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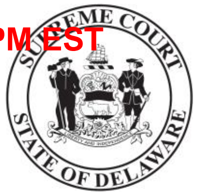

IN THE SUPREME COURT OF THE STATE OF DELAWARE

MUIRFIELD VALUE PARTNERS, L.P., OASIS INVESTMENTS II MASTER FUND LTD., CANDLEWOOD SPECIAL SITUATIONS MASTER FUND, LTD., CWD OC 522 MASTER FUND LTD., and RANDOLPH WATKINS SLIFKA Petitioners-Below, Appellees/Cross-Appellants, v. DFC GLOBAL CORPORATION, Respondent-Below, Appellant/Cross-Appellee.	No. 518, 2016 Appeal from the Memorandum Opinion dated July 8, 2016, as modified by the Order and Final Judgment dated September 14, 2016, of the Court of Chancery of the State of Delaware, Consolidated C.A. No. 10107-CB

APPELLEES/CROSS-APPELLANTS'
<u>REPLY BRIEF ON CROSS-APPEAL</u>

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NATURE OF THE PROCEEDINGS

In their opening brief on cross-appeal, Petitioners showed why the Court of Chancery's equal weighting of a comparable company analysis, deal price, and a DCF analysis was an abuse of discretion. Respondent's effort to salvage the comparable company analysis and deal price, and to belittle the DCF, is to no avail. This is Petitioners' brief addressing those efforts.

The language of the appraisal statute is clear. The Court of Chancery is required to "determine the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation," and in making such determination, "the Court shall take into account ***all relevant factors***." 8 *Del. C.* § 262(h) (emphasis added). This means that there is no formulaic approach to determining fair value in an appraisal. Every transaction is unique. Factors that may be relevant in one case may not be relevant in another. To adopt the one-size-fits-all rule deferring to deal price in instances where there is an arm's-length transaction, as proffered by Respondent, is contrary to both the statute and established precedent. *See Golden Telecom, Inc. v. Global GT LP*, 11 A.3d 214, 218-19 (Del. 2010).

The rule proffered by Respondent also ignores the premise that a deal price can be affected by many factors that have nothing to do with the fair value of the target company. As Vice Chancellor Laster recently explained, Delaware has

never embraced the notion of market fundamentalism.[1] For example, in hostile takeover situations, boards are empowered to deploy defense mechanisms to thwart hostile takeovers in instances where the board believes the company is worth more than what the market is currently reflecting or even what a majority of fully-informed stockholders are willing to accept for their shares. This power is premised on the notion that the market and stockholders can misprice the long-term value—*i.e.*, fair value—of a corporation's shares. Respondent would have this Court introduce a severe dissonance in our law, requiring trial courts to defer automatically to the market in appraisal proceedings, yet still embracing the idea that the market may not always be a reliable indicator of fair value in a takeover regime because the market can be utterly wrong on long-term value. *See id.*

Nor would it make sense under the statute itself. The statute does not contemplate a presumption that the deal price reflects the best evidence of fair value. It does not require the Court to begin its analysis by looking at whether there was an arm's-length sales process. Nor does the statute include any reference to the "market value" of the target company, and it certainly does not mandate deference to such a value as Respondent suggests. Instead, the Court is charged with assessing fair value using any methodology that is generally accepted within

[1] *Travis Laster on Appraisal Rights*, Audio blog post. The CLS Blue Sky Blog, Blue Sky Banter (Feb. 28, 2017), available at http://clsbluesky.law.columbia.edu/2017/02/28/25668/ (last visited March 8, 2017).

the financial community. *Weinberger v. UOP, Inc.*, 457 A.2d 701, 712-13 (Del. 1983).

