Client Alert.

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Delaware Court Provides Guidance to Financial Advisors in Conducting DCF Analyses

Two recent opinions by the Delaware Court of Chancery offer practical guidance to financial advisors in preparing discounted cash flow (DCF) analyses in connection with acquisitions. In one case,[1] the court sustained challenges to the financial advisor's valuation of the target. In the other case,[2] the court criticized the financial advisor's disclosure of the methodology it used in conducting its analyses. While the details of each decision are fact-specific, some useful generalizations can be drawn:

TERMINAL GROWTH RATE

- In determining the terminal growth rate to use for a profitable target without an identifiable risk of insolvency, the applicable long-term inflation rate generally should be the floor. For an established company in a mature industry, the terminal growth rate would generally approximate the rate of long-term nominal GDP growth in the relevant market.

- Deviations from those principles should be supported by a detailed analysis of the facts of the particular case (*e.g.*, relating to the target's long-term growth prospects relative to those of other companies in its industry, or the industry's long-term growth prospects relative to other industries in the relevant market).

DISCOUNT RATE

- Financial advisors should clearly explain to the board how they calculate the discount rate used to conduct a DCF analysis, particularly any adjustments to the weighted average cost of capital (WACC) estimated for the company. In *Maric*, the target's financial advisor calculated two estimates of the target's WACC, including one based on a comparable companies analysis. The financial advisor then used in its DCF analysis a range of discount rates with a bottom end higher than these estimates. The court criticized the disclosure in the proxy statement that indicated the discount rate range was based on the target's WACC, noting that the estimated WACC was outside of the range of discount rates used and there was no evidence the financial advisor had explained to the company why a higher discount rate was appropriate.[3]

- The *Maric* court also criticized as "dubious" the financial advisor's addition to the WACC of a liquidity discount on top of a large beta, a technology industry risk premium, and a small cap premium, particularly when advising the target.

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[1] *Global GT LP v. Golden Telecom, Inc.,* 993 A.2d 497 (Del. Ch., C.A. No. 3698-VCS, Apr. 23, 2010). *Global* was an appraisal action involving a challenge by stockholders of the target, a Russian telecom company, to the fairness of the merger consideration.

[2] *Maric Capital Master Fund, Ltd. v. Plato Learning, Inc.* (Del. Ch., C.A. No. 5402-VCS, May 13, 2010). *Maric* involved a preliminary injunction against a merger proceeding pending corrective financial disclosure in the target's proxy statement.

[3] At the court proceeding, the financial advisor attempted to justify the higher range by reference to the WACC of "comparable" companies and the illiquidity of the target's stock. The court dismissed those arguments, holding that that reasoning was contradicted by the advisor's estimate of the target's WACC using a comparable companies approach. While doing so is not a foolproof defense, this illustrates another reason why financial advisors should characterize samples as "selected" rather than "comparable" companies or transactions. Ultimately, the court found that the disclosure in the proxy statement was inconsistent with the steps actually taken by the financial advisor and was materially misleading, particularly since it tended to make the acquisition look more attractive to target stockholders, and required supplemental disclosure.

- The *Global* court also offered instruction on the selection of inputs used to arrive at the company's WACC:
  - *Equity Risk Premium*. After surveying the academic debate regarding the most accurate calculation of the equity risk premium (ERP), the court refused to adopt the 7.1% "historic ERP" derived from the 2008 Ibbotson SBBI Valuation Yearbook and noted that current thinking puts the ERP closer to the 6.0% "supply-side ERP" contained in the 2007 Ibbotson Yearbook.
  - *Beta*. The court found no consensus in the literature to support using a "predictive" beta, such as the one calculated by MSCI Barra, rather than a historical beta. While the court reserved judgment on the use of predictive betas in the future, the court noted that the Barra model is proprietary and cannot be reverse-engineered and, therefore, cannot be fully explained or even understood, making it unreliable as a legal matter. Nonetheless, there may be reasons to deviate from the historical beta. One such reason is that, if a target is projected to become more stable and less leveraged over time, it will become less risky and its beta should revert to the industry mean. In *Global*, the court itself calculated the beta by giving 2/3 weight to the Bloomberg historical beta.

DISCLOSURE OF PROJECTIONS

- The decision in *Maric* also required the target's proxy statement to be amended to include free cash flow projections that had been prepared by the company's management and furnished to its financial advisor but not included among other projected financial data disclosed in the proxy statement. While the court cited the particular relevance of estimated future cash flow, the ruling underscores the general principle that material information, including projected financial results, must be disclosed in the proxy, particularly if shared by a company with its financial advisor or other third party.

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