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BMC Software's Lessons For Expert Witnesses

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In the largest statutory appraisal action to reach trial in the Delaware Court of Chancery since Golden Telecom (2010), the decision in Merion Capital LP and Merion Capital II LP v. BMC Software Inc. highlights the need for experts to quantify deal synergies and account for the robustness of auction processes when opining on fair value, and presents the court's preferred approach on a number of discounted cash flow (DCF) model assumptions.

In this action, dissenting minority shareholder Merion Capital claimed the fair value of its shares was 45 percent higher than the price paid for BMC Software by a group of private equity firms in a competitive auction. Respondent BMC Software argued that the fair value of shares was substantially below the merger price after accounting for synergies, which must be excluded when determining fair value under Delaware's statutes.

In critiquing the experts' analysis, Vice Chancellor Sam Glasscock articulated the need to quantify deal synergies.[1] Neither expert, however, successfully did so, and neither opined on the robustness of the auction process.[2]

This article addresses the valuation issues highlighted by the court.

When Does the Merger Price Reflect Fair Value?

The Delaware court's responsibility in appraisal actions is to determine the "fair value" of the company's stock, which is not always the same as the "market value."[3] Market value is thought of as the price at which a company would sell for in a transaction between a willing buyer and a willing seller. Fair value, however, is defined by a legal or regulatory jurisdiction.[4] In Delaware, fair value is the firm's equity value as a going concern less any "speculative elements of value that may arise from accomplishment or expectation of the merger," or deal synergies.[5]

Synergies generally represent cost savings or revenue improvements that merging companies expect to achieve from a transaction. Typical examples include staff reductions, improved market reach, better use of technology, and economies of scale. The court noted that synergies consist of "value arising solely from the deal."[6]

Respondent BMC Software requested the court to deduct value from the deal price based on what it called "synergies from going-private" cost savings. BMC Software failed to actually quantify their value, however, with the court noting:

[w]hile it may be true that the Buyer Group considered the synergies in determining their offer price, it is also true that they required a 23% internal rate of return in their business model to justify the acquisition, raising the question of whether the synergies present in a going-private sale represent a true premium to the alternatives of selling to a public company or remaining independent. In other words, it is unclear whether the purported going-private savings outweighed the Buyer Group's rate of return ....[7]

After considering (1) the competitiveness of the auction for BMC Software, (2) the DCF input assumptions relied upon by the experts, and (3) the absence of any presented quantum of synergies, the court decided not to substitute its own calculation of "fair value" of the company's shares for the merger price that resulted from "arm's-length" negotiations in this case.

Lessons Learned for Expert Witnesses

Several lessons for Delaware valuation experts can be observed from the court's opinion.

First, the court has reaffirmed in BMC Software that the merger price itself as well as valuation models presented by experts are relevant factors to be considered in determining fair value. If the strategy of petitioners is to de-emphasize the negotiated merger price, expect future expert testimony assessing robustness (or lack thereof) of the auction process. For example, experts may need to examine the information content of multiple rounds of bidding, the potential of constraints on the auction process, and the value of deal provisions like "go-shop" or "no-shop" clauses. These expert analyses may require a combination of theory on auction processes and an assessment of the auction used in the specific transaction.

Second, there must be a clear distinction between the component of price that is attributable to the target company as a going concern and the component that is due exclusively to expected deal synergies. In the case of a strategic buyer, synergies are generally expected, but they are also possible with a financial buyer. In BMC Software, for example, the financial buyer claimed certain tax benefit synergies that could be realized only if the company was taken private.

The court expressed a willingness to consider synergies achievable by a financial, rather than strategic, buyer, finding them "likely properly excluded from the going-concern value."[8] Nonetheless it did not find the expert testimony compelling, particularly because the buyer was not able "to show what quantum of value should be ascribed to the acquisition, in addition to going-concern value; and if such value was available to the Buyer Group, what portion, if any, was shared with the stockholders."[9]

Third, in future actions, expert testimony quantifying synergies may not come exclusively from valuation experts, but perhaps from, or in tandem with, industry and practitioner experts. For example, a combination of industry, banking, auction and valuation expertise may be needed to dissect the value composition of a hypothetical deal involving the buyer of a target with assets that it planned to use to provide more widely marketable product offerings. Teasing out the component of future value arising from such a deal itself could require a multifaceted approach from industry experts assisting valuation experts.

