert used a 2-stage model, but estimated the terminal value using the convergence formula beginning in 2018. For the terminal value calculation, the Court used the Gordon growth model instead of the convergence model because the long-term growth rate was not an input in the convergence model. The Petitioners' expert used a 3-stage model, which used management's projections for 2014-2018, projections for 2019-2023 created by the expert based on a "linear extrapolation," and a terminal value using the Gordon growth model. In discussing the 3-stage model, the Court noted the "uncertainty regarding management's projections," and "question[ed] the reliability of [Petitioners' expert's] linear extrapolation of five years of additional projections." The Court also noted that the "somewhat sharp[]" drop off of the growth rate from the projection period to the terminal period is "not ideal but not necessarily

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problematic, as this Court has recognized," citing Owen v. Cannon and S. Muoio & Co. LLC v. Hallmark Entm't Invs. Co.

In the original opinion, the Court concluded on a 3.1% perpetuity growth rate. The Court based its conclusion on precedent selected rates demonstrating a "reasonable premium to inflation" (and the 3.1% was "a reasonable premium of 79 basis points over inflation") and that "some financial economists view the risk-free rate as the ceiling for a stable, long-term growth rate" (and the 3.1% "falls just under the suggested ceiling represented by the 3.14% risk-free rate"). In the September 14, 2016 order, the Court revised the perpetuity growth rate from 3.1% to 4.0%. The Court stated that it "failed to appreciate the extent to which DFC's projected revenue and working capital needs have a codependent relationship, i.e., a high-level requirement for working capital…necessarily corresponds with a high projected growth rate." The Court also noted that the "theory that a company's perpetuity growth rate should not exceed the risk-free rate…is only applicable to companies that have reached a stable stage." Because the Court adopted a "relatively high level of working capital," the Court selected a growth rate of 4.0%, as derived by the Petitioners' expert using the "plowback formula," which "provides that the perpetuity growth rate is the product of the reinvestment rate and the return on capital."

Lastly, both experts agreed that some adjustment should be made to account for stock-based compensation ("SBC"). The Court adopted the Petitioners' expert's use of an average historical cash expense as a percentage of revenues, adjusted to reflect tax benefits. While many companies do not have historical cash expenses associated with SBC, according to the Court, the Company had "average historical net cash outflow" for SBC. The nature and details of the cash outflows were not provided in the decision. The Court stated that "subtracting the accounting expense for all [SBC] from projected cash earnings" was "inappropriate," and cited BMC and Ancestry.com noting that deducting the full SBC accounting expense from cash flows "likely overstated the impact on cash earnings." While in those cases the Court adopted the method anyways because the opposing expert had not provided a better method, in this matter, the Court described the Petitioners' method as a "reasonable means of estimating the impact of future [SBC] on cash flows." The Court does note that this method may understate the cash expense, but ultimately concludes that "hypothetical risk" of an "understated cash expense is less problematic than the much likelier possibility that treating the full accounting expense as a cash outlay would overstate cash expense."

The Court adopted the Respondent's multiples-based comparable company analysis, stating that the methodology was "reasonable" by "selecting a suitable peer group, using correct multiples, and basing [the] analysis on the median rather than another percentile." The Petitioners' expert conducted a comparable company analysis using the 75th percentile of the peer group, but did not rely on it.

Finally, the Court considered the Transaction price an "appropriate factor" in this case, noting a number of factors. For example, the Court noted that the transaction involved a third-party buyer in an arm's length sale, the sale process lasted approximately 2 years and involved DFC's advisors reaching out to financial sponsors and strategic buyers. Additionally, the Court noted that the deal "did not involve the potential conflicts of interest inherent in a management buyout or negotiations to retain existing management" given that Lone Star (the buyer) replaced most key executives of DFC.

As of this publication, this matter is currently under appeal.

Case Summaries

In re ISN Software Corp. Appraisal Litigation,
C.A. No. 8388-VCG
(Del. Ch., August 11, 2016)

Click here to view the opinion.

This appraisal action involved the valuation of ISN Software Corp. ("ISN" or the "Company"), a subscription-based online contractor database, with its customers being either contractors seeking work, or businesses seeking to hire contractors. A large portion of ISNs customers were concentrated in the oil & gas industry.

In January 2013, ISN completed a merger in which the Company's controlling shareholder, Bill Addy, cashed out some of the minority shareholders at a price of $38,317 per share. This price was based, in part, on a third-party valuation performed in 2011. None of the parties relied on the merger price as an indication of fair value as of the date of the merger.