Here, the deal price was inherently unreliable as an indicator of fair value. *See* Petitioners' Cross-Appeal at 5-7. Lone Star specifically targeted DFC as a prime investment because it was experiencing trough financial performance. It bargained with DFC's board to obtain exclusivity at $12.00 per share, but then unilaterally slashed its offer to $9.50 based on one year of trough financial performance. Moreover, Lone Star's reduced offer was not based on any intrinsic valuation of DFC, but rather its own ability (or inability) to pay as a result of the reduction in available deal financing and its required internal hurdle rates. This, coupled with the fact that there was no go-shop following the expiration of Lone Star's exclusivity period, yielded a deal price in this case that is unreliable as an indicator of fair value. The best and most reliable methodology for determining fair value here is a discounted cash flow analysis. *See* Petitioners' Cross-Appeal Br. at 40-45. The March Projections were reliably prepared by a competent management team and reflected all of the information pertaining to the changing regulatory regime in the U.K. market at the time of the Transaction. Both parties' experts, likewise, relied on those projections in their respective DCF analyses, as did the trial court.

In conducting its DCF analysis, the trial court appropriately exercised its broad discretion by correcting the methodological deficiencies articulated by Petitioners in their Motion for Reargument and applying a 4% perpetual growth rate. Respondent has provided no evidence to the contrary. The trial court's decision to use a 4% terminal growth rate to account for the required net investment contained in the March Projections and the Court's 10.72% discount rate is supported by the factual record at trial, as well as economic theory. *See* Argument I, *infra*.

Respondent has failed to articulate how a comparable company analysis consisting of a vast canyon of values, ranging from a negative $0.39 to a positive $18.20, provides any reasonable assessment of DFC's fair value. The trial court's comparable company analysis was also predicated on trough financial performance of DFC, a fact that permeates the entire record and was the basis for Lone Star's decision to acquire DFC in the first place. Nor were any of the companies used in the comparable company analysis relied on by the trial court sufficiently comparable to DFC for purposes of assessing the Company's fair value. Thus, the Court of Chancery erred by including the comparable company analysis in its fair value determination; rather, it should have relied exclusively on its DCF analysis or some blend of DCF and the deal price, with the DCF being accorded substantially more weight.

ARGUMENT

I. THE COURT OF CHANCERY ERRED BY INAPPROPRIATELY WEIGHTING THE DCF ANALYSIS, DEAL PRICE, AND COMPARABLE COMPANY ANALYSIS

The Court of Chancery erred by according equal weight to a comparable company analysis, the deal price and a DCF analysis. Respondent tries to attack the entirety of the trial court's findings, but none of its arguments have merit. The trial court's DCF analysis is the most reliable indicator of fair value and should have been accorded the most weight in its fair value determination. The comparable company analysis was not at all reliable and should have been accorded no weight.

A. THE DCF ANALYSIS WAS THE MOST RELIABLE INDICATOR OF FAIR VALUE AND SHOULD HAVE BEEN ACCORDED EXCLUSIVE WEIGHT

Respondent's attempt to discredit the trial court's DCF analysis is not supported by the record and the DCF analysis should have been accorded substantial, or exclusive, weight in the Court of Chancery's overall fair value determination. In conducting its DCF analysis, the Court of Chancery properly adjusted the perpetuity growth rate from 3.1% to 4.0% following Petitioners' Motion for Reargument (the "Motion"). While Respondent's motion identified a mathematical error in the trial court's model, Petitioners' Motion raised a fundamental methodological deficiency that needed to be corrected. The Chancellor used his discretion under the statute to rectify that methodological

error, and the trial court's DCF analysis should have been given substantial, if not exclusive, weight.

Respondent's brief mischaracterizes Petitioners' argument and continues to ignore basic economic principles. Specifically, Petitioners' Motion explained that the "Court's decision to adopt a 3.1% PGR is methodologically inconsistent with an increase in the discount rate from 9.5% to 10.72% when combined with the investment in net working capital from the March Projections." A1352-53 [¶5]. Petitioners set forth two alternatives as to how the trial court could rectify this error: (1) by using the 3.1% growth rate but making a corresponding reduction in the Company's net working capital assumption; or (2) by using the net working capital assumption in the March Projections but adopting a correspondingly higher growth rate. A1343-44. Following Petitioners' briefing on the Motion, the trial court recognized this methodological error and, using the discretion provided to it under the statute, opted to use the net working capital assumptions from the March Projections and the corresponding 4% growth rate that relates to the 10.72% discount rate selected by the trial court. Reargument Order at 6; *see* Order and Final Judgment attached as Exhibit C to Appellant's Opening Brief.

