

# *iKang Healthcare Group, Inc*: 90 per cent weighting attributed to a DCF valuation when determining fair value

UPDATE

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The Grand Court of the Cayman Islands (the **Court**) has handed down judgment following the trial of *In the matter of iKang Healthcare Group*<sup>1</sup> in respect of fair value appraisal proceedings under section 238 of the Companies Act (the **Act**). In determining fair value, the Court ascribed a 90 per cent weighting to a discounted cash flow (**DCF**) valuation and a 10 per cent weighting to a comparable companies valuation. This is the highest weighting to be given to a DCF valuation in a Cayman fair value appraisal since the Court's fair value determination in *Shanda Games*<sup>2</sup> and only the second time that any value has been ascribed to a comparable companies valuation. This decision serves as a reminder that each fair value appraisal will be decided on its own facts and the Court is not bound to adopt a particular valuation method.

## Background

iKang Healthcare Group, Inc (the **Company**) is a Cayman Islands exempted limited company, previously listed on the NASDAQ Global Select Market, providing preventative healthcare solutions across the People's Republic of China. In 2018, the Company was taken private by a group of investors (the **Buyer Group**) by means of a merger between the Company and IK Healthcare Investment Limited and delisted.

The price agreed between the Company and the Buyer Group was US\$41.20 per share (the **Merger Price**). The dissenting shareholders (the **Dissenters**) considered that the Merger Price was below the fair value of their shares and exercised their rights under section 238 of the Act to dissent from the merger and seek the Court's determination of the fair value of their shares.

The Company argued, based on its expert's valuation evidence, that fair value was US\$38.42 per share. This was a blended average of its expert's DCF valuation weighted at 60 per cent, its expert's comparable company valuation (**CoCo Valuation**) weighted at 30 per cent and the Company's market trading price valuation weighted at 10 per cent. The Dissenters argued, based on their expert's valuation evidence, that fair value was US\$64.43 per share. This was a blended average of a DCF valuation weighted at 75 per cent, their expert's CoCo Valuation weighted at 15 per cent and their expert's comparable company transaction valuation (**CoTrans Valuation**) weighted at 10 per cent.

## The approach to determining fair value

The fundamental principles to be applied when assessing fair value are well established and were not in dispute. In summary:<sup>3</sup>

- In ascertaining fair value, the Court must assess and determine a monetary amount which in the circumstances represents the true worth of the Dissenters' shares;

<sup>1</sup> *In the matter of iKang Healthcare Group* (unreported, 21 June 2023).

<sup>2</sup> *In the matter of Shanda Games Limited* 2018 1 CILR 352.

<sup>3</sup> *In the matter of iKang Healthcare Group* (unreported, 21 June 2023), paragraphs 30 – 37.

- The reference to 'fair' requires that the manner and method of that determination is fair by considering all relevant facts and matters and fairly balancing, where appropriate, the alternative approaches to valuation;
- The role of expert valuation evidence will be a key factor for the determination of fair value. In assessing expert evidence, the parties must establish, on the balance of probabilities, that their experts' valuations are reasonable and reliable. If neither are reasonable and reliable, the Court must make its own determination by forming its own view; and
- There is no hierarchy with respect to the valuation approaches which may be applied to determine fair value. The traded price of the shares before the merger or the merger price will not necessarily be indicative of fair value.

The Court also commented that in section 238 fair value appraisals, Delaware case authorities have often been cited and relied on. The Court expressed a concern that Delaware case authorities were being cited by Cayman counsel as if they were decisions of courts of this jurisdiction or England and Wales without there being expert evidence from Delaware qualified attorneys to show that the Delaware authorities are up-to-date and balanced statements of the applicable law in Delaware. In this case, the Court therefore gave pre-trial directions that, if Delaware decisions were to be cited, they must be supported by an expert opinion of Delaware counsel in order to ensure that the cases being cited are up to date and remain authoritative. It appears that the Company did not follow this direction in this case.