The Respondent provided an expert, as did each of the two Petitioners (Polaris and Ad Venture). The Court noted the "alarmingly" wide gap between the three expert valuations, ranging from $230,000 per share to $29,360 per share. The experts utilized various methods and weightings. Ultimately, the Court relied exclusively on the Discounted Cash Flow ("DCF") method to determine the value of ISN as of the merger of approximately $357 million, or $98,783 per share.

All three experts relied to some degree on the guideline public company method, but disagreed on the universe of companies and the method by which they should be compared. Because ISN had no public competitors and the industry in which ISN operates "includes various and divergent software platforms," the Court concluded that the guideline public company method was less reliable than the DCF method.

Two of the experts included some form of a guideline transaction method. Petitioner Polaris's expert included a valuation based on "comparable transactions," but admitted that limited comparable transactions existed and assigned the analysis minimal weight. Respondent's expert used two recent transactions in ISN shares as indications of value. The first transaction was between Ad-Venture and Polaris, and included call and put options, an escrow agreement, a personal guarantee, and a "right of co-sale." The second transaction involved the sale of ISN shares by Ad-Venture in exchange for parcels of undeveloped "ranch" land in Colorado. The Court found these transactions to be unreliable indicators of value for several reasons, including: (i) the sale was partially driven by a desire for liquidity, with the seller not solely focused on maximizing the sales price; (ii) there was no indication that the shares were shopped to multiple buyers; (iii) there was no indication that the sales prices reflected complete and accurate information; and (iv) each of the transactions contained complex forms of considerations (like options and land) that are difficult to value.

As the basis for its DCF analysis, the Court utilized the framework provided by the Respondent's expert, including the use of a 5-year projection period, and the assumptions regarding future cash collections, EBITDA, and the Company's long-term growth rate.

The Court adjusted the Respondent's expert's model in a number of specific areas. First, the Court removed the working capital adjustment, which was based on the working capital needs of a set of guideline companies in the IT services industry. Instead, the Court included adjustments for two specific items: (1) the change in deferred revenue, relating to ISN's subscription-based business model, and (2) a one-time cash flow adjustment to account for an expected tax refund. The Court also added approximately $34 million of cash to the final concluded value based on a "Buyout and Litigation Reserve" account. The Court noted that this $34 million balance was a distributable, non-operating asset, and was not needed to fund the Company's ongoing operations.

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In re ISN Software Corp. Appraisal Litigation,
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The Court used a cost of capital of 10.46%, based on the capital asset pricing model (cost of equity) since the Company was debt-free, with a size premium of 2.46% as indicated by the Ibbotson 8th decile. The decision did not provide additional details regarding the cost of capital assumptions.

The Court concluded that the DCF method provided the most reliable indication of value in this case. Using the Respondent's expert's framework (adjusted as described above) and the cost of capital based on the capital asset pricing model, the Court concluded that the value of ISN as of the merger was approximately $357 million, or $98,783 per share.

As of this publication, this matter is currently under appeal.

Case Summaries

John Douglas Dunmire, et al. v. Farmers & Merchants Bancorp of Western Pennsylvania, Inc.,
C.A. No. 10589-CB
(Del. Ch., November 10, 2016)

Click here to view the opinion.

On November 10, 2016, Chancellor Bouchard issued an opinion in an appraisal action regarding the fair value of Farmers & Merchants Bancorp of Western Pennsylvania, Inc. ("F&M"), a small community bank located in Armstrong County, Pennsylvania. In October 2014, F&M was merged into NexTier, Inc. ("NexTier"), a neighboring community bank. At the time of the merger, the Snyder family controlled both F&M and NexTier. The Petitioners, members of the Dunmire family, were minority shareholders in F&M. The merger was a stock-for-stock transaction at an exchange ratio of 2.17, based on values of $83 per share for F&M, and $180 per share for NexTier. The Court found the merger price, as well as the comparable transactions and comparable company analyses used by the experts, to be unreliable indicators of F&M's fair value. As a result, the Court relied exclusively on the discounted net income model to arrive at a fair value conclusion of $91.90 per share.

