Dell Inc. Management Buyout—Why the Delaware Chancery Court Determined a Higher Fair Value after Appraisal Rights Proceeding

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In the matter of In Re Appraisal of Dell Inc.*, tried before the Delaware Court of Chancery, dissenters appraisal rights were petitioned by shareholders who held 5.2 million shares following the management buyout of Dell by its founder Michael Dell and by Silver Lake Partners. The Chancery Court concluded that the fair value per share was 27 percent greater than the actual merger price per share. This discussion (1) describes and analyzes the facts of the case, (2) provides a chronological time line of the company sale process, (3) summarizes the Chancery Court's reasoning for its judicial decisions, and (4) lists—and explains—the judicial precedents cited in the Chancery Court memorandum opinion.*

Introduction

Dell Inc. ("Dell"), which arguably was the pioneer in affordable, high quality, Windows-based personal computers ("PCs"), announced on February 5, 2013, its intent to go private by way of a leveraged management buyout ("MBO") transaction.

At the time of the MBO transaction, the market for PCs had experienced a significant decline in sales growth. This decline was due to competition from smartphones and tablet computers. This competition had pressured the Dell stock price.

The MBO transaction acquirers were Michael Dell, the company founder and chief executive officer, and Silver Lake Partners, L.P. ("Silver Lake"), a private equity firm. At the insistence of Michael Dell, due to his role as both an insider and counterparty to the company sale process, a special committee was formed to (1) marshal and supervise the sales process, (2) analyze financial forecasts for the purpose of estimating fair value, (3) evaluate submitted bids, and (4) negotiate with bidders.

Following due diligence by a handful of private equity firms and a failed attempt at a strategic merger, the MBO transaction was approved by a majority of shareholders (57 percent) and closed on October 28, 2013. Technically, the transaction was structured as a merger rather than an acquisition. This was because the company was merged into a shell entity with Michael Dell contributing his shares to that entity.

The total consideration was $24.9 billion, consisting of $13.75 per share in cash (a 25 percent premium over the closing stock price on January 11, 2013, the day before rumors circulated), plus a special dividend of $0.13 per share. After the MBO transaction closed, Michael Dell had increased his ownership interest to 75 percent from 16 percent, and Silver Lake owned approximately 25 percent.

Dissenting shareholder appraisal rights were sought by certain noncontrolling shareholders who held 5.2 million shares of the 1.8 billion diluted shares outstanding. The dissenting shareholder appraisal rights action was entitled *In Re Appraisal* *of Dell Inc.* ("*Appraisal of Dell*") and tried before the Delaware Court of Chancery (the "Chancery Court").

On May 31, 2016, Vice Chancellor J. Travis Laster of the Chancery Court ruled in favor of the petitioners and held that the fair value price per share of the common stock of Dell at the time of its sale to the MBO group was $17.62 per share.[1] That judicially concluded fair value per share was 27 percent higher than the total consideration price per share.

Selected Facts Conveyed in the *Appraisal of Dell* Opinion

The following discussion presents selected facts conveyed in the *Appraisal of Dell* memorandum opinion ("Opinion") by the Chancery Court.

No Breach of Fiduciary Duty by the Board of Directors

The Chancery Court found no evidence of a breach of fiduciary duty, and in fact, wrote that the special committee "did many praiseworthy things, and it would burden an already long opinion to catalog them."[2]

In the legal analysis section of the Opinion, the court noted that there was no evidence that Michael Dell sought to create a "valuation disconnect"[3] so as to take advantage of it. Rather, Michael Dell fretted over institutional investors' misunderstanding of the company's intrinsic value, and tried his best to convince investors that the company was worth much more than its publicly traded price.[4]

However, the Chancery Court found that certain aspects of the company sale process called into question whether fair value had, in fact, been offered as consideration.

Management Buyouts Should Be Evaluated More Thoroughly

The Opinion references judicial precedent and legal literature that suggest MBO transaction-related deals should be scrutinized more thoroughly than transactions with strategic buyers in which management will not be retained.[5]

The Sale Process Had Certain Identified Flaws

The petitioner's expert witness was Professor Guhan Subramanian. Professor Subramanian advised the court about the limitations of a go-shop period, particularly after a pre-signing phase of the sale process that consisted of few bidders and who would be partnered with the founder by way of an MBO.

The Opinion discussed the limitation at length, as well as the apparent focus by the Dell financial advisers on the leveraged buyout ("LBO") pricing model—rather than on the discounted cash flow ("DCF") valuation method.

Chancery Court Recognized That Neither the Merger Price per Share Nor the Publicly Traded Price per Share Were Equivalent to Fair Value

The Opinion cited numerous academic papers supporting the conclusion that a company's publicly traded price per share can depart from its fair value price per share ("valuation gap"). This valuation gap issue can sometimes be an issue when a company is involved in changing its business model.

Supporting the theory that there was a Dell valuation gap issue was evidence provided by certain value estimates that were significantly higher than the stock price. Roughly a year and a half before the onset of the sale process, Dell management performed a sum-of-the-parts valuation analysis that had valued the company at $22.49 to $27.05 per share, while the stock price traded around $14 per share.[6]

Early in the sale process, during October 2012, a Dell transaction adviser, JPMorgan Chase & Co. ("JPMorgan"), estimated a value range of $20 to $27 per share by one of its scenarios applying the DCF method. At the same time, the Dell publicly traded stock price was trading between $9 and $10 per share.[7]

Although the financial projections used for the JPMorgan analysis were found to be too optimistic, a significant valuation gap of this magnitude may deserve added scrutiny.

Additional Considerations Not Addressed by the Opinion

The Chancery Court took issue with the focus on the use of LBO models in determining the merger price. However, the court did not address the fact that an internal rate of return ("IRR") is based on a finite beginning and ending date—in this case roughly five years—which may not be appropriate for a turnaround situation.

Dell was in the midst of a transformation to diversify its revenue. This transformation project was intended to transition Dell business efforts away from PC sales. The transformation efforts were not expected to be implemented for around five years, and, therefore, the financial benefits of the transformation would not have been included in the LBO valuation models.

Alternatively, a DCF valuation analysis that includes a terminal value would include the benefits of restructuring and new initiatives beyond five years if modeled out longer than five years. The terminal value income component, which is often capitalized at the weighted average cost of capital minus the projected long-term growth rate, would also capture those results beyond five years.

This terminal value consideration may explain the valuation gap between the LBO valuation models and the internally generated sum-of-the-parts valuation estimated by Dell management in January 2011,[8] approximately a year and a half prior to when Michael Dell began to consider an MBO.[9]

The sum-of-the-parts valuation analysis estimated the value at $22.49 to $27.05 per share, significantly higher than the publicly traded stock price at the time of around $14 per share, and the acquisition price of $13.75 per share on October 28, 2013.

Sequence of Events Prior to and During the Sale Process

Because this transaction was structured as an MBO, the company sale process was given added scrutiny by the Chancery Court. The relevant sequence of events in this matter was as follows:

- 2009 – Faced with increasing competition from (1) low cost foreign manufacturers, (2) the introduction and popularity of smartphones and tablets, and (3) cloud-based storage services (affecting Dell's market for servers), Dell management decides to offer enterprise software and services in order to diversify away from the market for personal computers.
- 2010–2012 – Dell acquires 11 companies for $14 billion.
- January 2011 – Dell conducts an internal analysis of the company's intrinsic value. Its sum-of-the-parts valuation analysis provided a per-share value of between $22.49 and $27.05.
- June 2012 – Southeastern Asset Management, Inc. ("Southeastern"), proposes to Michael Dell that he consider pursuing an MBO transaction.
- July 2012 – Dell management prepares financial projections (the "July Case"), which supported internally produced valuation estimates that were "significantly higher than the company's stock price."[10]

  Dell management advises its board of directors that industry revenue multiples imply an enterprise value of $40 billion by the end of fiscal year 2012, which is $25 billion higher than the current enterprise value based on the publicly traded share price.

