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Delaware Court of Chancery Provides Further Guidance for Conducting DCF Analyses

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In two recent decisions,[1] the Delaware Court of Chancery used a discounted cash flow (DCF) analysis to determine the fair market value of an acquired company. Although both decisions were issued in the context of appraisal actions and not in cases involving fairness opinions, the holdings provide some practical guidance to financial advisors for the preparation of DCF analyses in connection with acquisitions.

Management Projections

- The court in *Gearreald v. Just Care, Inc.* confirmed that when management projections are made in the ordinary course of business they will usually be deemed reliable. In contrast, the court noted that management projections are not entitled to the same deference when they are made outside the ordinary course of business. It also remarked that the reliability of management projections may be adversely impacted by management's motives.[2]

Target's Capital Structure

- The *Gearreald* court confirmed that when considering the appropriate capital structure for the computation of a weighted average cost of capital (WACC), practitioners should adopt the capital structure that the target would have maintained as a going concern, exclusive of any changes made in expectation of the acquisition. In line with this approach, the court treated the target's preferred stock as common equity to reflect how the preferred stock functioned from an economic perspective.

Equity Risk Premium

- Both the *Gearreald* court and the court in *In re Appraisal of The Orchard Enterprises, Inc*. followed *Global GT LP v. Golden Telecom, Inc*.[3] in adopting a supply-side equity risk premium (ERP) over a historical ERP. Although it was acknowledged that Delaware courts had in the past applied a historical ERP, the courts noted that in recent years the academic community has gravitated towards greater support for utilizing the supply-side ERP. It can be expected that going forward, Delaware courts will presume that a supply-side ERP is the appropriate metric to be applied in a capital asset pricing model (CAPM) calculation when there appears to be no persuasive reason why the application of a supply-side ERP would be inappropriate.

Discount Rate

- The *Orchard* court adopted a CAPM calculation instead of a build-up rate model, stating that build-up rate models are not as well accepted by mainstream corporate finance theory as a method for determining the discount rate. The court

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[1] *Gearreald v. Just Care, Inc*., C.A. No. 5233-VCP (Del. Ch. Apr. 30, 2012); *In re Appraisal of The Orchard Enterprises, Inc.*, C.A. No. 5713-CS (Del. Ch. July 18, 2012).

[2] The court noted that the projections relied on by the target stockholders in the appraisal proceeding were prepared when the CEO and the CFO risked losing their jobs if the acquisition went forward and were trying to influence the board to pursue different alternatives.

[3] 993 A.2d 497 (Del. Ch. 2010). See our Client Alert discussing the case at http://www.mofo.com/files/Uploads/Images/100802DCF.pdf.

was also critical of using multiple models to calculate the discount rate and blending them together. It is likely that Delaware courts will continue to view with skepticism calculations of the discount rate that use the build-up rate model or variants thereof.

Company-Specific Risk Premium

- Delaware courts will most likely disapprove of the use of a company-specific risk premium in a CAPM calculation of a discount rate, especially when there are no concerns about the reliability of the target's projections.
- Although the *Orchard* court recognized that a company-specific risk premium is sometimes added to the discount rate by practitioners as a short-cut to reflect that the target has risk factors that have not been captured by the equity risk premium and (if applicable) the size premium, the court held that the better approach for taking into account company-specific risk is an adjustment to the target's cash-flow estimates.

Cost of Debt

- The *Gearreald* court dismissed the target stockholders' calculation of the company's cost of debt that was based largely on its expected borrowing rate for a speculative expansion project. It can be expected that Delaware courts will be skeptical of estimates that rely heavily on the prospective terms of a company's incremental debt relative to its existing credit characteristics.

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