Respondent is incorrect that the trial court's ruling is not supported by the record. In making this claim, Respondent argues that "Petitioners have no answer for the fact that their own valuation expert proposed, and repeatedly defended, the

3.1% growth rate at trial[.]" Respondent's Answering Br. at 27. That is not only incorrect, but misunderstands the point. As explained in Petitioners' Motion, the appropriate growth rate to be used in a DCF model cannot be determined in a vacuum. A1352 [¶4].[2] Dages used a 3.1% growth rate in ***his model*** using ***his*** terminal investment assumption and ***his*** assumed discount rate of 9.5%. The trial court, however, used a discount rate of 10.72%. Thus, a DCF analysis using the net investment and discount rate chosen by the Court required the application of a higher corresponding growth rate. Respondent completely ignores this fundamental economic principle and provides no evidence to the contrary.

Moreover, while Dages relied on a 3.1% growth rate (given the assumptions that he relied on in his model),[3] he also stated that "the level of net investment as of the end of the forecast period … in any of my DCF models supports a stable growth rate ***in excess of*** the maximum 3.1% I use in my perpetuity growth rate

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[2] "As a matter of economics, a PGR is the product of the reinvestment rate (i.e., net reinvestment divided by unlevered net income) and the return on capital (i.e., unlevered net income divided by invested capital), where net reinvestment is defined as the increase in working capital plus capital expenditures less depreciation & amortization and the return on capital is assumed to approximate the WACC." A1352 [¶4] (citing Damodaran, Aswath, *Investment Valuation: Tools and Techniques for Determining the Value of an Any Asset*, 313 (3d ed. 2012); Viebig, Jan, Thorsten Poddig & Armin Varmaz, *Equity Valuation: Models From Leading Investment Banks*, 46 (2008).

[3] Respondent claims that Petitioners only cite to Dages' new declaration in support of the 4% growth rate adopted by the trial court, but that is also incorrect. Respondent's Answering Br. at 28. The Dages Affidavit incorporated nearly all of the record evidence supporting the 4% growth rate.

range." A901 [61 n.198] (emphasis added).[4] Dages also cautioned that "a two-stage model with a terminal growth rate of 3.1% is not high enough to adequately take into account a reasonable expectation for DFC Global's growth rate beyond the explicit five-year forecast period[,]" a fact the trial court held it "failed to accord enough weight to[.]" A905-06 [¶97]; Reargument Order at ¶5 n.8.[5]

The 4.0% growth rate adopted by the trial court is also within the acceptable range of reasonable growth rates, as it falls within the boundaries of inflation and nominal GDP growth. Aswath Damodaran, *Investment Valuation: Tools and Techniques for Determining the Value of Any Asset*, 306-307 (3d ed. 2012); Robert W. Holthausen and Mark E. Zmijewski, *Corporate Valuation: Theory, Practice & Evidence*, 147 (2014). Respondent admits that the maximum ceiling for a company's perpetuity growth rate is the GDP growth rate. Respondent's Answering Br. at 29.[6] Dages estimated nominal GDP growth at a range of 4.5% to

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[4] *See* Jan Viebig, Thorsten Poddig, and Armin Varmaz, *Equity Valuation: Models From Leading Investment Banks*, 47 (2008) ("The assumed growth rate *g*TV, the assumed return on invested capital *r*TV and the implied plowback ratio *b*TV must be consistent.").

[5] Respondent also claims that a 4% PGR is not supported by arguing that Dages' 3-stage model translates to "no more than a 3.5% growth rate in a two-stage model." Respondent's Answering Br. at 32. Again, this misses the point. Both Dages' three-stage model and two-stage model (upon which he did not rely) were based on Dages' chosen net investment, discount rate, and growth rate.