  Dell management also suggests that the company's diversification to enterprise software and services should increase the enterprise value to $70 billion.[11]
- August 2012 – Silver Lake approaches Michael Dell and also suggests an MBO transaction. Michael Dell then approaches Kohlberg Kravis Roberts & Co., L.P. ("KKR"), to discuss the viability of an MBO transaction.
- August 14, 2012 – Michael Dell informs Alex Mandl, the lead independent director of Dell, of his discussions with Southeastern, Silver Lake, and KKR.
- August 17, 2012 – The Dell board of directors meet and then inform Michael Dell that they will consider an MBO. Michael Dell then informs Silver Lake and KKR of this, but does not inform Southeastern.
- August 20, 2012 – Dell board of directors forms a special committee. The special committee then hires Debevoise & Plimpton LLP as legal counsel and JPMorgan as financial adviser.
- First Week, September 2012 – The special committee enters into confidentiality agreements with Silver Lake, KKR, and Michael Dell. Mr. Dell's confidentiality agreement prohibited him from pursuing a transaction with any person or entity other than Silver Lake or KKR, unless approved by the special committee.
- September 13, 2012 – Dell management provides the special committee with financial projections, which imply an enterprise value of $40 billion, or $25 billion higher than the value based on the current stock price. Dell management states that, if the last 12 months of free cash flow were capitalized into perpetuity, the share price would be higher than $30 per share.[12]

  The publicly traded share price, as of the same time period, implies that the Dell's free cash flow would decline by 20 percent per year into perpetuity.[13]

The July Case projections are met with skepticism by the special committee, which views them as "very optimistic."[14]

The special committee instructs the Dell chief financial officer to modify the July Case projections to incorporate a more downward biased forecast for PC sales over the next five years that was published in a market research report by International Data Corporation ("IDC").

- September 14, 2012 – JPMorgan advises the special committee that "KKR and Silver Lake were among the best qualified potential acquirers" and that there was "a low probability of strategic buyer interest in acquiring the company."[15]

  The special committee then "decided to refrain from contacting other sponsor groups until an offer was received from Michael Dell and either KKR or Silver Lake."[16]

- September 17, 2012 – The Dell chief financial officer presents revised financial projections to the special committee (the "September Case") that projects lower revenue and profit margins than the July Case.

  The special committee states that the September Case is still "overly optimistic," but nonetheless authorizes the September Case projections to be presented to the bidders.

- October 9, 2012 – JPMorgan presents valuation ranges to the special committee. The valuation ranges under the DCF valuation method analysis are as follows:[17]

  1. September Case – $20.00 to $27.00 per share
  2. Sell-side analyst highest projections – $19.25 to $25.75 per share
  3. Sell-side analyst consensus projections – $15.25 to $19.25 per share
  4. Sell-side analyst lowest projections – $9.50 to $11.50 per share

  JPMorgan also provides an analysis of the implied pricing multiple that financial buyers may base on a standard LBO model, which solves for an IRR. At a leverage ratio of 3.1, JPMorgan projects that a financial buyer could pay $14.13 per share at higher projected pricing multiples.

  However, at higher projected multiples, a financial buyer may not achieve an IRR in excess of 20 percent.

  Based on IRR projections ranging from 20 percent to 25 percent, JPMorgan finds that a financial buyer could pay between $11.75 and $13.00 per share or, with further recapitalizations, $13.25 to $14.25 per share.

- October 10, 2012 – Goldman Sachs assists Dell management by preparing financial projections that are presented to the special committee. Goldman Sachs presents an analysis based on an LBO model. Based on the September Case projections, Goldman Sachs projects that a financial buyer could pay $16.00 per share and still generate a five-year IRR of 20 percent.[18]

  At the time that these financial projections were prepared, the Dell common stock had a publicly traded daily closing price of $9.43 per share.[19]

- October 23, 2012 – Both Silver Lake and KKR submit bids. Silver Lake proposes an all cash transaction valued at $11.22 to $12.16 per share. KKR proposes an all cash transaction valued at $12.00 to $13.00 per share.

  As of October 23, 2012, Dell had a publicly traded stock daily closing price of $9.35. The special committee considers that the implied transaction premium is comparable to premiums offered by private equity firms for other large deals over the prior five years.

  However, the private equity prices of $11.22 to $13.00 per share are well below the DCF valuation estimates per share prepared by JPMorgan. Only the JPMorgan and Goldman Sachs "street" low case and LBO model valuations are in close proximity to the private equity offers.[20]

- November 2012 – Special committee member Laura Conigliaro, a partner at Goldman Sachs and former equity research analyst covering the tech sector, states that there is "a potential need for us to consider a very conservative forecast, possibly even one that we once may have viewed as being close to 'worst case' in order for us to get ahead of the downward changes that we have been watching."

  The special committee then hires Boston Consulting Group, Inc. ("BCG"), to create independent financial projections for Dell.[21]

- November 15, 2012 – Dell reports its financial results for the third quarter. Revenue and earnings per share were below the company's guidance and "street" consensus. Revenue and earnings per share declined 11 percent and 28 percent year-over-year, respectively.[22]

- December 3, 2012 – KKR withdraws its bid and drops out of the transaction negotiation. This leaves Silver Lake as the lone bidder, with no pre-signing competition.[23]

- December 4, 2012 – Silver Lake increases its bid to $12.70 per share. The special committee rejects the bid as inadequate.[24]

- December 5, 2012 – BCG presents to the special committee for the first time, but later provides detailed financial projections. BCG observes that the preliminary valuation estimates do "not match apparent company strengths," but rather reflects "investor concerns."[25]

  JPMorgan echoes this view, stating that "limited visibility and missed Street expectations appear to have led to increased investor focus on near-term execution."[26]

  Michael Dell concurs with this view, believing that his long-term plans for Dell would be perceived negatively because "they would dramatically reduce near-term profitability."[27]

- December 2012 – The special committee contacts the private equity firm, Texas Pacific Group, to solicit interest. Texas Pacific Group signs a confidentiality agreement, is given access to the data room, and meets with Michael Dell at his home.

  On December 23, Texas Pacific Group informs JPMorgan that it would not submit a bid, explaining that the future of the PC market is too unpredictable.[28]

- January 2, 2013 – BCG provides detailed financial projections, which it updates on January 15 to incorporate new projections by IDC. There are three projection scenarios:

  1. The "BCG Base Case," which is more pessimistic than the September Case, but in line with recent sell-side analyst reports
  2. The "BCG 25% Case," which assumes that Dell would be able to achieve 25 percent of its planned $3.3 billion cost-saving initiative
  3. The "BCG 75% Case," which assumes that Dell would be able to achieve 75 percent of its planned $3.3 billion cost-saving initiative

  For each case, it uses the same revenue projections. BCG notes that its BCG 75% Case would realize higher margins than the company or its competitors had ever achieved.[29]

- January 7, 2013 – The special committee retains Evercore Partners ("Evercore") as a second financial adviser in addition to JPMorgan. Evercore presents a preliminary DCF valuation estimate of $14.27 to $18.40 per share, and an LBO model valuation estimate of $14.27 to $18.40 per share.[30]

- January 15, 2013 – Silver Lake increases its bid to $12.90 per share. JPMorgan analyzes the proposal and finds that it is near the midpoint of values generated by trading multiples based on LBO model estimates. The bid price per share is also near the DCF method price based on the low case and the most conservative BCG case.

