Delaware Court Determines ISN Value, Despite Divergent Expert Opinions

The Delaware Court of Chancery recently determined the value of ISN Software Corporation stock to be $98,783 per share, 158% more than the merger price. ISN did not rely on a financial advisor, investment bank, or fairness opinion, but self-determined that its stock was fairly valued at $38,317 per share. Petitioners Polaris and Ad-Venture objected, and promptly filed suit. With experts for all parties submitting wildly different valuations, the Vice Chancellor was forced to rely on his own, hybrid discounted cash flow ("DCF") analysis, and ultimately pegged ISN's fair value well above the merger price. Litigators would be remiss in neglecting to glean insight from the published opinion, which covers critical valuation parameters, including cash flow projections and discount rate factors.

Key Case Highlights:

- In January 2013, after receiving approval from majority stockholders, Bill Addy, and CEO, Joe Eastin, which owned 65% and 5% of ISN stock, respectively, ISN merged with a newly formed, wholly owned subsidiary, and squeezed out certain minority holders.
- ISN did not seek guidance from a financial advisor or investment bank, and did not obtain a fairness opinion.
- Under the merger agreement, minority stockholders received $38,317 per share.
- Minority stockholders Polaris and Ad-Venture felt the offer price undervalued the company, and demanded appraisal of their shares.
- ISN, Polaris, and Ad-Venture each produced valuation experts, whose conclusions varied dramatically from $29,360 (ISN) to $230,000 (Polaris) per share.
- While the valuation experts relied on several methodologies, Vice Chancellor Glasscock rejected all but the DCF method as valid.
- The Vice Chancellor made significant adjustments to the DCF analyses in setting fair value at $98,783 per share.

Opinion Overview:

The valuations provided by the three valuation experts led to a wide range of values. Polaris's expert submitted a value of $230,000 per share, while Ad-Venture's expert opined to $222,414 per share. Meanwhile, ISN's expert testified that the fair value of ISN was a mere $29,360 per share, slightly less than the merger price. To arrive at each of their figures, the experts applied a series of different valuation methods, including the guideline public company method, the income capitalization approach, and the DCF. Each weighted the results as they deemed appropriate. Due to ISN's lack of relevant public competitors, Vice Chancellor Glasscock eliminated the guideline public company method. He also eliminated the income capitalization approach, pointing out that due to ISN's uneven growth rate, the underlying "normalization" assumption was violated. Finally, the judge rejected that historical transactions in the stock were indicative of fair value, due to the nature of the transactions and the fact that the stock was highly illiquid and, therefore, unlikely to fetch fair value.

Vice Chancellor Glasscock deemed only the DCF model as a valid indicator of fair value. While each expert incorporated the DCF approach as a component of their analysis, each differed on the accepted growth period for ISN. The Vice Chancellor supported the standard five-year projection period, subsequently selecting the DCF model of ISN's expert, Daniel Beaulne, as a framework for value. To arrive at the concluded company value of $98,783 per share, the Vice Chancellor adjusted key inputs and assumptions to the DCF model.

The Analysis:

While the Vice Chancellor approved of Beaulne's basic model, he shelved certain of the critical inputs and made significant adjustments to the cash flow projections and the discount rate.[1] The adjustments included:

- Removal of Beaulne's annual cash flow adjustment for incremental working capital, determining instead that ISN had negligible incremental working capital needs;
- Recognizing that the deferred revenue model utilized by ISN increases its current liabilities during the year, an adjustment was made to annual cash flow for changes in deferred revenue;
- An additional cash flow adjustment was made in 2014 in the amount of $16.5 million to account for an expected tax refund;
- The addition of $34 million to the sum of ISN's discounted cash flows for the "Buyout and Litigation Reserve," deemed to be a distributable non-operating asset;
- The application of a 2.46% size premium, based on Ibbotson's 8th decile ($514 - $818 million market capitalization companies) to calculate the company's cost of equity; and
- Determination of 10.46% cost of equity based solely on the capital asset pricing model.

MPI's Observation:

As evidenced by the wide chasm between the concluded values, we draw two conclusions. The first is that valuation is, inherently, an imprecise exercise. Seemingly minor adjustments to critical inputs can result in meaningful changes to the concluded value. The second is that often the "independent" experts allow advocacy for their client to drive the concluded value. In this case we see that Petitioners' experts

1 Source: *In re ISN Software Corp. Appraisal Litigation*, C.A. No. 8388-VCG.

arrive at fair value some 500% in excess of the merger price, while Respondent's expert concludes that the Company is worth less than merger price. MPI questions whether any of the parties are well served by expert opinions that seem to border on the extreme, frustrating the trier of fact and the process, and resulting in a protracted and costly litigation. In this letter opinion, the Vice Chancellor rejected certain valuation techniques as a poor fit, due to ISN's unique line of business, growth prospects, and illiquidity, favoring the DCF approach as most reliable in arriving at a reasonable value. Further adjustments to cash flows and discount rates followed, with the Court ultimately determining fair value at $357 million, within the colossal range of $106 - $860 million suggested by the experts.

More Information

For more information or specific questions on this case, please contact the author, whose contact information follows:

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About MPI

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