[6] Respondent also claims that the GDP growth rates for each of DFC's markets should be averaged to come up with a maximum perpetuity growth rate. Respondent's Answering Br. at 29-30. However, it provides no legal support for

4.82%. A878 [¶65]; Op. at 50. The 4% terminal growth rate adopted by the trial court is well below this range.[7]

The trial court's 4% growth rate is also supported by the fact that DFC was emerging from trough performance at the end of the projection period and was still not operating at steady state. Indeed, Respondent acknowledges that DFC was planning on continuing to expand into additional markets, such that the Company would be positioned for continued high-level growth through the end of the projection period. Respondent's Answering Br. 39-40; A308 [631:18-633:12]; A291 [567:11-15]. Respondent's contention that DFC was not in a trough at the time the Transaction closed is contradicted by the record, as Lone Star's entire investment strategy was based on this fact. BR58-59, BR72; Op. at 62. For all of these reasons, the trial court's DCF analysis was appropriate and should have been given substantial, if not exclusive, weight.

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such a proposition, nor does it provide any support in the factual record. Neither expert in this case opined that the GDP growth rate should consist of an average of the GDP growth rates of the specific markets in which DFC operates.

[7] The growth rate implied by Respondent's own expert further supports the 4% growth rate adopted by the trial court. While Respondent is technically correct that the Convergence Model used by Beaulne did not require Beaulne to select a specific growth rate, an implied growth rate can be determined from the inputs used in the analysis. A1117 [n.17]; A1139-41 [¶¶46-47]. In this case, the implied growth rate from Beaulne's analysis was 4.5%, well above that selected by the trial court here.

B. THE COURT OF CHANCERY ERRED BY ACCORDING THE COMPARABLE COMPANY ANALYSIS ANY WEIGHT IN ITS FAIR VALUE DETERMINATION

Despite the Court of Chancery correctly giving weight to the DCF analysis, it nonetheless erred by according Beaulne's comparable company analysis any weight in its fair value determination. The comparable company methodology is an unreliable indicator of fair value under the facts of this case because the output range is so vast that it provides no reliable assessment of DFC's fair value. Moreover, the trial court's analysis only takes into account three years of DFC's financial data – all of which constitute the "valley" of DFC's trough financial performance.[8] Finally, the companies used in the analysis adopted by the trial court were not sufficiently comparable to DFC to be used as a valuation metric.

[8] Beaulne's analysis took into account the "average of MVIC [market value of invested capital] for last twelve months, 2014, and 2015[.]" Respondent's Answering Br. at 36. In 2013, DFC was in the midst of market overreaction to the newly announced regulatory changes that were being planned in the U.K., followed by DFC's proactive implementation of those anticipated changes. A452; A394; B1015 [220:6-25]; B1182-B1183. In 2014, DFC was still implementing regulatory changes in the U.K. and was just receiving clarity on the final rules. A394; A114-15 [¶¶128-130]. Following the close of the deal in June 2014, DFC was no longer a public company. In 2015, DFC still expected its financial performance to be below historical levels as it continued to navigate the business through the continued implementation of regulatory changes and the impact of the new regulatory regime on its competitors. B797-98 [113:20-114:10]; A123-24 [¶¶161-64]. Nonetheless, as of the Transaction date, DFC expected its financial performance to rebound to historical levels in the out-years of the projection period (i.e., 2016-2019), which are not contemplated by the comparable company analysis. B797-98 [113:20-114:10]; A123-24 [¶¶161-64].

For all of these reasons, the trial court's comparable company analysis should be excluded from the fair value determination of DFC.