  However, the Silver Lake bid price is below the value generated by the DCF market consensus case, the BCG 25% Case, BCG 75% Case, and the September Case.

  Evercore reaches a similar conclusion, and calculates that if Dell performed according to the September Case, Silver Lake would achieve a five-year IRR of 45 percent. Evercore also calculates that if Dell achieved financial results in between the BCG 25% Case and BCG 75% Case, Silver Lake would achieve a five-year IRR of 39.8 percent based on consideration of $12.90 per share.[31]

- January 18, 2013 – The special committee recommends a sale price of $13.75 per share. Shortly thereafter, Michael Dell offers to roll his shares over at a lower valuation to further entice Silver Lake, which increases its bid to either (1) $13.60 per share or (2) $13.75 per share if Dell ceased paying dividends.

  The special committee again resists, and Silver Lake increases its bid to $13.65 (with continuance of dividends).[32]

- February 5, 2013 – JPMorgan and Evercore conclude that the Silver Lake offer is fair. The cash offer for $13.65 per share is supported by the low end of the DCF method valuation using the BCG 25% Case, which provides a range of $12.00 to $16.50 per share. It is also comparable to the BCG Base Case, which provides a range of $10.50 to $14.25 per share.

Evercore estimates at that $13.65 transaction price and an exit pricing multiple of 4.0x earnings before interest, taxes, depreciation, and amortization ("EBITDA"), Silver Lake would achieve a 4.5-year IRR of 23.3 percent.

The special committee recommends to the board of directors that it accept the offer, which it does on February 6, 2013. The merger agreement provides for a 45-day go-shop period and a $180 million termination fee. Evercore commences the go-shop period.

Within 10 days, Evercore reaches out to 60 entities. Hewlett Packard expresses no interest.[33]

- March 5, 2013 – Carl Icahn and Icahn Enterprises L.P. (collectively, "Icahn") send a letter to the Dell board of directors expressing opposition to the merger, and propose a leveraged recapitalization that would involve paying a special dividend of $9 per share. Evercore invites Icahn to conduct due diligence.[34]

- March 22, 2013 – Icahn submits a new proposal whereby shareholders would roll over their shares into a new entity on a one-to-one basis or receive $15.00 per share in cash, subject to a cap of $15.6 billion in total cash payments.

  Evercore values this proposal at $13.37 to $14.42 per share. Blackstone also submits a similar proposal, which Evercore values at $14.25 per share.[35]

- March 23, 2013 – The go-shop period ends. Blackstone and Icahn request fee reimbursement for their time spent on due diligence, which the special committee agrees to for Blackstone, but not Icahn.

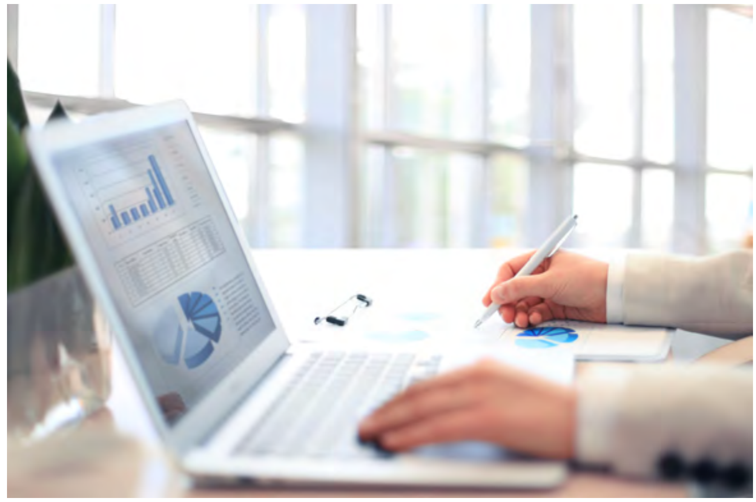
  Michael Dell informs Blackstone that he is receptive to their offer, until rumors are reported on Reuters that Blackstone is vetting alternative chief executive officer candidates to replace Michael Dell. This rumor is allegedly met with contempt by Michael Dell.[36]

- April 18, 2013 – Blackstone withdraws its bid. Blackstone had never been given the BCG projections.[37]

- May 2013 – The Dell board of directors set a special meeting to vote on the merger for July 18, 2013.

- May 31, 2013 – The Dell board of directors disclose in the company proxy statement, that the "committee did not seek to determine a pre-merger going-concern value for the common stock to determine the fairness of the merger consideration."

  The proxy statement states that the special committee recommends the transaction because (1) it is a cash transaction, (2) it is a 37 percent premium over the 90-day average stock price, and (3) there is a declining "street" consensus for earnings per share forecasts.[38]



- July 31, 2013 – After the special committee learned earlier in the month that the merger proposal likely would not receive majority support at the shareholder vote, Evercore increases its offer by $0.10, to $13.75 per share, plus a special cash dividend of $0.13 per share.

  To finance the increased price, Michael Dell also agrees to roll over his shares at $12.51 per share.[39]

- August 2013 – Dell management and Evercore make a presentation to rating agencies regarding post-acquisition debt to finance the transaction. They use financial projections that are more optimistic than analyst projections or the IDC report and project long-term growth of 2 to 3 percent.

  Dell management tell rating agencies that Dell is "well on its way" to achieving $1.3 billion out of the targeted $3.5 billion in cost savings (previously $3.3 billion), and they are "very confident" that Dell will realize the remaining cost savings.

  The case that Silver Lake presents to the banks that would finance the merger (the "Bank Case") assumes $3.6 billion in cost savings (equal to 109 percent of the original cost savings estimate for the BCG scenarios, higher than the highest scenario, which was 75 percent of cost savings, the BCG 75% Case).[40]

- September 12, 2013 – The merger is approved by 57 percent of shareholders (70 percent of those who voted).

Observations on the Company Sale Process

Eroding Market Share and Competition from Substitute Products

From 1997 through 2004, Dell consistently gained market share. The disruption to the Dell market began around 2005, well before the sales process commenced.

When Michael Dell rejoined the company as chief executive officer in 2007, Dell had lost its lead in the PC market the prior year to Hewlett-Packard. In addition, Dell had been the subject of an investigation by the SEC for possible accounting improprieties. Several executives had left the company during 2007, including the chief financial officer.

Dell had attempted to expand into offering flat-panel TVs and MP3 players, to little avail. Dell was also too slow to adopt AMD processors. Another issue was that to maintain its low prices and sustain profit margins, Dell shifted customer service to India and its customers complained about the poor service. The price erosion for PCs seemed to be a vicious cycle with no end in sight.

As of 2007, consumers accounted for only 15 percent of Dell revenue, and it was difficult to increase that proportion because it still sold directly over the Internet or by phone. This constraint posed a problem for selling flat-screen TVs. The company lacked the necessary distribution channels to more effectively reach individual consumers.[41]

Negotiating terms during the sale process is obviously difficult when the target continually reports disappointing quarterly financial results and the industry in which it participates is affected by eroding market share due to substitute products or services. This condition makes the preparation of financial projections more challenging, as evidenced by the diverging financial forecasts by Dell management and financial advisers.

A year and a half prior to the sale process, Dell management had conducted a sum-of-the-parts valuation for internal use, which provided estimated company value of $22.49 to $27.05 per share. By the time the sale process was underway, the financial forecasts on which that valuation range was based were stale.

