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Valuation Guidance from the Delaware Court of Chancery

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October 10, 2012

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Introduction

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Introduction

- Valuation decisions from the Delaware Court of Chancery contain important and practical guidance
- In this session we will
  - Summarize key valuation issues as addressed by the Court
  - Reference leading cases on each issue
  - Contrast the Court's preferences with other venues
- Statements and opinions expressed herein are solely those of the author and may not coincide with those of Houlihan Lokey

Delaware Court of Chancery

- Widely recognized as the nation's preeminent forum for the determination of corporate disputes
  - 50% of public companies are incorporated in DE[1]
- Its unique competence in and exposure to issues of business law are unmatched
- Issues of value and valuation process are common and critical
- The Court's valuation-related opinions offer valuable insights to appraisers practicing both in and out of Delaware

1. "About Agency." Delaware Division of Corporations. Web. 6 Sept. 2012. <http://corp.delaware.gov/aboutagency.shtml>

Appraisal Proceedings

- Statutory remedy available to stockholders who are cashed out in a transaction
  - Entitled to judicial determination of "fair value"
- "Fair value" does not mean "fair market value"
  - Provides the equivalent of what has been taken away from the stockholder: proportionate interest in the going concern as of the date of the merger
  - No premiums/discounts at stockholder level
  - Exclusive of elements of value arising from consummation of the transaction, such as synergies

Appraisal Proceedings (cont.)

- In determining fair value, the Court is required to take into account all relevant factors
  - Factors known or susceptible of proof and not product of speculation
  - Using "any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible in court"
- Often involve a "battle of the experts," but the Court is not required to accept or credit the valuations presented by either of the parties

Valuation Issues

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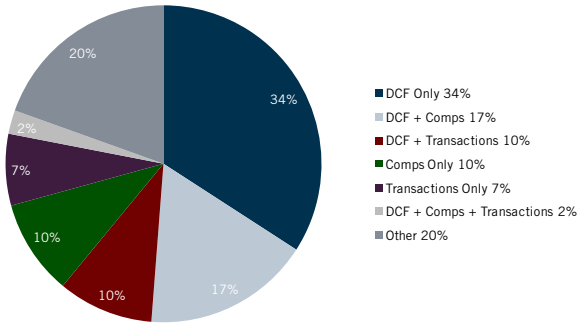
Valuation Methods

- We've come a long way from "Delaware Block Method"
  - *Weinberger*
- Discounted cash flow has become the Court's favorite valuation method
- Where appropriate, the Court will also consider other methodologies
  - *Hanover*
- Limited deference to any actual deal price
  - *Union Illinois, Highfields Capital, eMachines, Golden Telecom*

Valuation Methods (cont.)

Valuation Methods Used by Delaware Courts



Source: Based on 41 cases with disclosed valuation methodology.

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Third-Party Sale

- The Court has historically accorded a limited role to third-party sale value in the appraisal process
- Judicial concerns
  - Statutory exclusion of "value arising from the accomplishment or expectation of the merger"
  - Transaction price becoming a floor on fair value, thereby encouraging appraisal proceedings
    - *Union Illinois, Highfields Capital*
  - Some basis for impugning the effectiveness of the sales process
    - *eMachines, Golden Telecom*

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Discounted Cash Flow Method

- The Court is willing to rely exclusively on DCF method
  - *Andaloro, JR Cigar, Sunbelt*
- Prefers management's contemporaneous projections
  - Especially when they have been provided to a financing source or regulator
    - *Coleman, Emerging Communications, Montgomery Cellular, Delaware Open MRI*
- In the absence of management projections, de novo projections require substantial support
  - *Montgomery Cellular*

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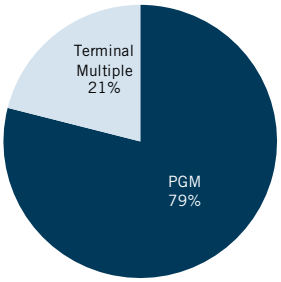
Terminal Value Methods

- Judicial preference for a perpetuity growth model
- Identified problems with the exit multiple method include:
  - The need to estimate a perpetual growth rate
    - *Golden Telecom*
  - The need to back out any synergies in guideline transaction multiples
    - *Highfields, Montgomery Cellular, Andaloro*
  - The need to back out any minority discount in public company multiples
    - *PNB Holdings*

Terminal Value Methods (cont.)