In arriving at a fair value of $91.90 per share, the Court considered several valuation methodologies. First, the Court determined that the merger price was not a reliable indication of value due to the fact that "no third parties were solicited and no confidential information was disseminated to any other potential buyer," and because the Snyder family controlled both F&M and NexTier and "stood on both sides of the transaction." Although a Special Committee was formed by F&M to negotiate on behalf of the minority shareholders, the Court questioned whether the negotiations were truly arms-length. Second, the Court gave no weight to either the comparable transactions method or the comparable company method. Each expert's comparable transactions analysis was discarded, with the Court stating that (i) the Petitioners' expert failed to adjust for synergies potentially contained in the merger prices; and (ii) too much doubt existed regarding the appropriateness of the Respondent's expert's selected transactions. The Respondent's expert's comparable company analysis was also rejected due to the illiquidity of the shares of the selected comparable banks. Ultimately, in light of the reasoning above, and because the experts both applied a similar income-based approach, the Court determined the fair value of F&M by solely relying upon the discounted net income method.

The discounted net income method utilized four basic inputs: (i) F&M's projected net income for the twelve-month period after the closing of the Merger; (ii) a discount rate; (iii) a long-term growth rate; and (iv) an adjustment for excess capital. Following is a summary of the Court's findings on each of these key issues.

- **Projected net income:** The Court adopted the Respondent's expert's net income estimate, based on the 12-month period ending September 30, 2015. The Court noted that this estimate was corroborated by a management income projection and was based on the correct time frame (the 12 months after the merger closed). The Court rejected the Petitioners' expert's net income estimate, which were based on the assumption that F&M's net earnings for calendar year 2014 would be the same as its adjusted 2013 net income.

- **Discount rate:** The Court determined the discount rate based on the Capital Asset Pricing Model. The Court utilized the long-term supply-side equity risk premium, and a size premium based on the aggregate 9th and 10th deciles, both of which were based on data published in the Duff & Phelps Valuation Handbook (the "D&P Handbook"). The Court noted that for the equity risk premium assumption, the Petitioners' expert relied on an online survey conducted by two Duke University professors "that asked chief financial officers and other executives for their 'best guess' as to the average annual return of the S&P 500 over the next decade." The Court gave no weight to this approach, stating that the Petitioners "were unable to identify any court that ha[d] adopted [these] findings," and

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that the reasoning for choosing the approach was "not apparent beyond the fact that it provide[d] a better outcome for petitioners."

The Court rejected both experts' beta estimates. Citing the D&P Handbook, the Court noted that "whatever type of beta you ultimately choose to employ, you should match the source of the size premium […] with the type of beta estimate you have chosen for your subject company." In this case, the Court adopted an Ordinary Least Squares (or OLS)-based size premium, and thus rejected the Petitioners' expert's beta estimate because it was not clear from the record whether the expert's selected beta was an OLS beta. Similarly, the Court explained that according to the D&P Handbook, "[a]n unlevered beta is the beta that would be expected if a company were financed only with equity capital." Due to F&M's "virtually debt-free capital structure," the Court found it inappropriate to implement the Respondent's expert's levered beta. Ultimately, the Court decided to adopt the median OLS-based unlevered beta for commercial banks and trust companies (SIC Code 602), based on beta information published by Duff & Phelps.

- **Long-term growth rate:** The Court adopted the Respondent's expert's long-term growth rate of 3.0 percent, noting the Court's precedent for applying a terminal growth rate that is "a premium, such as 100 basis points, over inflation," and that the Respondent's expert's assumption was consistent with the growth in F&M's 2012 Strategic Plan. The Court stated that the Petitioners' expert's growth assumptions failed to account for the bank's geographic constraints, and the fact that the growth the company had previously enjoyed was "largely a result of past overcapitalization."

- **Excess Capital:** In estimating excess capital, the experts disagreed as to "the appropriate level of capital that should be maintained on F&M's balance sheet." The Court utilized the Respondent's expert's approach, applying a risk-based capital ratio based on peer group banks to F&M's risk-weighted assets. In contrast, the Court rejected the Petitioners' expert's approach, stating that the expert's selected capital ratio was "below the 10% ratio that banks typically maintain to remain well-capitalized," as described in the expert's own report.

Case Summaries

Merion Capital L.P. v. Lender Processing Services, Inc.,
C.A. No. 9320-VCL
(Del. Ch. December 16, 2016)

Click here to view the opinion.