Projecting financial results for a company involved in a Dell-type turnaround situation is challenging—not just because of the nebulous outlook for its core PC business, but because its revenue diversification plans were in their infancy. Michael Dell was understandably frustrated by the valuation gap vis-à-vis Dell management's estimate of intrinsic value.

It is rather common for a company to implement a Dell-type turnaround situation, and the Chancery Court addressed this issue. One example is when Starbucks Corporation ("Starbucks") began to implement a strategy during 2008 to reduce cannibalization of its stores by closing stores and reducing its capital expenditures.

The Starbucks strategy and its financial forecasts were widely publicized to the investment community, but were panned by many as "addition through subtraction" and fraught with execution risk, despite the obvious increase in free cash flow that would result. The Starbucks plan was to increase the return on capital for each store by driving traffic from nearby stores that were to be shuttered.

Nonetheless, the Starbucks stock price began 2008 at $9.65, sputtered through the first three quarters of the year, and ended the year at $4.73. Those who bought the stock may have been pleased with its closing price on December 31, 2010, of $16.07, and closing price on December 30, 2011, of $23.01.

Transaction Timing

Regarding the lack of bidders, one may wonder—why did Dell have to be sold at this particular time? Based on the facts presented at trial, it appeared that Michael Dell was frustrated by the valuation gap for several years, and was inspired to explore an MBO only upon being approached by Southeastern. He properly formed the special committee, and he appears to have not committed breaches of fiduciary duty.

The sale process, however, involved only two serious bidders before the go-shop period—Silver Lake and KKR. JPMorgan stated that Dell was not likely to receive any offers from strategic bidders (such as a competing company). The lack of bidders, particularly from strategic acquirers, raises the question if this was the right time to sell.

Dell Transaction Pricing Reliance on the LBO Model

During the sale process, the Dell advisers used an LBO model—along with the income approach and market approach—to estimate the company value. The two main flaws with the LBO model in the context of the Dell valuation are that (1) LBO models do not provide an estimate of value, the LBO models are used to solve for the IRR based on an assumed transaction multiple, and (2) LBO models require an assumption of an exit date, usually five years.

In the instant case, financial projections for the planned company turnaround will take more than five years to implement and will omit growth beyond the fifth year because the private equity firm expects to sell the company in the fifth year.

The DCF method analyses include a variable discrete period and a terminal period value that is capitalized in perpetuity. A DCF method may project 10 years of financial results and, as an example, project that only after 5 years would stability and a resumption of growth occur.

The DCF method valuation would, therefore, capture financial results after the first five years of projections. An LBO model based on a projected 5-year exit (when the private equity firm liquidates its position either through a sale of its interest to another entity or through an initial public offering) would not include financial projections for years 6 through 10.

The LBO model provides the means to essentially back solve to find the EBITDA pricing multiple a private equity firm would be willing to pay based on its targeted IRR. This "back solve" calculation is a very easy calculation using the Excel "goal seek" function to solve for the IRR by changing the purchase or sale price multiples in an integrated financial model.

Explanation of the LBO Model

LBO models can be used to solve for the IRR based on a valuation; they do not solve for value. The IRR is a commonly used financial metric by private equity firms to analyze and assess the merits of making a new investment.

The calculation of an IRR involves a beginning point—when capital is initially deployed in an investment—and an ending point—when an investment is liquidated. The IRR is similar to a compound annual growth rate ("CAGR") in that it is expressed as a percentage and represents an average annual growth rate over the course of some defined timespan.

The primary difference between the IRR and the CAGR is that the CAGR calculation is based on only a beginning and ending value, whereas the IRR also captures interim period cash flow in its discrete IRR figure.

Most, but not all, private equity firms use leverage to acquire a company. The use of leverage magnifies the equity returns, which are expressed as an IRR. The debt financing obtained by a private equity firm becomes a liability of the target and is recorded on the target's balance sheet. The private equity firm then gradually pays down the target company debt, over the course of several years, using the target company cash flow.

According to a survey of 79 private equity firms published by Harvard Business School, the average targeted IRR of private equity firms is 22 percent, and the average realized IRR of private equity firms is 2.7 percent above the targeted IRR, or a 24.7 percent realized IRR.[42]

As of 2015, the average length of time that private equity firms hold an investment before exiting was 5.5 years.[43]

Dell Final Consideration—LBO Model IRR Suggests DCF Method Took a Back Seat

Since the only two bidders during the pre-signing phase were private equity firms, the Dell financial advisers prepared a range of estimated valuations that included an LBO model analysis, in addition to the DCF method and the guideline publicly traded company method.

For merger and acquisition ("M&A") negotiations, if private equity firms are among the bidders, target company financial advisers typically construct an LBO model for the purpose of estimating the highest price the private equity firm may be willing to pay. Hence, the LBO model is a negotiating tool rather than a method to estimate fair value.

Although there is nothing wrong with using an LBO model for the sake of negotiations, it appeared that there was too much focus on the LBO model analysis during the sale process. It appears this way because the final transaction consideration was more similar to the LBO model results than the valuation ranges by other methods.

The cash offer of $13.65 per share was at the low end of JPMorgan's final DCF valuation using the BCG 25% Case, which provided a range of $12.00 to $16.50 per share.[44]

All of the BCG financial projection scenarios assumed the same revenue each year in the projection, and there was no explanation in the Opinion as to why an optimistic scenario would have the same revenue as a pessimistic scenario. Before terms were accepted in principal, Evercore updated its LBO model.

Based on the consideration offered and financial projections under the BCG 25% Case, Silver Lake would realize a 4.5-year IRR of 23.3 percent at an exit pricing multiple of 4.0x EBITDA in 4.5 years and 30.2 percent at an exit pricing multiple of 5.0x EBITDA in 4.5 years.[45]

There are a few problems with how these figures line up. According to studies previously cited, the average exit period is 5.5 years, not 4.5 years. The problem with using a 4.5-year IRR is that it does not capture the financial results for a turnaround company after 4.5 years.

Furthermore, much the same as why a fixed income security will pay a lower interest rate the lower its duration, due to less risk of the length of the holding period, a private equity firm would likely accept a lower IRR if its expected holding period is one year less than average. This point was not addressed in the Opinion.

Also, according to studies previously cited, the average targeted IRR is 22 percent, which agrees with an exit pricing multiple of 4.0x EBITDA according to the Evercore LBO model. An exit multiple of 4.0x EBITDA does appear to be a bit low for a reputable, large company that is profitable despite its industry challenges.

For the sake of argument, let's assume that a 4.0x exit pricing multiple is reasonable. The IRR would then be within range of the average targeted IRR if based on the BCG 25% Case.

Silver Lake Presents Projections to Its Lenders—Consistent with BCG 25% Case

The Opinion discussed the three BCG projection scenarios prepared during the sale process:[46]

1. The BCG Base Case (assuming the planned streamlining is a complete failure and achieves zero cost savings)
2. The BCG 25% Case (achieving 25 percent of planned cost savings of $3.3 billion, recurring annually, beginning in 2016)
3. The BCG 75% Case (achieving 75 percent of planned cost savings of $3.3 billion, recurring annually, beginning in 2016); fiscal year 2016 was the third year of the projection period

In September 2013, which was the month the shareholders approved the MBO deal, Dell management told rating agencies that it was "well on its way" to achieving $1.3 billion out of the targeted $3.5 billion in cost savings (previously $3.3 billion), representing 37 percent of targeted annual cost savings, higher than the BCG 25% Case.

Dell management was "very confident" that Dell would realize the remaining cost savings, which would have been even higher than the cost savings achieved under the BCG 75% Case.

