Delaware Court of Chancery Provides Guidance Regarding Preparation and Use of Discounted Cash Flow Analysis

June 8, 2010

Two recent opinions from the Delaware Court of Chancery, both authored by Vice Chancellor Leo E. Strine, Jr., provide important guidance for the preparation and use of a discounted cash flow (DCF) analysis in appraisal and other merger-related proceedings.[1]

In *Global GT LP v. Golden Telecom, Inc., C.A. No. 3698-VCS (Del. Ch. April 23, 2010)*, shareholders successfully challenged the pre-merger value of a Russian telecommunications company, Golden Telecom, Inc., in an appraisal proceeding. The valuation experts for both the shareholders and the company each primarily relied on the DCF method of valuation but arrived at meaningfully different results: $139 per share (shareholder valuation expert) versus $88 per share (company valuation expert). Vice Chancellor Strine ultimately arrived at an appraised value of approximately $125 per share (Golden was originally purchased at $105 per share) after making determinations with respect to the key differences between the experts' competing DCF valuations. In particular, the Vice Chancellor made determinations with respect to the following key elements of the DCF:

- *Terminal Growth Rate* – Strine set the context for his review of the competing DCF analyses by observing that a fundamental component of any DCF analysis involves projecting future cash flow for a set period (e.g., five years) and, after that point, using a terminal value to predict a company's cash flow into perpetuity. Significantly, he indicated that the applicable inflation rate is "the floor for a terminal value estimate for a solidly profitable company that does not have an identifiable risk of insolvency." In rejecting the company's arguments, he stated that the assumption that the company would grow in perpetuity only at the rate of inflation was "unduly pessimistic" and further noted that the inflation rate was selected "with no rational basis." Ultimately, Strine adopted a terminal growth rate that reflected the average of both the Russian GDP and inflation rate in order to account for the possibility that the target company's growth rate could be close to or exceed the GDP

[1] The discounted cash flow analysis is a method used to value a company by calculating the present value of expected future cash flow. Generally, current forecasts are used to establish the cash flow for three to five years and a terminal growth rate (or terminal multiple) is used to predict the cash flow into perpetuity. The sum of the future cash flow of the current projections and the terminal value (i.e., value of all future cash flows beyond the date of projections) is then discounted to establish a present value for the cash flow. The discount rate, which is used to calculate the present value of cash flows, is typically based on the company's estimated weighted average cost of capital (blend of cost of equity and after-tax cost of debt). The determination of the cost of equity is most typically focused upon the equity risk premium (the expected return above a risk-free return rate) and the beta (market risk as a function of the premium an investor should receive for the risk associated with investing in equities versus riskless assets).

growth rate for a period of time and then settle closer to the inflation rate as the Russian telecommunications market matured.

- *Equity Risk Premium* – In order to establish the cost of equity for purposes of discounting the appraised company's future cash flows, Strine, as suggested by the shareholders' expert, selected an equity risk premium (ERP) of 6.0% based on the supply side ERP published in the 2007 Ibbotson Yearbook. In contrast, the company's expert contended that the historic ERP of 7.1% as published in the 2008 Ibbotson SBBI Valuation Yearbook (based on long-term historical data from 1926 through 2007) was appropriate. Although the historical ERP published in the Ibbotson SBBI Valuation Yearbook had previously been accepted by the Delaware Chancery Court, Strine ruled that the weight of published academic and professional opinion favors using the supply side ERP. The supply side rate uses the historical sample from 1926 but is also designed to take into account that the relationship between stocks and bonds observed in the past may not remain stable in the future.
- *Beta* – For purposes of establishing the discount rate, Strine selected a beta that gave 2/3 weight to the Bloomberg historic raw beta for the target company and 1/3 weight to the relevant industry's beta. The Vice Chancellor fully accepted neither the company expert's proposed reliance on historical beta alone nor the shareholder expert's proposed reliance on the so-called predictive beta from the financial consultancy MSCI Barra. Strine crafted his balance between historic and industry beta to account for the fact that the target company operates in a riskier, emerging high-growth market. Yet, he tempered the number to account for evidence that Russia is normalizing and that the target is a stable company that could eventually achieve a beta closer to its more mature, NASDAQ-traded peers. Although the court predominantly relied upon historic beta in *Global*, Strine reserved judgment on the use of the more predictive Barra beta technique in future cases. Strine noted that, unlike the supply side ERP, the Barra beta's reliability is not presently supported by the weight of any reliable professional or academic literature. He indicated "a more detailed and objective record of *how* the Barra beta works and *why* it is superior to other betas" would be required for the court to accept its application.

The *Global* opinion also provides additional guidance for litigating valuation in the appraisal context because the court did not defer to the merger price itself as an accurate indication of fair value. Although the merger price is a common factor in appraisal proceedings, the facts of the case suggested there was not a robust sale process. The court was also not influenced by the high percentage of stockholders that tendered their shares (or the low percentage of stockholders that brought a subsequent appraisal claim). Finally, the court took notice of the negative reaction by analysts and the market to the announced merger price in assessing the fair value of the target company.

In *Maric Capital Master Fund, Ltd. v. Plato Learning, Inc., C.A. No. 5402-VCS (Del. Ch. May 13, 2010)*, Vice Chancellor Strine temporarily enjoined a proposed merger because he concluded that the proxy statement was misleading with respect to its explanation of how a discount rate was selected. According to the proxy statement, the discount rate was based on the target company's weighted average cost of capital (WACC). Strine found that, however, the investment bank chose the disclosed range of 23–27% because: (1) the WACC of comparable companies was around 25%; (2) the target company's estimated WACC was about 23%; and (3) the investment bank thought it was appropriate to increase the upper end of the range since the target company was a micro-cap company with illiquid stock. As the court noted, the investment bank actually calculated two estimates of a WACC (one using a loose variation of the capital asset pricing model and one using a comparable company analysis) to generate discount rates of 22.6% and 22.5%. Accordingly, the "lofty" 23–27% range made the deal price appear more favorable to shareholders.

With respect to disclosure issues, Strine noted that the proxy statement omitted, for "some inexplicable reason," the free cash flow estimates made by the target company's management and provided to the investment bank. The court described a company's own best estimate of expected future cash flows as "clearly material information," while noting that Delaware courts have previously held staleness or other factors might render the information non-material in certain circumstances.

IMPLICATIONS

- Delaware courts can be expected to carefully examine whether valuation professionals used the most professionally accepted and credible practices when conducting financial analysis in connection with appraisals and other merger-related proceedings.
- While Vice Chancellor Strine did not explicitly state that the basis for the selection of the discount rate was material (or refer to any federal securities laws requirements in that regard), practitioners were, in the context of preparing a description of a financial analysis, reminded of the longstanding principle that once a proxy statement speaks to a subject, there is a duty to do so in a non-misleading fashion.
- Boilerplate descriptions are not sufficient when describing the DCF analysis but must be tailored to the actual analyses conducted and presented to a board or special committee.
- Where possible, growth rates should be industry and country specific. In the appraisal context, the assumption that a terminal growth rate will trail or match the rate of inflation may be subject to challenge.
- The actual merger price of a company may not always be an adequate indication of the fair value in the appraisal context, especially when a court questions whether a robust sale process took place.

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