Courts Favor Valuation Methodology Supported by Case Facts

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Courts have recently increased their scrutiny of the details of valuations that experts perform. In *In re Appraisal of Dell Inc.*, for example, the Delaware Court of Chancery scrutinized details of the experts' valuation analysis.[1] This Court's opinions on valuation are usually very detailed and give experts a clear understanding of how courts dissect and analyze valuation opinions.

In a recent ruling, in *In re Appraisal of SWS Group, Inc.*,[2] the same Court opined regarding the choice of valuation methodologies in appraisal litigation, the importance of unique case facts, and the selection of several inputs in the valuation model by the experts representing the two opposing parties. Even though this ruling is specific to the SWS Group, which was a struggling bank holding company and primarily a broker-dealer, it provides a good opportunity to review the important inputs and assumptions in an expert's valuation.

Valuation methodologies

Fair value determination

A valuation expert opining on a statutory appraisal of shares can determine fair value using several methods, such as the sale price, the discounted cash flow method (DCF), comparable company analysis, etc. Many experts have relied on the deal price itself as a measure for the fair value when the sales process exposes the company to market forces.

When all the information is available to all the potential bidders, an arm's-length transaction should reflect a fair valuation. For example, in *Merion Capital LP v. Lender Processing Services, Inc.*, the Court deferred to the deal price because the "company ran a sale process that generated reliable evidence of fair value."[3] However, in *In re Appraisal of Dell, Inc.*, the Court awarded dissenting shareholders a 28% premium over the deal price. In that case, the Court concluded that the sale process functioned imperfectly as a price discovery tool. More strikingly, in *In re Appraisal of DFC Global Corp.*[4], the Court found that the sales process was a robust arm's-length sale yet chose to afford only one-third weight in its fair value assessment to the deal price itself.

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

2 *In re Appraisal of SWS Group, Inc.* C.A. No. 10554-VCG (Del. Ch. May 30, 2017).

3 *In re Merion Capital L.P., et al. v. Lender Processing Services, Inc.*, No. 9320-VCL (Del. Ch. Dec. 16, 2016).

4 *In re Appraisal of DFC Global Corp.* (Del. Ch. July 2016).

Fair value assessment is more than just the deal price, even if a robust sales process has occurred. Often, unique case facts make the merger price unreliable, for example, when there is a pre-existing relationship between the parties. Moreover, many deal prices rely heavily on the assumption (and valuation) of expected synergies between the merging parties.

Synergies need to be excluded from the merger price in determining fair value when the merger price is driven solely by synergies. Additionally, a fair value calculation has to focus on going concern and not on a valuation to a third party in an acquisition. These are other case-specific reasons that make a deal price an important reference—but not always the only reference an expert should rely on.

Traditional valuation

In the SWS Group matter, the Court rejected the sale price as a measure of fair value because it found that the sale of the SWS Group did not reflect market value. The opposing experts did not propose sale price either, but for different reasons. The Petitioner's expert opined that the sale process was flawed, and the Respondent's expert argued that the deal price included large synergies that were inappropriate to statutory fair value.

Instead, both experts relied on traditional valuation methods. The Petitioner's expert presented two valuation methods and placed 80% weight on his DCF method and 20% weight on a comparable company analysis. The Respondent's expert placed 100% weight on his DCF analysis. The ruling points out that one of the important considerations is that an appraisal fair value should be focused on going concern value and that any valuation analysis must necessarily be tied to the case facts.

Comparable company analysis

As the Court noted, finding comparable companies can be challenging. The expert proposing the analysis must provide a good sample of companies that are comparable in terms of size, business lines, and performance. In the SWS Group matter, the Petitioner's expert selected companies that were in both banking and broker-dealer lines of business that the Court found to be dissimilar in size and other characteristics (such as growth profile). The court rejected the comparable company analysis because it did not find it to be supported by the case facts.

This case highlights the importance of selecting companies that are truly comparable to the company in question. It also highlights that there could be cases in which a company does not have reasonable comparables because its business model is unique. In such a case, an expert either cannot use a comparable company analysis or has to find a creative and robust way to account for the differences.

Discounted cash flow analysis

DCF is a popular valuation method to employ in fair value determination. As the Court noted, "The DCF valuation, although complex in practice, is rooted around a simple principle: the value of the company at the time of the merger is simply the sum of its future cash flows discounted back to present value."[5] More importantly, the reliability of the method is only as good as the inputs and the underlying assumptions.