This is not to say that Silver Lake was projecting higher earnings before interest and taxes ("EBIT") than any of the BCG scenarios.

Comparing the EBIT forecasts under the Bank Case on page 39 of the Opinion to the EBIT forecasts under the three BCG scenarios on page 20, it is apparent that the Bank Case projects EBIT that is less than the BCG 25% Case for the first three years of the projection period, but in the fourth year exceeds the BCG 25% Case by $80 million (the difference being only 2 percent of total EBIT).

Therefore, the Bank Case provided a lower EBIT and EBIT margin than the BCG Base Case, but added the full amount of projected cost savings—higher than the BCG 75% Case. The net effect on the Bank Case EBIT projection, by 2017, was roughly the same as the BCG 25% Case EBIT projection.

Delaware Chancery Court Opinion—May 31, 2016

The Chancery Court concluded that the fair value of Dell common stock at the effective time of the merger was $17.62 per share, which was 27 percent higher than the total consideration.

The trial lasted four days and the trier of fact heard from seven fact witnesses and five expert witnesses, including two who served as independent valuation analysts.

The legal analysis section of the Opinion began by explaining (1) the statutory appraisal mandate, (2) the final merger consideration is a relevant factor but not the only factor in determining fair value, (3) the court found no breach of fiduciary duty, and (4) the deal price for an MBO, depending on the facts and circumstances, may be scrutinized more than for a true arm's-length transaction.[47]

The Opinion then provided a discussion of its analyses and opinions that pertained to fair value as follows:

1. The LBO pricing model[48]
2. The valuation gap (difference between publicly traded price and intrinsic value)[49]
3. Limited pre-signing competition[50]

4. The post-signing go-shop phase[51]
5. The analysis and fair value estimates by the two valuation analysts for the petitioners and for the respondents[52]

The LBO Pricing Model

The Chancery Court observed and took issue with certain aforementioned flaws of the LBO pricing model, such as the fact that it does not provide an estimate of fair value. However, the Opinion did not address that the LBO model projections are confined to the expected holding period.

As discussed previously, a turnaround situation may last more than 4.5 years. The Opinion also did not discuss why there were diverging results for the DCF method versus the LBO model, except to observe that the amount of leverage is a key variable for the IRR calculated through an LBO model.

The Chancery Court took issue with (1) the diverging values, (2) the deposition of the Dell chief financial officer that Silver Lake was "not concerned at all . . . with the intrinsic value analysis of the business,"[53] and (3) the fact that the special committee did not focus on fair value, even disclosing in its proxy statement that the "Committee did not seek to determine a pre-merger going concern value for the Common Stock to determine the fairness of the merger consideration to the Company's unaffiliated stockholders."[54]

The Chancery Court observed that one of the two Dell financial advisers, JPMorgan, performed both a DCF and an LBO analysis, and the diverging results demonstrated that a private equity firm "would not be willing to pay an amount approaching the company's going-concern value."[55]

JPMorgan concluded that an MBO was not feasible at prices of $19 or higher because the targeted IRR would require an amount of leverage that would not have been possible to obtain.[56]

The Valuation Gap

The Opinion offered two particularly compelling observations when discussing that there may have been a significant gap between the Dell publicly traded stock price and intrinsic value per share—Dell management performed a sum-of-the-parts analysis that valued the company at $22.49 to $27.05 per share, when its stock traded at around $14 per share.

Although this was performed a year and a half before the sale process began, it appears that the Chancery Court considered that the valuation gap at that time may have persisted during the sale process.

To support this assertion, it was observed that when Dell's stock traded between $9 and $10 per share during October 2012, JPMorgan employed several valuation methods that exceeded those prices, and its initial DCF method resulted in a valuation range of $20 to $27 per share. It was later recognized, however, that the financial projections used at the time to arrive at that valuation range were dated and optimistic.

A Dell company equity analyst report prepared by Goldman Sachs was mentioned. This report cited a series of reasons for the valuation gap, including that "companies at the center of industries undergoing major structural changes often suffer from depressed valuation that seem 'disconnected' from fundamentals."[57]

The Opinion cited a short article by M&A attorney Martin Lipton, senior partner at Wachtel, Lipton, Rosen & Katz, published by the Columbia Law School blog. That article provides a discussion of a study that presents "substantial empirical evidence" that short-term investors can pressure companies to maximize near-term gains at the expense of long-term growth.[58]

The Opinion footnotes this article in writing that "investors focused on short-term, quarterly results can excessively discount the value of long-term investments." Apparently, the court considered that the Dell product diversification turnaround plan was not being given credit by the financial markets.

The Opinion did not delve into empirical anecdotes. It is worth noting that the technology sector, in particular, can be afflicted by momentum-chasing institutional investors who can overly reward companies with high growth expectations, while overly penalizing those afflicted by setbacks. The technology sector is unique from a lot of other sectors in that buyer preferences can change rapidly.

Sometimes a new, popular product can spawn an entire new market for peripherals. Gyrations in stock prices for publicly traded technology companies reflect how difficult it is for companies to maintain their competitive edge and market share.

Limited Pre-Signing Competition

The Chancery Court found that the lack of price competition during the pre-signing phase undermined the persuasiveness of the merger consideration as evidence of fair value. The special committee initially engaged only two private equity bidders. And, the special committee financial advisers did not contact any potential strategic acquirers.

KKR dropped out after initially expressing interest. A third private equity firm was invited to the due diligence process—Texas Pacific Group—who also dropped out after a short period of time.

Evercore considered that Hewlett Packard could be a potential acquirer, but the company was not contacted.

Numerous academic papers were cited to support the credence that the go-shop period following the pre-signing phase rarely results in topping bids. In general, the most transaction price competition occurs before the deal is accepted in principle.[59]

One footnote in the Opinion cited a quote by M&A attorney Martin Lipton during an interview of Mr. Lipton by one of the expert witnesses in this matter, Professor Guhan Subramanian: "The ability to bring somebody into a situation [pre-signing phase] is far more important than the extra dollar a share at the back end [go-shop phase]. At the front end, you're probably talking about 50%. At the back end, you're talking about 1 or 2 percent."[60]

The Post-Signing, Go-Shop Phase

During the 45-day go-shop period, after terms had been accepted in principle with Silver Lake, Dell financial adviser Evercore reached out to 60 entities. Hewlett Packard, which had been considered but not contacted during the pre-signing phase, expressed no interest.

Two new bidders emerged—Icahn and Blackstone. Icahn initially proposed a leveraged recapitalization that would involve paying a special dividend. Icahn's bid was valued by Evercore at $13.37 to $14.42 per share, and Blackstone's bid was valued at $14.25 per share.

Blackstone ultimately dropped out after rumors circulated that Blackstone was interviewing replacement candidates for chief executive officer. Dell rejected the Icahn bid.

The Chancery Court accepted, in part, the respondents' argument that if Dell were worth significantly more than the Silver Lake offer, then surely another bidder would offer much more. The court found that if the intrinsic value were, say, $28.61 as the petitioner's argued, Dell would have received other offers from other bidders.

However, the court found that due to the limited pre-signing competition, a smaller valuation gap could have existed.[61]

The Chancery Court also found that the acceptance of the deal price by a majority of shareholders does not equate to fair value. This is because of the possibility that some institutional shareholders may have been happy to take a premium over the trading price for the sake of booking quarterly gains to improve their returns.[62]

In the Opinion, the Chancery Court seemed to place a lot of credence in the testimony of expert witness Professor Guhan Subramanian who testified as to the shortfalls of go-shop periods.