## The decision

### DCF valuation

The parties' experts both adopted a weighted approach and placed the greatest weight on their DCF valuations. The parties' experts both also relied on cash flow projections prepared by management and agreed minor adjustments to those projections. The key dispute between the experts was in relation to (mainly fact specific) inputs into their DCF valuations:

- Size premium: A size premium is an adjustment to a company's estimated cost of capital to reflect risks stemming from the size of the company, following the general theory that smaller companies tend to be riskier than larger ones. The Company's expert applied a size premium of 1.58 per cent to reflect the additional risks that needed to be captured in the Company's cost of capital by reason of its size, ascertained by reference to its market capitalisation. The Dissenters' expert opined that there was no proper justification in applying a size premium, but that if one was to be applied by the Court it should be 0.87 per cent. The Court was persuaded by the opinion of the Company's expert that applying a size premium was reasonable and justifiable. However, the Court held that the Company's expert had failed to establish the evidence on the quantification of the size premium and adopted the Dissenter's expert's (secondary) position, applying a 0.87 per cent size premium.
- Terminal growth model and terminal growth rate: A DCF valuation typically contains a specified forecast period, being the first stage of the DCF model followed by a terminal value, which represents the value of the company that arises from the cash flows after the specified forecast period. The parties' experts could not agree on (a) the terminal value methodology, where the Company's expert used a two stage DCF growth model and the Dissenter's expert used a three stage DCF model, or (b) the long-term terminal growth rate, where the Company's expert applied 3.5 per cent and the Dissenter's expert applied 4.5 per cent. On the facts of this case the Court ultimately (a) adopted a two stage model given the moderate levels of growth of the Company at the end of the specified forecast period, and (b) considered 3.75 per cent to be a reasonable and fair estimate of the long-term growth rate.
- Foreign exchange: While the Company's projections were in RMB, both experts used a USD risk free rate to build their discount rates. There was a dispute regarding the best way of making an adjustment for currency risk. The Company's expert used the forward rate method whereas the Dissenters' expert did not make an adjustment to the RMB cash flows as he was of the opinion that it was not necessary given he had included a country risk premium in his calculation. The difference in approach had a significant impact on the expert's valuations - had the Dissenters' expert used the Company's experts' forward rate method his valuation would have been \$4.13 per share lower. The Court favoured the approach of the Company's expert, noting that it was more conventional and reliable, closely following the guidelines in the textbooks and clearly meeting the need to achieve consistent monetary assumptions in the valuation process.

- (d) **Minority discount:** The Company's expert applied a 5 per cent minority discount to reflect both the blocking vote of the Company's founder, chairman and CEO, who held 34 per cent of the total voting power of the Company's outstanding ordinary shares and anti-takeover provisions in the memorandum and articles of association. The Dissenters' expert did not apply a minority discount to his DCF valuation on the basis that the projections already reflected cash flows that would flow to a minority shareholder. The Court agreed with the Company's expert that a minority discount should be applied but reduced it by half to 2.5 per cent, finding that the risk derived from the absence of control should only have a relatively low monetary value, noting that the 5 per cent discount proposed by the Company overstated the risk.

### CoCo Valuation

A CoCo Valuation is based on multiples derived from the financial information of comparable companies and their market value. This was only the second case in the Cayman Islands to date in which the Court had relied on a CoCo Valuation.<sup>4</sup> The Court held that the core question for the Court was whether the evidence established that the comparator companies were sufficiently similar to justify the CoCo Valuation being relied on. As no two companies are ever identical, the Court must consider whether the similarities are sufficient or whether the differences between them are so material as to make it unsafe to rely on the comparison.

Both experts placed the second greatest weight on their CoCo Valuations, with the Company's expert ascribing a 30 per cent weighting and the Dissenter's expert ascribing a 15 per cent weighting. While both experts agreed on four companies being properly comparable with the Company, there were other companies identified that the experts did not agree on, with the key difference largely driven by the Dissenters' expert's inclusion of mainland Chinese listed companies. Further, there was a dispute as to the applicable multiples used for two of the companies in the CoCo Valuation.

The Court found that the four companies the experts had agreed on were sufficiently comparable, noting that the fact the experts were in agreement was to be given substantial weight and their joint view should be only displaced if there was some clear and sound reason for doing so. The Court was not persuaded to conclude that mainland Chinese listed companies should be included in the CoCo Valuation. In addition, the Court made certain adjustments to the calculation of the multiples used in calculating the CoCo Valuation. In light of the problems in assessing both comparability and the relevant variables, the Court held that only a low weighting of 10 per cent should be attributed to the CoCo Valuation.