The Court ruling stated that cash flow projections have been recognized as the "most important input" in a DCF. Thus, reliable management projections prepared over the regular course of business are favored over "litigation-facing expert derived projections."[6] In this case, the Petitioner's expert took the three-year management projection (i.e., from 2015 to 2017) and extended it by two years (from 2018 to 2019), arguing that a "steady state" had not been reached. The Respondent's expert used the projections without any adjustment. The Court ruled that there was "inadequate evidence to support the extension of straight-line unprecedented growth"[7] and thus to find the three-year projection appropriate. Additionally, as in any component of a valuation, the unique facts of the case are important and pertinent. For example, the SWS Group had never met its budget projection, and its write-down of net operating losses showed that its own projections were optimistic. These facts need to be incorporated in the valuation.

One of the DCF inputs that engendered differing opinions between the experts was the treatment of warrant, its exercise and impact on the valuation. The Court ruled that the warrant exercise three months prior to the close was an "operative reality" as of the merger date. "Because the warrant exercise occurred earlier than management expected in its projections, I do find it appropriate to reduce the interest expense accordingly to reflect the Company's operative reality."[8] As a result, the Court ruled that the projected net income must be increased in the two affected years by the after-tax interest expense saved as a result of the warrant exercise that removed debt from the company's balance sheet. This ruling highlights the need for experts to make adjustments to management's cash flow projections, when appropriate, by evaluating case facts.

Terminal value growth rate

Terminal growth rate is a key component in a going concern analysis because it is used to estimate the terminal value. The Court adopted the terminal growth rate of 3.35% (mid-point of long-term expected inflation rate and long-term expected economic growth rate) that the Respondent's expert

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5 *In re Appraisal of SWS Group, Inc. C.A.* No. 10554-VCG (Del. Ch. May 30, 2017), 31.

6 *In re Appraisal of SWS Group, Inc. C.A.* No. 10554-VCG (Del. Ch. May 30, 2017), 32.

7 *In re Appraisal of SWS Group, Inc. C.A.* No. 10554-VCG (Del. Ch. May 30, 2017), 35.

8 *In re Appraisal of SWS Group, Inc. C.A.* No. 10554-VCG (Del. Ch. May 30, 2017), 43.

proposed because it was set without major adjustments to the projections. The Petitioner's expert proposed 3% but in rebuttal accepted the opposing expert's terminal value growth rate.

Discount rate

Discount rate is central to a DCF analysis because it is the rate used to calculate the present value of future cash flow. The discount rate chosen should reflect the appropriate risks of the cash flow being valued. Both the experts estimated cost of equity by relying on the widely accepted Capital Asset Pricing Model. The cost of equity was calculated as the risk-free rate plus market risk premium (beta multiplied by equity risk premium) plus the size premium.

Both experts agreed on the risk-free rate of 2.47%. The experts differed in the choice of an Equity Risk Premium (ERP). The Respondent's expert used a historical ERP of 7.0%; the Petitioner's expert used a supply-side ERP of 6.21%. The Court ruled that case facts did not support the use of the historical ERP, which represents the spread between historical market returns and risk-free rate. This Court's recent decisions have favored the supply-side ERP.[9]

Another important input in the cost of equity is the beta, which is a measure that represents how the returns of a stock respond to market returns.[10] The Respondent's expert used a beta based on two years of SWS Group weekly stock returns preceding the announcement. But the Court ruled that this beta was not acceptable because it was impacted by "merger-froth" and corresponding higher volatility. The Court noted that the higher volatility in that period was underlined by the lower five-year monthly and five-year weekly betas. In contrast, the Petitioner's expert used median beta based on peers that were not closely comparable. Nevertheless, the Court ruled that based on the facts of the case, the median beta was the better choice of the two.

Size premium

Both experts included size premium in the discount rate. The Respondent's expert estimated the size premium based on the market capitalization of the SWS Group prior to the offer and excluding the exercise of the warrant. The Petitioner's expert arrived at a preliminary valuation and used that to select the size premium, arguing that the large amount of warrants makes this approach more preferable. The Court ruled that a mid-point of the two approaches was appropriate because while the

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9 A common risk premium is a historical one, but a supply-side risk premium takes into account the earnings that companies generate (supply). Thus, it does not take into account the expected premium or discount embedded in market price attributed to investor trading.

10 A beta of 1 means that stock return moves along with the market returns. Beta "tells us on how much on average the stock price changed for each additional 1 percent change in the market index." Richard A. Brealey, Stewart C. Myers, and Franklin Allen, *Principles of Corporate Finance* (New York: McGraw-Hill, 2006), 219.

SWS Group was a public company, it was in “some ways analogous to a private company” because of the substantial amount of in-the-money warrants and influence by certain major creditors.

Conclusion

Based on the above valuation inputs, the Court found that the fair value was $6.38 per share. In comparison, the merger price was $6.92 per share, the Petitioner’s expert’s estimate was $9.61 per share, and the Respondent’s expert estimate was $5.17 per share.

This careful opinion by the Court shows the importance of not using a one-size-fits-all valuation, whereby the same method is applied to any situation. A valuation needs to be relevant to the unique details of a case, while following the guidelines that the Courts have established.