The Chancery Court observed that the terms of the go-shop period were flexible, such as the requirements for status of a bidder to be an "excluded party," which is the right for a new bidder to continue negotiations beyond the 45-day period (in this case, it was four months).

Subramanian testified that while he found no structural impediments in the go-shop terms, the Dell merger was 25 times larger than any transaction in his sample of "jumped deals" (a higher bidder emerges and wins).[63]

The size and complexity of Dell meant that even an extended go-shop period may not have been enough time to adequately determine a fair merger price.

Valuation Analysts for the Petitioners and the Respondents

The valuation analyst for the petitioners was Professor Bradford Cornell of the California Institute of Technology. Cornell's estimated fair value using the DCF method was $28.61 per share.

The valuation analyst for the respondents was Professor Glenn Hubbard of the Columbia Business School. Hubbard's estimated fair value using the DCF method was $12.68 per share.

The Opinion discussed broadly why these two fair value estimates were so far apart, and observed that the major difference was in the projected cash flow used in the DCF methods.

Projections

Cornell, the petitioner's analyst who arrived at the higher fair value estimate, first calculated an average of the BCG 25% Case and the BCG 75% Case. Then, Cornell gave equal weight to the BCG average and the Bank Case.[64]

Hubbard, the respondent's analyst who arrived at the lower fair value, used an adjusted version of the BCG 25% Case. Hubbard's adjustments were premised on a report by IDC in August 2013 that PC shipments were weaker than anticipated. Hubbard adjusted revenue projections under the BCG 25% Case to reflect this, but maintained profit margin projections despite the downward adjustments to revenue.

Hubbard also adjusted for stock-based compensation expense, which Cornell agreed with as well. Finally, Hubbard extended the projection period by five years to better capture the Dell transition plan.[65]

The Chancery Court cited a prior court ruling—*Highfields Capital, Ltd. v. AXA Financial, Inc.*[66]—as a precedent matter. In *Highfields*, the court found that a valuation analyst's adjustments to management projections may be considered if proven defensible, but are viewed with caution.

The Chancery Court determined that the most credible set of projections were Hubbard's adjusted BCG 25% Case, which "was likely somewhat conservative,"[67] and an adjusted version of the Bank Case. Hubbard apparently did not use the Bank Case initially, but later calculated an adjusted Bank Case that adjusted for nonrecurring restructuring expenses and stock-based compensation.

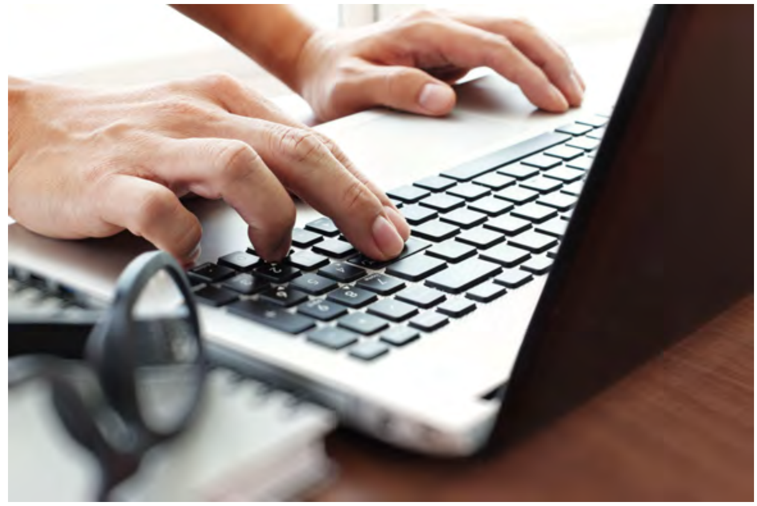
Perpetuity (Long-Term) Growth Rate for the DCF Terminal Period

Cornell, the petitioner's analyst, used a perpetuity growth rate of 1 percent, and Hubbard, the respondent's analyst, used a perpetuity growth rate of 2 percent.

The Chancery Court noted that it has held before that the "rate of inflation is the floor for a terminal value estimate for a solidly profitable company that does not have an identifiable risk of insolvency."[68]

This is also a widely held belief among the community of valuation analysts . Since the weighted average cost of capital ("WACC") used in a DCF valuation includes a risk-free rate, unless the company is expected to have declining growth indefinitely until it is insolvent, it would be erroneous to not include it in the long-term growth rate used to capitalize the terminal period.

According to one author, the "discount rate incorporates the expected rate of inflation as part of the required rate of return. Since the nominal government bond interest rates used in developing



these discount rates incorporate expected inflation over the duration of the bond, the implication is that the selected long-term growth rate should also reflect the impact of expected inflation on the economic income variable being capitalized."[69]

The Chancery Court decided that while a 3 percent perpetuity growth rate may be more appropriate, it used a 2 percent rate.[70]

This 2 percent rate departed slightly from the projected inflation rate published by the Federal Reserve Bank of Philadelphia's Livingston Survey. On December 12, 2012, the Livingston Survey projected 10-year annual real gross domestic product growth of 2.5 percent, and a 10-year consumer price index ("CPI") based inflation of 2.5 percent.[71]

The Opinion did not cite a discrete CPI-based inflation rate projected at the time.

Tax-Affecting Cash Flow Projections[72]

Cornell, the petitioner's analyst, applied a 21 percent income tax rate throughout the projection period. The 21 percent income tax rate was provided by the September Case and the valuation models prepared by the Dell financial advisers.

Hubbard, the respondent's analyst, used two different income tax rates—17.8 percent for the projection period and 35.8 percent for the terminal period. Hubbard cited academic literature to support his use of the 35.8 percent income tax rate and his conclusion that Dell would likely repatriate its capital held overseas (on which Dell would have to pay income taxes).

Further, to apply the top income tax rate to the terminal period implied that Dell would perpetually pay that income tax rate.

The Chancery Court found Hubbard's approach to be speculative, and the court observed that Dell had not paid income taxes at the marginal rate since at least 2000. The Chancery Court accepted Cornell's income tax estimate.

Weighted Average Cost of Capital (The Discount Rate)[73]

The two analysts disagreed on every input to the WACC except for the risk-free rate. The Chancery Court ruled that the cost of debt should have been based on the Dell BBB credit rating by Standard & Poor's as of the valuation date, which equated to a 4.95 percent cost of debt.

The two analysts used very similar capital structures to weight the cost of debt and equity in the WACC, and the Chancery Court selected the middle ground at 75 percent. For the selected beta, Cornell, the petitioner's analyst, derived a beta of 1.31 using weekly betas of guideline publicly traded companies over a two-year period.

The Chancery Court decided that the use of the Dell beta was more appropriate, and used Hubbard's beta, but did not enumerate the beta. For the equity risk premium, Cornell used a forward-looking equity risk premium of 5.50 percent, while Hubbard used a blended historical and supply-side equity risk premium of 6.41 percent.

The Chancery Court selected the supply-side equity risk premium of 6.11 percent, and cited two court cases supporting its decision.

Adjustments for Balance Sheet Cash[74]

Lastly, the Chancery Court addressed the amount of excess cash that should be added to the valuation. Cornell, the petitioner's analyst, added back the entire amount of net cash, or $6.158 billion.

Hubbard, the respondent's analyst, made four deductions to net cash—$3 billion for working capital needs, $2 billion for restricted cash, $2.24 billion for deferred taxes, and $3 billion for contingent taxes.

The Chancery Court accepted Hubbard's deduction for working capital needs, noting that Silver Lake had left $5.665 billion in cash on the balance sheet after closing. The court partly accepted Hubbard's deduction for restricted cash, reducing that amount to $1.2 billion based on the Dell presentation to the rating agencies when they disclosed that they had obtained access to $0.8 billion in restricted cash before the merger closed.