### CoTrans Valuation

The Dissenters' expert gave a 10 per cent weighting to a valuation based upon comparable transactions in the shares of companies he considered to be sufficiently similar to the Company, identifying 20 potential transactions but narrowed that down to five transactions involving companies that the Dissenters' expert considered to be the most closely comparable to the Company based on the underlying operating, financial and geographic characteristics of the target companies. The Company's expert gave no weight to this method, with the Company submitting that this valuation should not be considered by the Court, or only considered after adjusting for certain alleged errors identified in the Dissenters' expert's analysis and removing the synergies affecting the price of certain transactions.

The Court held that the CoTrans Valuation was not sufficiently reliable to justify applying it to the determination of fair value, noting that the Dissenters' expert's conclusions were called into question and were weakened by certain material corrections he was required to make to his valuation.

### Market trading price

The Dissenters' expert placed no weight on the Company's market trading price prior to the valuation date. The Dissenters argued that the essential problem with the market trading price was that the Company was known to be subject to acquisition proposals from 31 August 2015 until the valuation date on 20 August 2018. Accordingly, for almost three years the market trading price for the Company was primarily determined by market participants' assessment of the likelihood of a deal being concluded rather than the Company's fundamentals. The Company's expert gave a low 10 per cent weighting to a valuation based on

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<sup>4</sup> The only other section 238 case to date in which the Court had relied on a CoCo analysis was *In the matter of Integra Group* 2016 (1) CILR 192.

an assessment of the Company's market trading price in the 30 days prior to the valuation date, acknowledging that this weighting was chosen because of serious problems with the reliability of an analysis of value based on the market price.

The key question for the Court was whether, despite serious problems with the reliability of the market price, any reliance of the market price was justifiable. The Court held that the substantial problems identified in reliably being able to determine whether the Company's market trading price reflected fundamentals during the relevant period and the weaknesses identified in the grounds relied on by the Company's expert for his limited reliance on the market price were so significant that no reliance on this valuation was justified and that a zero weighting was the only safe approach.

### Merger Price

While neither expert placed any weight on the Merger Price the Company's expert opined that, as a minimum, the Merger Price served as a useful cross-check when considering fair value. The Dissenters' expert submitted that the merger process was a deeply unsatisfactory means of discovering fair value, due amongst other factors to the fundamental and structural difficulties in the merger process. In particular, the Company's founder, chairman and CEO, who held 34 per cent of the total voting power of the Company's outstanding ordinary shares had publicly refused to support a bid from a competitor or to work with other investors and it was not possible to conduct a robust market check given his position and informational asymmetries.

The Court found that in the circumstances of the case the Merger Price did not assist as a cross-check. The Court was not convinced by the Company's approach, asking: '*if the Merger Price is ultimately unreliable as a measure of fair value and is to be given no weight for that purpose, how can it then have sufficient weight to impact on the fair value determination at all?*'<sup>5</sup> The Court agreed with the Dissenters' expert that the position of the blocking vote created a fundamental (and structural) difficulty for the merger process and had a substantial chilling and complicating effect that reduced the pool of interested parties and resulted in a price paid that was likely to be below what would be paid by an arm's length buyer in a competitive bidding process.

### Weighting

The Court agreed with the Dissenters that the case for a complete or very substantial reliance on a DCF valuation was very strong, finding that the DCF valuation was based on agreed cash flows and that while the issues in dispute were not straightforward or capable of resolution without the application of judgment, they were limited and subject to analysis by reference to valuation literature and practice. By contrast, the Court held that the other valuation methodologies were subject to fundamental difficulties and much greater uncertainty. Accordingly, in the circumstances of the case, the DCF valuation was the most reliable methodology and to be given a substantial weighting of 90 per cent.

The Court considered that the adjusted CoCo Valuation was sufficiently reliable to justify a limited weighting and that it would be reasonable to include it as a modest market-based modification to the DCF valuation. However, it remained subject to difficult comparisons and judgments and should be given a lower weighting. The Court therefore attributed a 10 per cent weighting to the (adjusted) CoCo Valuation.

The Court invited the parties, with the assistance of their experts, to prepare and seek to agree the revised valuation figure.

### Conclusion

This decision represents the highest weighting attributed to a DCF valuation in a Cayman appraisal case since the Court's appraisal decision in *Shanda Games* and only the second time that any value has been ascribed to a comparable companies valuation. The decision serves as a reminder that each appraisal case will be decided on its own facts and the Court is not bound to adopt a particular valuation method. It is necessary in each case to consider, with the assistance of expert evidence, which method(s) of valuation is most suitable and appropriate.

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<sup>5</sup> *In the matter of iKang Healthcare Group* (unreported, 21 June 2023), para 469.

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