Delaware Court Delivers on Dell Value

Vice Chancellor Laster's recent decision in the Delaware appraisal action involving Dell, Inc. determined that Dell's stock was valued at $17.62 per share, or some 26% above the going private offer worth $13.96 per share.[1] The four day trial included testimony from both Petitioners' and Respondent's valuation experts, as well as testimony from the investment bankers who originally advised Dell's board of directors. Ultimately, the Vice Chancellor developed a hybrid valuation model, selecting what was deemed to be the most reliable data from each of the experts, in arriving at his opinion on the value of the shares. Litigators would be remiss in neglecting to glean insight from the published opinion which speaks to critical valuation parameters, including financial forecasts, growth rates, taxes, and the cost of capital.

Key Case Highlights:

- In February 2013, Dell's board agreed to a deal from founder Michael Dell and private equity firm Silver Lake Partners to buy the shares at $13.65 per share.
- The board and Special Committee were advised by J.P. Morgan and Evercore.
- The offer price reflected a 25% premium to the unaffected share price prior to published rumors regarding a deal.
- Dell's shares had been trading at depressed prices after several quarters of disappointing earnings and an industry-wide decline in demand for personal computers.
- Several large shareholders, including Carl Icahn, felt the offer price was inadequate.
- In the interest of increasing shareholder support, the buyout group raised the offer price to $13.75 on July 24, 2013.

[1] The offer price consisted of $13.75 per share in cash, a special cash dividend of $0.13, and a regular stock dividend of $0.08 per share.

- Shareholders voted to approve the deal on September 12, 2013. Shortly thereafter, the appraisal proceeding commenced.

Opinion Overview:

Vice Chancellor Laster found the original merger consideration of $13.65 to be inadequate for two reasons. First, he noted that J.P. Morgan and Evercore relied heavily on the depressed market price of the shares in rendering their opinions that the offer price was fair. He argued that market price is one of the factors that should be considered but is not dispositive as to value. Referring to the "semi-strong" form of market efficiency, market prices only reflect public information about a company and not management's best assessment of the company's potential value, he said. Secondly, he criticized the board's reliance on the leveraged buyout model ("LBO model") as an indicator of fair value, noting that negotiations with the financial sponsors largely reflect their threshold rates of return.[2] The Vice Chancellor argued that LBO models only tell you what a financial buyer might be willing to pay, which may or may not be indicative of fair value.

Looking beyond the original fairness opinions, the judge considered the valuations presented by each side's valuation expert. Petitioners' expert Bradford Cornell opined that Dell's shares were worth $28.61 per share, while Respondent's expert Glenn Hubbard opined that the shares were worth $12.68. The judge gave his stamp of approval to the Discounted Cash Flow ("DCF") method as being "well established" and garnering the most confidence within the financial community. Each of the experts employed the DCF method. The wide chasm between the two results was largely explained by the cash flow projections each had relied on.

Early on in the sale process, Dell retained Boston Consulting Group ("BCG") to develop a set of independent financial projections for the company. BCG prepared a Base Case, and cases reflecting 25% and 75% achievement of the company's cost reduction strategy. These financial forecasts were presented to the board in January 2013, just prior to the first merger agreement. Subsequent to the board signing off on the deal, market conditions for personal computers worsened, yet the forecasts were never updated. The Court was clear that if market conditions change between the time the projections are prepared and the valuation date, they must be revised.

[2] Generally speaking, LBO models establish valuation ranges by assuming various internal rates of return demanded by financial sponsors.

The Analysis:

- Petitioners' expert relied on the BCG 25% and 75% Projections, weighing them each 50% with no adjustment. He assigned a 50% weighting to the weighted BCG Projections. In addition, he assigned a 50% weighting to a set of financials prepared by Silver Lake and Dell in September 2013 which were presented to the bank in order to finance the deal (the "Bank Projections"). The judge viewed the Bank Projections as optimistic.

- Respondent's expert relied on the BCG 25% Projections and Bank Projections, but adjusted each to account for recent negative trends. He also adjusted for non-recurring transaction costs and stock based compensation. The Court adopted the financial projections relied upon by Hubbard.

- Another adjustment to the DCF model made by the Court was the selection of a terminal value growth rate of 2%. The Court found that for healthy companies, perpetuity growth rates must be above the rate of inflation, rejecting Cornell's 1% growth rate and adopting Hubbard's 2%.

- With regard to corporate taxes, Vice Chancellor Laster rejected the use of a marginal 35% tax rate in favor of Dell's historical tax rate, approximating 21%. Given Dell's strategy, he said, there was no reason to believe Dell would ever pay the marginal rate.

- The experts differed on key inputs for Dell's Weighted Average Cost of Capital. The judge utilized the current yield on BBB rated debt as the company's borrowing rate. The Court adopted a supply-side Equity Risk Premium of 6.11%, and relied on Dell's historical two-year weekly beta. Petitioners' expert advocated a blended beta, based on those of Dell's peers, but the Court found a company-specific beta more reliable.

- Other areas of disagreement included the amount of excess cash on hand and Dell's working capital requirements. Both experts agreed that cash should be added back to the valuation, with Cornell adding all of the $6.158 billion in cash back and Hubbard adjusting the cash position for working capital needs, restricted cash, and taxes. The Court found that deductions for restricted cash and tax liabilities were warranted as was an adjustment for working capital.

- The Court concluded that Dell's shares were worth $16.43 using the more conservative BCG 25% Projections (adjusted) and $18.81 using the Bank Projections (adjusted). It equally weighted these two outcomes to arrive at fair value of $17.62 per share.

MPI's Observation:

Aside from the detailed roadmap to the concluded value, one of the more useful guidelines from this opinion was borrowed from Cede & Co. v. Technicolor, Inc., that "the value of a corporation is not a point on a line, but a range of reasonable values…" asserting that the judge's duty is to determine which value within the range is the most reasonable, given all of the available evidence.[3] It is clear from the Dell appraisal proceedings that Vice Chancellor Laster successfully discharged his duty, testing assumptions and inputs for reliability and ultimately arriving at what we consider to be a reasonable value for Dell's shares.

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About MPI

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[3] *Cede & Co. v. Technicolor, Inc.*, 2003 WL 23700218, at *2 (Del. Ch. July 9, 2004), *aff'd in part, rev'd on other grounds*, 884 A.2d 26 (Del. 2005).