With regard to deferred taxes, the Chancery Court had already concluded that Hubbard's opinion—that is, that Dell would eventually repatriate its cash held overseas—was speculative. Accordingly, the Chancery Court rejected this deduction from excess cash.

Lastly, the court ruled on the deduction for contingent income taxes. Under FASB Interpretation No. 48, a company should maintain a reserve on its balance sheet for the amount it may have to pay should its position on prior tax positions be disputed and proved incorrect. Hubbard deducted the entire amount and the Chancery Court disagreed on the premise that Dell management is better equipped to estimate its tax liability than the Chancery Court.

Although the court did not use the word "speculative" in this context, it appears that to deduct the entire amount would be speculative. The court cited that the Bank Case did deduct $650 million to account for contingent tax liabilities, which the court accepted as a deduction from excess cash.

The Chancery Court Ruling

The Chancery Court determined a fair value of $17.62, which was 27 percent higher than the merger price. The Chancery Court based its decision on the aforementioned inputs to the DCF method, as well as on the application of both (1) Hubbard's DCF method using the adjusted BCG 25% Case and (2) Hubbard's DCF analysis using the adjusted Bank Case.

The former valuation method produced a fair value estimate of $16.43 per share, and the latter produced a fair value estimate of $18.81 per share.

Court Cases Cited in the Opinion

The following are some of the judicial precedent cited in the Opinion, and the context in which they were cited:

- In Delaware dissenting shareholder appraisal rights actions, the deal price may be the most reliable indicator of fair value when other evidence is weak – *Merion Capital LP and Merion Capital II LP v. BMC Software, Inc.*, No. 8900-VCG, 2015 WL 616477 (Del. Ch. Oct. 21, 2015); *Highfields Capital, Inc. v. AXA Fin., Inc.*, 939 A.2d 34 (Del. Ch. 2007)[75]
- In Delaware dissenting shareholder appraisal rights actions, merger consideration is not the sole element that should be considered; publicly traded market prices should be considered, but are not dispositive – *Cede & Co. v. Technicolor, Inc.*, No. 7129, 1990 WL 161084 (Del. Ch. Oct. 19, 1990); *Gonsalves v. Straight Arrow Publ'rs, Inc.*, 793 A.2d 312 (Del. 1998); Rapid-Am. Corp. v. Harris, 603 A.2d 796 (Del. 1992)

- The Chancery Court is required to take into account all relevant factors to determine going concern value – *Golden Telecom, Inc. v. Glob. GT LP*, 11 A.3d 214 (Del. 2010)
- The sale process may fall within the Revlon range of reasonableness, but may generate a price not equivalent to fair value – *In re Appraisal of Ancestery.com, Inc.*, No. 8173–VCG, 2015 WL 399726 (Del. Ch. Jan. 30, 2015); *M.P.M. Enters., Inc. v. Gilbert*, 731 A2d 790 (Del. 1999); *In re Orchard Enters., Inc. S'holder Litig.*, 88 A.3d 1 (Del. Ch. 2014)
- There should be evidence that the merger price represents the going concern value of the company, rather than just the value to one specific buyer; the highest price a bidder is willing to pay is not the same as fair value – *M.P.M. Enters., Inc. v. Gilbert*; *In re Orchard Enters., Inc. S'holder Litig.*
- In a statutory appraisal, both sides have the burden of proof – *M.G. Bancorporation, Inc. v. Le Beau*, 737 A.2d 513 (Del. 1999); *Pinson v. Campbell-Taggart, Inc.*, No. 7499, 1989 WL 17438 (Del. Ch. Feb. 28, 1989)
- Fair value under Delaware law is not equivalent to fair market value; fair value "for purposes of Delaware's appraisal statute is largely a judge-made creation, freighted with policy considerations"[76] – *Finkelstein v. Liberty Digital, Inc.*, No. 19598, 2005 WL 1074364 (Del. Ch. April 25, 2005)
- Under the appraisal rights statute, stockholders are entitled to be paid for their proportionate interest in a going concern – *Tri-Continental Corp. v. Battye*, 74 A.2d 71 (Del. 1950)
- The valuation date is the date on which the merger closes – *Cede & Co. v. Technicolor, Inc. (Technicolor II)*, 684 A.2d 289 (Del. 1996)
- Publicly traded stock prices can still be incorrect at any point in time, for the purposes of determining fair value – *Dollar Thrifty*, 14 A.3d 573 (Del. Ch. 2010) (citing Michael L. Wachter, "Takeover Defenses When Financial Markets are (Only) Relatively Efficient, 161 U. Pa. L. Rev. (2003))
- Fair value should exclude synergies – *BMC*, 2015 WL 6164771
- In an MBO, management has a conflicting role as a buyer, and MBOs present different concerns than true arm's-length transactions – *Mills Acq. Co. v. McMillan, Inc.*, 559 A.2d 1261 (Del. 1989); *Revlon, Inc. v. MacAndrews & Forbes Hldgs., Inc.*, 506 A.2d 713 (Del. 1986); *In re RJR Nabisco, Inc. S'holders Litig.*, No. 10389, 1989 WL 7036 (Del. Ch. Jan. 31, 1989); *In re Fort Howard Corp. S'holders Litig.*, No. 9991, 1988 WL 83147 (Del. Ch. Aug. 8, 1988); *In re Lear Corp. S'holder Litig.*, 926 A.2d 94 (Del. Ch. 2007); *In re Topps Co. S'holders Litig.*, 926 A.2d 58 (Del. Ch. 2007)
- The highest price a bidder is willing to pay is not necessarily equivalent to fair value – *Appraisal of Orchard*, 2012 WL 2923305
- If a merger or acquisition was timed to take advantage of a depressed market or a low point in the company's cyclical earnings, the appraised value may be adjusted accordingly – *Glassman v. Unocal Exploration Corp.*, 777 A.2d 242 (Del. 2001)
- When a target company has expansion plans in place, the value of those plans must be considered in determining fair value – *MRI Radiology Assocs., P.A. v. Kessler*, 898 A.2d 290 (Del. Ch. 2006)
- There is anecdotal evidence that private equity firms do not always engage in competitive bidding – *In re Lear Corp. S'holder Litig.* The opinion for *Appraisal of Dell* included a footnote stating that "consistent with the professional culture of not topping other firms' deals, Silver Lake, KKR, Blackstone, and TPG were among the sponsors who settled a lawsuit alleging they and other private equity firms conspired to fix prices in LBOs."[77]
- Just because a majority of unaffiliated shares vote in favor of a transaction does not mean the transaction price was at fair value; certain institutional investors may be happy to take a gain for quarterly reporting purposes or to offset other losses – *Glob. GT LP v. Golden Telecom, Inc.*, 993 A.2d 497 (Del. Ch. 2010)
- The Chancery Court has preferred valuations based on contemporaneously prepared management projections – *Doft & Co. v. Travelocity.com*, No. 19734, 2004 WL 1152338 (Del. Ch. May 20, 2004)
- The Chancery Court is skeptical of litigation-driven adjustments to management projections – *Cede & Co. v. JRC Acq. Corp.*, No. 18648-NC, 2004 WL 286963 (Del. Ch. Feb. 10, 2004)
- The Chancery Court may adopt reasonable adjustments to management projections –

Highfields Capital, Ltd. v. AXA Fin., Inc.