Terminal Value Methodology



Source: Based on 19 cases with disclosed terminal value methodology.

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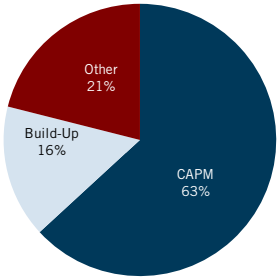
Discount Rate Estimation

- The Court has generally approved the CAPM for estimating the cost of capital component in the DCF

Cost of Equity Methodology



Source: Based on 19 cases with disclosed discount rate methodology.

- Alternative methods have been used (e.g., Fama-French Model)
  - *Union Financial*
  - *Medpointe*
  - *PNB Holdings*

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Equity Risk Premium

- The Court has closely followed ERP developments over the past decade
- Traditionally the Court has focused on the SBBI long-term average
  - *Delaware Open MRI, MedPointe*
- More recently the Court appears to have shifted to a supply-side or expectational estimate
  - *PNB Holding, Golden Telecom*

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Beta

- The Court resists the use of "black box" data
  - *Golden Telecom*
- E.g., the Court found the MSCI Barra beta to be
  - Proprietary, not replicable, overly complex
- The Court does recognize the need to depart from a pure historical beta
- Measurement period of two to five years
  - *JRC Acquisition; Andaloro*
- No preference expressed on frequency of data

Size Premium

- The Court generally accepts the premise and application of a size premium
  - *Emerging Communications, Sunbelt, ECM*
- The propriety of this adjustment has been questioned by some academics and the Court has noted the controversy
- SBBI (Morningstar) data has been generally accepted by the Court

Company-Specific Risk Premium

- Commonly proposed, but rarely accepted
- The Court is highly skeptical of CSRP
  - "[t]o judges, the company-specific risk premium often seems like the device experts employ to bring their final results in line with their clients' objectives, when other valuation inputs fail to do the trick." [V.C. Strine]
    - *Delaware Open MRI*
- The Court will not accept a CSRP without
  - A basis firmly grounded in valuation theory and
  - Fact-based evidence produced at trial
    - *Emerging Communications, Gesoff*

Cost of Debt

- The Court generally prefers the use of the subject company's actual cost of debt
  - Rather than a hypothetical cost of debt derived from market comparables
    - *Hintmann, Emerging Communications, U.S. Cellular*
- Commonly computed as the weighted average of each of the subject company's debt tranches
  - *ECM, U.S. Cellular*

Capital Structure

- The Court appears to favor the use of a company's actual capital structure
  - Supported by evidence of management's plans to maintain the existing capital structure
    - *JRC Acquisition, ECM, MedPointe, Gearreald*
- On occasion, the Court has sanctioned the use of a target capital structure
  - Supported by evidence of management's plans to seek a different capitalization structure over time
    - *Andaloro, PNB Holdings, Trilithic*

Guideline Public Company Method

- Proposing party carries the burden of proving that the comps are truly comparable
  - *Andaloro, eMachines, PNB Holdings, Travelocity*
- Most commonly used are multiples of
  - Revenues, EBITDA, EBIT and EPS
- In the absence of reliable management projections, the Court has relied solely on a comp analysis
  - *Travelocity*
- Market multiples include a built-in minority discount
  - *Travelocity*

Control Premiums

- The Court routinely permits the application of a control premium to the guideline public company method
  - *Berger, Rapid-American*
- In contrast, the Court has consistently held that a control premium should not be applied to a DCF method
  - *Berger*

Control Premiums (cont.)