Respondent argues that Petitioners are incorrect that the comparable company analysis "yielded wildly divergent results." Respondent's Answering Br. at 36. This argument fails to address or explain the vast canyon separating the range of values resulting from Beaulne's comparable company analysis, spanning from a ***negative*** $0.39 to ***positive*** $18.20 – a fact Respondent's brief does not even mention. A206 [225:5-226:24]; A207 [231]; A1157. This huge delta was the precise reason Dages chose not to rely on this methodology, as the comparable company analysis that Dages performed ***and*** the comparable company analysis performed by Houlihan Lokey both suffered from this same large disparity in values. A911 [¶104] (values ranging from $11.38 to $26.95); BR126 (values ranging from negative $4.00 to positive $7.50); A206 [225:5-226:14]; BR235; A909 [¶102].

Respondent argues that Beaulne's use of market value of invested capital ("MVIC") was designed to address fluctuations in financial performance in any given year.[9] Respondent's Answering Br. at 36. DFC, however, was not

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[9] The fact that Beaulne used MVIC to compare DFC over other available metrics is irrelevant. A market-based approach using any of the metrics observed in this case yields the same disparate range in outputs and is inherently unreliable. *See Gholl v. eMachines, Inc.*, 2004 WL 2847865, at *6 (Del. Ch. Nov. 24, 2004), *aff'd*, 875

experiencing slight fluctuations in EBITDA; the Company was experiencing a financial trough affecting all of the years incorporated in the trial court's analysis. BR141 ("If the base year represents the bottom or trough of a cycle and we use the earnings from that year to value companies, we will consistently under estimate their values."); James R. Hitchner, *Financial Valuation: Applications and Models*, 278 (3d ed. 2011); *cf. Glassman v. Unocal Exploration Corp.*, 777 A.2d 242, 248 (Del. 2001) (acknowledging that an appraisal proceeding can and should address the problem of opportunistic timing, including when there is a trough in a company's performance).

Respondent also claims that DFC was not operating at a trough, but rather was affected by a structural change to its core business. Respondent's Answering Br. at 35. This argument is simply Monday-morning quarterbacking. The record makes clear that DFC was experiencing trough EBITDA at the time the Transaction closed (the only relevant time period) and that all the parties expected that the business would rebound in FY 2016 and beyond. A193 [173:4-174:22]; A206 [228:3-10] ("And it's agreed by everybody that the current periods here are trough-level performances, and the only reason somebody's buying in is because they and the management team feel this business is going to – is going to achieve those outer-year forecasts, as exhibited by how little the outer-year forecasts

A.2d 632 (Del. 2005) (when "a market analysis … yields such a wide range of results, the Court seriously questions its usefulness").

moved when they did their February and March revisions."); B984-85 [95:19-99:9]; B797-98 [113:20-114:10]; A123-24 [¶¶161-64]; A128-29 [¶¶184-85]; *see* BR1; BR11; A474; BR133; A109-10 [¶108]; A113 [¶123]; A123 [¶161], A128-29 [¶184]; Op. at 2. In fact, Lone Star's entire investment thesis was premised on the fact that DFC was exhibiting trough EBITDA performance at the time it was acquired. BR58-59; A135 [¶220]; A136 [¶223] ("The Investment Committee Memorandum that was presented to Lone Star's Investment Committee in support of the Transaction in March 2014 stated that Lone Star believed that DFC Global represented an opportunity to acquire a best-in-class global platform in the short-term consumer lending space at trough EBITDA levels"); A283-84 [533:9-537:20]; Op. at 10, 62. Thus, a market-based valuation analysis using financial information from DFC's trough years is not a reliable indicator of fair value.

In fact, Respondent's own authorities recognize that there are a variety of factors that could detract from the reliability of a market-based approach.[10] *See*