- The rate of inflation should be the floor for a terminal value estimate for a solidly profitable company that does not have an identifiable risk of insolvency – *Glob. GT LP v. Golden Telecom, Inc.*
- In determining fair value, any speculative future tax liabilities should be excluded, such as speculating that there will be taxes paid in some given year on the repatriation of funds held outside the U.S. – *Paskill Corp. v. Alcoma Corp.*, 747 A.2d 549 (Del. 2000)

Summary and Final Commentary

By seeming to rely more on the LBO model based on the valuation ranges compared to the final consideration, the financial advisers to Dell were essentially confined to negotiating the best price that a private equity firm would be willing to pay, based on financial forecasts that extended only as far as the IRR's targeted exit year. This is similar to concluding that since Silver Lake and KKR (and later, Icahn and Blackstone during the go-shop period) were the only bidders, then Dell surely must only be worth *at this time* what these small number of bidders were willing to pay.

The thinking was not—since these were the only two bidders in the pre-signing phase and there is no interest from strategic buyers—perhaps this is not the right time to sell the company.

In addition to taking exception to the Dell financial advisers' overreliance on the LBO model, evidenced by the merger price being at the low end of the DCF method valuation ranges, the Chancery Court discussed the likelihood that there was a valuation gap, meaning that the publicly traded stock price was discrepant from intrinsic value. What makes this interesting is that the Chancery Court essentially ruled that both the merger price and the publicly traded stock price were not necessarily equivalent to fair value.

The Delaware appraisal rights statute does indeed give the triers of fact latitude to determine their own best estimate of fair value, and the statute may very well have presciently been intended for circumstances such as *Appraisal of Dell*.

The *Appraisal of Dell* illustrates the Chancery Court's preference for the most contemporaneous set of financial projections. The two set of projections viewed as most credible by the Chancery Court were the Bank Case, which was then adjusted for nonrecurring restructuring expenses and stock-based compensation, and the BCG 25% Case, which Hubbard adjusted for recently released IDC data and extended the forecast period.

The Chancery Court viewed the adjusted Bank Case as slightly optimistic and the adjusted BCG 25% Case as slightly conservative. A significant difference between the two valuation expert witnesses was the tax rate applied to projected cash flow. The respondent's analyst projected that Dell would eventually repatriate cash held overseas and incur the top marginal tax rate in perpetuity.

The Chancery Court viewed this as both speculative and erroneous to apply a top marginal income tax rate in perpetuity for a one-time event that may or may not occur.

Given the dearth of bidders during the pre-signing phase, the absence of strategic bidders and private equity bidders who dropped out of the company sale process, one may argue that perhaps Dell should not have been sold to any entity at that particular point in the company's history at a transaction price of $13.75 per share.

It seems that once the company sale process had commenced, the train had left the station, and there was no inclination to walk away and wait for the valuation gap to narrow in future years.

Notes:

1. In re Appraisal of Dell Inc., C.A. No. 9322-VCL, 2016 WL 3186538 (Del. Ch. May 31, 2016).
2. Id. at *29.
3. Id. at *32.
4. Id.
5. Id. at *28.
6. Id. at *1.
7. Id. at *6.
8. Id. at *1.
9. Id. at *2.
10. Id. at *5.
11. Id. The Opinion did not specify how long it would take to achieve that enterprise value.
12. This type of income approach to valuation is known as the direct capitalization of cash flow method.
13. The Opinion did not provide details as to the key variables used by Dell management to reach this valuation opinion.
14. In re Appraisal of Dell Inc., 2016 WL 3186538 at *5.
15. Id. at *6.
16. Id. A "sponsor" is a term for a leveraged buyout fund.
17. Id. The Opinion did not provide further detail as to the key variables used for JPMorgan's DCF analyses. It should be noted that sell-side analysts typically do not forecast financial results

beyond the ensuing two fiscal years, and Dell was in the throes of a transformation in its product and services portfolio that Mr. Dell opined would require sacrificing short-term results for long-term performance. When a company is either in transformation or experiencing unusually positive or negative financial results, it may be advisable, depending on other facts and circumstances, for the terminal year projection for a DCF valuation to be a year in the future when the subject company's positive or negative growth is projected to have stabilized. The terminal year projection may then better reflect the subject company's expected long-term growth in revenue and free cash flow.

18. Id. at *7.
19. Data obtained from S&P Capital IQ.
20. In re Appraisal of Dell Inc., 2016 WL 3186538 at *7.
21. Id. at *8.
22. Id.
23. Id..
24. Id. at *9
25. Id.
26. Id. Chancery Court, in this matter, later cited an article by renowned M&A attorney Martin Lipton that concurred with the issue of near-term focus by investors in the capital markets. See Martin Lipton & Marshall P. Shaffer, "Wachtel Lipton Discusses Short-Term Investors, Long-Term Investments and Firm Value," *Blue Sky Blog,* Columbia Law School (February 3, 2016).
27. Id.
28. Id. at *10.
29. Id.
30. Id.
31. Id. at *10–11.
32. Id. at *11.
33. Id. at *12–14.
34. Id. at *14.
35. Id..
36. Id. at *14–15.
37. Id. at *15.
38. Id. at *17.
39. Id. at *18.
40. Id. at *19.
41. Tom Krazit, "Michael Dell Back as CEO; Rolling Resigns," www.cnet.com (December 7, 2007).
42. Paul Gompers, Steven N. Kaplan, and Vladimir Mukharlyamov, "What Do Private Equity Firms Say They Do?" Harvard Business School working paper 15-081 (2015): 3, 10.
43. Amy Or, "Average Private Equity Hold Times Drop to 5.5 Years," *Wall Street Journal* (June 10, 2015).
44. In re Appraisal of Dell Inc., 2016 WL 3186538 at *12.
45. Id.
46. Id. at *10–11.
47. Id., nn.20 & 21.
48. Id. at *29–32.
49. Id. at *32–36.
50. Id. at *36–37.
51. Id. at *38–44.
52. Id. at *45–51.
53. Id. at *31.
54. Id.
55. Id. at *30.
56. Id.
57. Id. at *35.
58. Lipton and Shaffer, "Wachtel Lipton Discusses Short-Term Investors, Long-Term Investments and Firm Value."
59. In re Appraisal of Dell Inc., 2016 WL 3186538 at *36.
60. Id., n.36.
61. Id. at *38.
62. Id. at *39, citing Glob. GT LP v. Golden Telecom, Inc. (Golden Telecom I), 993 A.2d 497, 508-509 (Del. Ch. 2010).
63. Id. at *42.
64. Id. at *45.
65. Id. at *46.
66. Highfields Capital, Ltd. v. AXA Fin., Inc., 939 A.2d 34 (Del. Ch. 2007).
67. In re Appraisal of Dell Inc., 2016 WL 3186538 at *47.
68. Id.
69. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008): 244.
70. In re Appraisal of Dell Inc., 2016 WL 3186538 at *47.
71. Federal Reserve Bank of Philadelphia, *Livingston Survey* (December 12, 2012).
72. In re Appraisal of Dell Inc., 2016 WL 3186538 at *47–48.
73. Id. at *49.
74. Id. at *49–51.
75. In Highfields Capital, Inc. v. AXA Fin., Inc., the court opined that substantial weight should be given to the merger price as an indicator of value provided that the merger resulted from an arm's-length process between two independent parties. In Appraisal of Dell Inc., the court did not cast doubt on whether the sales process and terms were at arm's length from a statutory duty of loyalty perspective, but rather scrutinized more closely the fairness of the consideration because it was an MBO.
76. In re Appraisal of Dell Inc., 2016 WL 3186538 at *21.
77. Id. at *39.

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