- The Court's position contrasts with
  - Appraisal books and literature
  - ASA educational position
  - The Court's own treatment of the issue in the context of a DCF terminal value is determined using an exit multiple procedure

Guideline Transaction Method

- The Court has expressed concern regarding comparable transaction analyses
  - "[t]he merger and acquisition data undoubtedly contains post-merger value, such as synergies… that must be excluded from appraisal value"
    - *Kleinwort Benson*
- Nevertheless, the Court will consider comparable transactions if they are, indeed, sufficiently comparable
  - The Court will closely evaluate whether an expert has met its burden of persuasion.
    - *Highfields Capital, JRC Acquisition, MC, Sunbelt, Trilithic*

Pass-Through Entities

- The Court has presented an interesting view on the "S Corp Premium" issue
- Essentially "solving" for the corporate tax rate that would equalize the post-tax distributions
  - *Delaware Open MRI*

	C Corp	S Corp	S Corp Valuation	
Income before tax	$100	$100	$100	
Corporate tax rate	40%	--	29.4%	← Solve
Available earnings	$60	$100	$70.60	
Dividend/personal income tax rate	15%	40%	15%	
Total, post-tax distributions	$51	$60	$60	← Match

Built-in Capital Gains

- The Court has had limited exposure to this issue
- The Court declined to reduce a company's value for a projected capital gain tax liability
- Concerns included:
  - No evidence of an intent to sell the appreciated assets
  - Future tax liability is uncertain
  - Focus on *going concern* value vs. *liquidation value*
    - *Berger*
- Inconsistent with recent Tax Court cases

Appendices

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Case Citations

- ***Andaloro***: *Andaloro v. PFPC Worldwide, Inc.*, 2005 Del. Ch. LEXIS 125 (Aug. 19, 2005).
- ***Berger*** : *Berger v. Pubco Corp.*, No. 3414-CC, 2010 WL 2025483 (Del. Ch. May 10, 2010).
- ***Cancer Treatment Centers***: *Lane v. Cancer Treatment Ctrs. of Am., Inc.*, CA 12207-NC, 2004 Del. Ch. LEXIS 108 (July 30, 2004).
- ***Coleman***: *Prescott Group Small Cap, L.P. v. Coleman Co.*, 2004 Del. Ch. LEXIS 131 (Sept. 8, 2004).
- ***Crescent/Mach1***: *Crescent/Mach I P'ship, L.P. v. Turner*, CA 17455-VCN, 17711-VCN, Crescent/Mach I P'ship, L.P., (May 2, 2007).
- ***Crown Media***: *S. Muoio v. Crown Media Holdings, Inc. et. al.*, C.A. 4729-CC (Del. Ch. March 9, 2011).
- ***Delaware Open MRI***: *Del. Open MRI Radiology Assocs.*, P.A. v. Kessler, 898 A.2d 290 (Del. Ch. 2006).
- ***eMachines***: *Gholl v. eMachines, Inc.*, CA 19444-NC, 2004 Del. Ch. LEXIS 171 (Nov. 24, 2004), *aff'd*, 2005 Del. LEXIS 220 (June 14, 2005).
- ***Emerging Communications***: *In re Emerging Commc'ns, Inc. S'holders Litig.*, C.A. 16415, 2004 Del. Ch. LEXIS 70 (May 3, 2004).
- ***Gearreald:*** *Gearreald v. Just Care,* C.A. No. 5233-VCP (Del. Ch. Apr. 30, 2012).
- ***Gesoff***: *Gesoff v. IIC Indust., Inc.*, 902 A.2d 1130 (Del. Ch. 2006).
- ***Ginette Reis***: *Ginette Reis v. Hazelett Strip Casting Corp.*, C.A. 3552-VCL (Del. Ch. Jan. 21, 2011).
- ***Golden Telecom***: *Global GT LP v. Golden Telecom, Inc., 993 A. 2d 497* (Del. Ch. *2010).*
- ***Gonsalves***: *Gonsalves v. Straight Arrow Publishers, Inc.*, C.A. 8474, 2002 Del. Ch. LEXIS 105 (Sept. 10, 2002).
- ***Hanover***: *In re Hanover Direct, Inc. S'holders Litig.*, Del. Ch. No. 1969, CC (Sept. 24, 2010).
- ***Heng Sang Realty***: *Ng v. Heng Sang Realty Corp.*, C.A. 18462, 2004 Del. Ch. LEXIS 69 (Apr. 22, 2004, rev'd May 18, 2004), *aff'd*, 2005 Del. LEXIS 45 (Jan. 27, 2005).
- ***Highfields Capital***: *Highfields Capital, Ltd. v. AXA Fin., Inc.*, C.A. 804-VCL, 939 A.2d 34 (Del. Ch. 2007).