In this appraisal action resulting from the acquisition of Lender Processing Services, Inc. ("LPS" or the "Company"), a publicly traded company, by Fidelity National Financial, Inc. ("Fidelity"), the Court gave full weight to the transaction price of $37.14 per share to determine the fair value of LPS's stock. The Court also performed a discounted cash flow ("DCF") analysis, resulting in an estimate of value just 4 percent higher than the transaction price. While recognizing that the DCF method "has featured prominently in [the Delaware Chancery] Court because it is the approach that merits the greatest confidence within the financial community," the Court found that in this case, the transaction price, resulting from the seller's robust sales process, provided the best measure of value. The Court did not discuss whether any market approach was performed by either party.

Fidelity acquired LPS on January 2, 2014. After the close, shareholders Merion Capital L.P. and Merion Capital II L.P. (together, "Merion" or the "Petitioners") brought an appraisal action to determine the fair value of their shares of LPS. Using a DCF analysis, Merion's expert estimated that the Company's fair value at closing was $50.46 per share. With a different set of assumptions, LPS' expert's DCF analysis resulted in a fair value estimate of $33.57 per share. The Court, after evaluating the disagreements between the experts, concluded that the "best estimate of the fair value of the Company based on the DCF method" was $38.67. The Court elected to place no weight on that analysis, however, finding that while the projections in this case supported "a meaningful DCF analysis," the analysis was dependent on conflicting assumptions related to forecasts, growth rates, and discount rate inputs that affected the reliability of the resulting estimate. In contrast, the Court found the transaction price to be reliable, given its conclusion that LPS had run a sales process that "provided an effective means of price discovery."

Before assigning full weight to the deal price, the Court conducted a detailed analysis of the experts' respective DCF models, and ultimately performed its own DCF analysis. In conducting that review, the Court evaluated the key differences in the inputs used by the experts, including:

- **Capital Expenditures and Depreciation:** Both experts used the same set of forecasts as the starting point for the cash flows during the projection period, but disagreed on how to extend the projections to derive an estimate of cash flows during the "terminal period." In the last year of LPS' projections, depreciation exceeded capital expenditures. Merion's expert did not follow LPS' projections, but rather assumed that capital expenditures would exceed depreciation over time "by an amount sufficient to cause [the Company's] net amortizable assets to grow at the Company's long-term growth rate." LPS' expert also did not follow the projections, but rather increased capital expenditures in the terminal year to equal depreciation. The Court appeared to agree with this approach generally, noting that "over the long run, capital expenditures should equal depreciation." However, the Court found that it was most appropriate to assume depreciation would decrease during the terminal period to match the terminal year capital expenditures, rather than the other way around as proposed by LPS' expert.

- **Perpetuity Growth Rate:** Merion's expert used a perpetuity growth rate of 3.4 percent based on the projected rate of loan originations within LPS' core business. LPS' expert used a long-term growth rate of 2.2 percent, equal to the long-term rate of inflation. The Court decided that, given the Company's business mix and prospects, a long-term growth rate between inflation and nominal GDP would be appropriate, and therefore adopted Merion's expert's rate of 3.4 percent.

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(Del. Ch. December 16, 2016)

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- **Discount Rate:** Both experts used a weighted average cost of capital ("WACC") in formulating a discount rate, but disagreed on every input except the appropriate tax rate. Points of disagreement included:
  - **Capital structure:** Merion's expert relied on the Company's financial statements from 2013 and the equity value implied by his DCF analysis to arrive at a capital structure of 81.1 percent equity. LPS' expert relied on the Company's pre-announcement capital structure of 70 percent equity. The Court adopted LPS' approach, as it avoided "circularity" and was consistent with prior decisions in Delaware.
  - **Equity Risk Premium ("ERP"):** Both experts used the supply-side equity risk premium. Merion's expert used a value obtained from Ibbotson's 2013 Valuation Yearbook while LPS' expert used a value obtained from the 2014 Duff & Phelps Valuation Handbook. Citing In Re Appraisal of Ancestry.com, Inc., the Court found that although the 2014 Duff & Phelps Yearbook would not have been available to investors when the merger closed, this value better captured the Company's operative reality on the closing date.
  - **Beta:** Merion's expert used a beta of 0.845 based on five years of daily observations. LPS' expert used a beta of 1.395, based on an average of a beta derived from five years of monthly observations and a beta derived from two years of weekly observations. The Court found that while a "five-year measurement period is both acceptable and common," a "shorter period should be used if a five-year look back encompasses significant changes in the macroeconomic environment or the Company's business." Because LPS' performance was affected in the prior five years as a result of the Great Recession, the Court found a two-year beta to be more appropriate.
  - **Size Premium:** Merion's expert used a size premium of 0.92%, while LPS' expert did not apply a size premium. The Court stated that LPS' expert's decision to not apply a size premium favored the Petitioners (applying a size premium would have increased the discount rate and reduced the resulting value), so the Court applied that approach.