[10] The Court has also routinely rejected a comparable company analysis in cases where, like here, the peers used were not sufficiently comparable. *See Merlin P'rs LP v. AutoInfo, Inc.*, 2015 WL 2069417, at *11 (Del. Ch. Apr. 30, 2015); *Merion Capital, L.P. v. 3M Cogent, Inc.*, 2013 WL 3793896, at *7 (Del. Ch. July 8, 2013), *judgment entered sub nom.* 2013 WL 3833763 (July 23, 2013); *In re AT&T Mobility Wireless Operations Hldgs. Appraisal Litig.*, 2013 WL 3865099, at *2 (Del. Ch. June 24, 2013); *In re Sunbelt Bev. Corp. S'holder Litig.*, 2010 WL 26539, at *10 (Del. Ch. Jan. 5, 2010), *as revised* (Feb. 15, 2010); *Highfields Capital, Ltd. v. AXA Fin.*, Inc., 939 A.2d 34, 56–57 (Del. Ch. 2007); *In re PNB Hldg. Co. S'holders Litig.*, 2006 WL 2403999, at *25 (Del. Ch. Aug. 18, 2006); *Gilbert v. MPM Enters., Inc.*, 709 A.2d 663, 668 (Del. Ch. 1997), *on reargument sub nom.*

Joshua Rosenbaum & Joshua Pearl, *Investment Banking: Valuation, Leveraged Buyouts, and Mergers & Acquisitions*, 13 (2d ed. 2013) ("At the same time, market trading levels may be subject to periods of irrational investor sentiment that skew valuation either too high or too low. Furthermore, no two companies are exactly the same, so assigning a valuation based on the trading characteristics of similar companies may fail to accurately capture a given company's true value."); *Financial Valuation*, at 263 ("Unlike the income approach, in the market approach it is sometimes difficult to include unique operating characteristics of the firm in the value it produces. For example, a shifting product mix, resulting in higher future margins, may not be easily incorporated into a market approach analysis because there may be no other guideline company whose product mix is expected to change in a similar fashion."). The regulatory landscape affecting DFC's business in the U.K. at the time of the Transaction, coupled with the fact that it was experiencing significant market overreaction affecting its stock price as a result of the proactive changes the Company was making to its business, presented exactly the situation that makes a market-based approach unreliable. A452; A394; B1015 [220:6-25]; B1182-83.

Finally, the companies relied upon by the trial court in its comparable company analysis were not sufficiently comparable to DFC to be used as an

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1998 WL 229439 (Apr. 24, 1998), *and aff'd sub nom.* 731 A.2d 790 (Del. 1999); *In re Radiology Assocs., Inc. Litig.*, 611 A.2d 485, 490 (Del. Ch. 1991).

indicator of fair value. While these companies might be suitable for purposes of calculating a peer beta (which was then blended with DFC's actual beta) for use in a DCF analysis, they are not appropriately comparable for a comparable company analysis. *See Radiology Assocs.*, 611 A.2d at 493 ("[D]efendants fail to recognize that the choice of companies for the comparable company valuation approach is a much more comprehensive analysis than the choice of companies for the decision of whether they belong to the same industry."). The companies relied on by the trial court had different product offerings than DFC, had a much smaller geographical footprint than DFC, and did not have as much exposure to the lending markets in Canada and the U.K., which are DFC's primary markets. A194 [179:2-180:22]; A208-09 [236:16-237:4]; A908-09 [¶100]; A1141-42 [¶49]; B1125 [288:6-25]; A684 [220:17-221:6]. Respondent's brief fails to provide any evidence to the contrary. Even Lone Star testified that none of the companies were directly comparable to DFC. B903 [144:7-17]; B993-94 [133:13-134:11]. Despite all of these reasons why the comparable company analysis was unreliable and should not have been used, the trial court not only used that analysis, but gave it ***equal weight*** to its DCF analysis. This was an abuse of the trial court's discretion.

CONCLUSION

For the foregoing reasons, the Court should either affirm the trial court's fair value award of $10.30 per share or, in the alternative, either rely exclusively on the trial court's discounted cash flow analysis yielding a fair value of $13.33 or some blend of the deal price and the DCF analysis, with the DCF being accorded substantially more weight than the deal price.

Dated: March 9, 2017

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I, Kimberly A. Evans, hereby certify that on March 9, 2017, I caused a copy of *Appellees/Cross-Appellants' Reply Brief on Cross-Appeal* to be filed and served to all counsel below via File and Serve*Xpress*:

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