Case Citations (cont.)

- ***Hintmann***: *Hintmann v. Fred Weber, Inc.*, 1998 Del. Ch. LEXIS 26 (Feb. 17, 1998).
- ***JRC Acquisition***: *Cede & Co. v. JRC Acquisition Corp.*, C.A. 19648-NC, 2004 Del. Ch. LEXIS 12 (Feb. 10, 2004).
- ***Kleinwort Benson***: *Kleinwort Benson Ltd. v. Silgan Corp.*, C.A. 11107, 1995 Del. Ch. LEXIS 75 (June 15, 1995).
- ***Liberty Digital***: *Finkelstein v. Liberty Digital, Inc.,* C.A. No. 19598, 2005 WL 1074364 (Del. Ch. Apr. 25, 2005).
- ***MedPointe***: *Cede & Co. v. MedPointe Healthcare, Inc.*, C.A. 19354-NC, 2004 Del. Ch. LEXIS 124 (Aug. 16, 2004).
- ***Montgomery Cellular***: *Dobler v. Montgomery Cellular Holding Co.*, C.A. 19211, 2004 Del. Ch. LEXIS 139 (Sept. 30, 2004).
- ***Onti***: *Onti, Inc. v. Integra Bank*, 751 A.2d 904 (Del. Ch. 1999).
- ***PNB Holdings***: *In re PNB Holding Co. S'holders Litig.*, 2006 Del. Ch. LEXIS 158 (Aug. 18, 2006).
- ***Sunbelt***: *In re Sunbelt Beverage Corp. S'holders Litig.,* 2010 Del. Ch. LEXIS (Del. Ch. Jan. 5, 2010).
- ***Taylor***: *Taylor v. Am. Specialty Retailing Group, Inc.*, Del. Ch., C.A. No. 19239)
- ***Technicolor VI***: *Cede & Co. v. Technicolor, Inc.* (Del. Ch. Oct. 19, 1990).
- ***Travelocity***: *Doft & Co. v. Travelocity.com, Inc.*, C.A. 19734, 2004 Del. Ch. LEXIS 75 (May 20, 2004), *on reargument*, 2004 Del. Ch. LEXIS 84 (June 10, 2004).
- ***Tri-Continental***: *Tri-Continental Corp. v. Battye*, 74 A.2d 71 (Del. 1950).
- ***Trilithic***: *Henke v. Trilithic, Inc.*, C.A. 13155, 2005 WL 2899677 2005 Del. Ch. LEXIS 170 (Oct. 18, 2005), *modified*, 2005 Del. Ch. LEXIS 204 (Dec. 20, 2005).
- ***Union Financial***: *Union Ill. 1995 Inv. Ltd. P'ship v. Union Fin. Group, Ltd.*, 847 A.2d 340 (Del. Ch. 2004).
- ***U.S. Cellular***: *In re U.S. Cellular Operating Co.*, 2005 Del. Ch. LEXIS 1 (Jan. 6, 2005).
- ***Weinberger***: *Weinberger v. UOP, Inc.,* 457 A.2d 701 (Del. 1983).

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About the Presenter

Mr. Tarbell is a Director in the Financial Advisory Services business of Houlihan Lokey. He has more than two decades of experience providing valuation and financial opinions to private and publicly traded companies. He is a member of the firm's Technical Standards Committee and Head of the firm's Estate and Gift Tax Valuation practice.

Before joining Houlihan Lokey, Mr. Tarbell was a principal and national director of financial advisory services for a national valuation firm. Earlier, he was a vice president in the M&A group of a boutique investment banking firm.

Mr. Tarbell earned a B.S. from the University of Oregon and an MBA from the University of Chicago Booth School of Business. He is an accredited senior appraiser (ASA), certified in business valuation, of the American Society of Appraisers and an elected member of the organization's Business Valuation Committee. He holds the designation of Chartered Financial Analyst (CFA) of the CFA Institute. He is a member of the executive committee of the International Institute of Business Valuers (IIBV) and the Board of Directors of the Valuation Roundtable of San Francisco. He is a member of the Portland Society of Financial Analysts and the Valuation Advisory Committee of the ESOP Association. He is also an associate member of the National Association of Corporation Directors and the American Bar Association.

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