Finally, the court also addressed several key DCF model assumptions that future valuation experts in Delaware should consider:

- ***Financial Projections: Default to Relying on Management Projections Unless You Have Good Reason Not To.*** The court conceded that the management projections in BMC Software may have been optimistic, but found modifications by the experts overly speculative and therefore relied on the unaltered projections.

- ***Discount Rate: The "Supply Side" Method is the Preferred Approach for Estimating Equity Risk Premia, a Key Component of Discount Rates.*** The supply-side equity risk premium modifies the more traditional historic equity-risk premium by adjusting it for any inflation included in the price-to-earnings ratio. Despite continued academic debate regarding the equity risk premium, the supply-side approach appears to have become the preferred approach in Delaware courts and other venues in recent years.[10]

- ***Terminal Growth Rate: Split the Difference Between Expected Inflation and GDP Growth Rate.*** The terminal value, or estimate of future value beyond the period of financial projections, has been called "the tail that wags the dog" by some valuation professionals. The reason is that small changes in terminal value assumptions can have an outsized effect on the total valuation result. In BMC Software, the court rejected both experts' perpetuity growth assumptions and relied on the precedent of Golden Telecom to apply a terminal growth rate at the midpoint of inflation and expected long-run gross domestic product growth.[11]

- ***Offshore Cash: Include a Tax Offset for Offshore Cash.*** The court reasoned that cash held overseas represented an opportunity for the company "either in terms of investment or in repatriating those funds for use in the United States, which would likely trigger a taxable event."[12]

- ***Stock-Based Compensation: Treat Estimated Future Stock-Based Compensation as an Expense and Reduce Free Cash Flows, if the Company Has History of Buying Back Shares to Prevent Dilution.*** The petitioner's expert argued for the treasury stock method, which would have increased the number of shares to account for the dilutive economic effect, and not reduced free cash flow. The court rejected this approach as inconsistent with BMC Software's past practice and agreed with the approach by the respondent's expert to treat stock-based compensation as a cash expense.

Conclusion

The BMC Software post-trial decision provides an important lesson regarding the need for valuation experts to quantify deal synergies if they hope to influence the court's fair value determination, and it may require industry or practitioner experts to do so persuasively on future appraisal actions. It also emphasized the need for experts to address the robustness of the auction process as a first step if they hope for the court to duly consider any presented valuation models. Finally, the court provided its approach on a number of DCF valuation assumptions, which may make experts' testimony more persuasive to the court in the future.

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[1] It is important to note that the concept of fair value depends on the specific venue of an action. While the Delaware Court of Chancery excludes synergies from the valuation in dissenting shareholders rights to an appraisal action like BMC Software, the calculation of a market value including synergies may be entirely appropriate in other circumstances or venues.

[2] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), p. 49 "A two-step analysis is required: first, were synergies realized from the deal; and if so, were they captured by sellers in the deal price? Neither party has pointed to evidence, nor can I locate any in the record, sufficient to show what quantum of value should be ascribed to the acquisition, in addition to going-concern value; and if such value was available to the Buyer Group, what portion, if any, was shared with the stockholder." See also Id. pp. 38-44.

[3] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), p. 30.

[4] Delaware Courts make a clear distinction between fair value and fair market value. The appraisal statue states that "the Court shall determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation, together with interest, if any, to be paid upon the amount determined to be the fair value. In determining such fair value, the Court shall take into account all relevant factors" 8 Del. C. § 262(h). The standard definition of fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." See for example, Internal Revenue Service Treasury Regulations §20.2031-1(b). The BMC Software decision specifically relies on the Delaware Court's definition of fair value.

[5] Weinberger v. UOP, Inc., 457 A.2d 701, 713 (Del. 1983).

[6] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), p. 38.

[7] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), pp. 47-48 "During trial and in post-trial briefing, Respondent offered the testimony of a Bain principal to show that the Buyer Group would have been

unwilling to pay the Merger price had they not intended to receive the tax benefits and cost reductions associated with taking the Company private. In fact, had these savings not existed the Buyer Group would have been willing to pay only $36 per share, an amount that resembles the going-concern value posited by Respondent‘s expert. However, demonstrating the acquirer‘s internal valuation is insufficient to demonstrate that such savings formed a part of the purchase price.”

[8] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), p. 47.

[9] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), p. 49.

[10] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), p. 33.

[11] See Global GT LP v. Golden Telecom, Inc. (Del. 2010).

[12] BMC Opinion, C.A. No. 8900-VCG (Del. 2015), p. 35.