The inputs described above resulted in a value per share of $38.67, roughly 4 percent higher than the merger consideration of $37.14 per share. Ultimately, though, the Court discarded the DCF analysis in favor of the deal price, while indicating that the proximity of the DCF estimate to the transaction price was "comforting." The Court supported its reliance on the transaction price by discussing the weight given to the deal price in previous cases, commenting that "in evaluating the persuasiveness of the deal price, this court has cautioned that '[t]he dependability of a transaction price is only as strong as the process by which it was negotiated.' Merlin P'rs LP v. Autoinfo, Inc., 2015 WL 2069417 at *11 (Del. Ch. Apr. 30, 2015). What is required is 'a proper transactional process likely to have resulted in an accurate valuation of [the] acquired corporation.' LongPath Capital, LLC v. Ramtron Int'l Corp. 2015 WL 4540443, at *21 (Del. Ch. June 30, 2015). Under this standard, the court will rely 'on the merger price itself as evidence of fair value, so long as the process leading to the transaction is a reliable indicator of value and any merger-specific value in that price is excluded.' Merion Capital LP v. BMC Software, Inc., 2015 WL 6164771, at *11 (Del. Ch. Oct. 21, 2015)."

In favoring the deal price, the Court cited several supporting factors. These factors included (i) independent "in-depth review of the Company's business," resulting in a "report that

Case Summaries

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spanned more than 200 pages" by a consulting firm hired by the Board in 2012 and the Company's two financial advisors; (ii) discussions with multiple potential strategic and financial buyers that created competition or, at a minimum, a "credible threat of competition;" (iii) adequate and reliable information being made available to all participants in the sale process; (iv) the lack of collusion or favoritism with any potential buyers; and (v) the rejection of prior offers by Fidelity that indicated LPS' willingness to continue operating as a stand-alone entity. The court also reviewed the 40-day go-shop period during which more than 40 potential buyers were contacted, but gave the provision little weight due to the appearance that the go-shop was included primarily for legal reasons, the "suspect" quality of the contacts during the go-shop, and the match right held by Fidelity which acted as a deterrent to other potential bidders.

Additionally, the Court considered the post-closing performance of both Fidelity and LPS, noting that Fidelity's stock price rose after the announcement of the transaction, and continued to rise during the post-signing period. Because the merger consideration included both cash and stock, the increase in the value of Fidelity's stock caused the value of the merger consideration to increase. At the same time, LPS's financial performance was declining. The Court found that, given that the Petitioners argued that the declines in performance did not require adjustments to the Updated Base Case, and that "management reaffirmed the Company's belief in the reliability of its projections…it suggests that the going concern value of the Company did not change." The Court concluded that the "Initial Merger Consideration remained a reliable indicator of fair value and the Final Merger Consideration established a ceiling for fair value."

Finally, the Court cited evidence indicating that the merger consideration included a portion of the value that Fidelity expected to generate from "the existence of combinatorial synergies," providing "an additional reason to think that the Final Merger Consideration exceeded the fair value of the Company."

Ultimately, the Court noted that while LPS "created a reliable set of projections that support a meaningful DCF analysis," small changes in the assumptions that drive the DCF analysis generated "a range of prices that starts below the merger price and extends far above it." In its efforts to resolve the differences between the two experts' DCF models, the Court's DCF analysis resulted in a value within 4% percent of the merger consideration. The consistency of the DCF analysis and the transaction price, along with the evidence of a reliable sale process, resulted in the Court assigning 100 percent weight to the transaction price of $37.14 per share.

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For further information regarding our services or issues discussed in this publication, please contact:

Jaime d'Almeida
Managing Director
+1 617 378 9445
jaime.dalmeida@duffandphelps.com

Rebecca Levy
Director
+1 617 378 9461
rebecca.levy@duffandphelps.com

Duff & Phelps Contributing Authors

Emma Baumgartner
David Furman
Matthew Root

For more information please visit:
www.duffandphelps.com

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