Thought Leadership

Development and Application of Company Management-Prepared Projections in a Dissenting Shareholder Appraisal Action Context

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The proper usage of company management-prepared projections when applying the income approach—discounted cash flow method—is an ongoing issue for any valuation analyst, especially as it relates to shareholder appraisal rights actions. The Delaware Chancery Court regularly provides guidance as to the proper usage of management projections when applying the discounted cash flow method within a dissenting shareholder appraisal rights action. This discussion highlights several historical and recent Delaware Chancery Court decisions, and it provides insights into the valuation analyst's role in properly utilizing management projections when applying the income approach—discounted cash flow method—within a dissenting shareholder appraisal rights action.

Introduction

It has been said that, "In the simplest sense, the theory surrounding the value of an interest in a business depends on the future benefits that will accrue to its owner. The value of the business interest, then, depends upon an estimate of the future benefits and the required rate of return at which those future benefits are discounted back to present value as of the valuation date."[1]

As such, in valuing any business, the income approach—discounted cash flow method (DCF)—is fundamentally based on the calculation of a current (i.e., present) value of the business's anticipated future economic benefits, or earnings.

The two common components of the DCF method are as follows:

1. The estimation of future economic earnings
2. The estimation of an appropriate risk-adjusted required rate of return used to discount the estimated future economic earnings back to present value

While the estimation of each component is equally important in applying the DCF method, this discussion focuses on the development and use of company management-prepared projections as estimates of a company's future economic earnings. Specifically, this discussion considers the development and application of DCF projections within the context of a dissenting shareholder appraisal rights action ("appraisal action").

By definition, an appraisal right is a statutory remedy that is available in certain states to corporate minority stockholders who object to certain actions, such as mergers, taken by the corporation. The appraisal right provides an option to the dissenting shareholders that would require the corporation to repurchase the shareholders' stock at a price equivalent to the corporation's value immediately prior to the corporate action.

Generally, in an appraisal action the standard of value is fair value. Fair value is typically defined as the pro rata, business enterprise value that is not discounted for illiquidity or lack of control by the shareholder, but that takes into account all relevant factors known or ascertainable as of the valuation date, excluding any synergistic value.

The Delaware Court of Chancery (the "Chancery Court"), which decides on matters concerning shareholder equity claims, is generally viewed as the primary forum for ruling on dispute litigation involving matters related to shareholder dissent.

With its significant influence on valuation-related matters, attorneys and valuation analysts alike frequently look to the Chancery Court for guidance regarding the appropriate method to value business interests for appraisal actions.

The goals of this discussion are as follows:

1. To describe the role of projections within the income approach—discounted cash flow method
2. To review various company management projection-related issues that have been addressed by the Court in the recent past in regards to appraisal actions
3. To describe proposed steps the valuation analyst should take to ensure the appropriate treatment and reliance on company management-prepared projections in an appraisal action

The DCF Method and Company Management-Prepared Projections

Within the income approach, there are a number of generally accepted valuation methods, each fundamentally based on the premise that the value of an investment is a function of the economic income that will be generated by that investment over its expected life.

There are a number of methods that can be used to estimate value under this premise, most of which are based on the estimation of an investment's future economic earnings stream, and the application of an appropriate risk-adjusted, present value discount/capitalization rate.

The DCF method is a well-recognized method used to value companies on a going-concern basis. It has appeal because it directly incorporates the trade-off between risk and expected return, a critical component to the investment decision and value calculation process.

The DCF method provides an indication of value by:

1. estimating the future economic earnings of a business and
2. estimating an appropriate risk-adjusted required rate of return used to discount the estimated future economic earnings back to present value.

While there are many issues a valuation analyst should consider in developing a discount rate that reflects the related risk associated with the future company economic earnings (i.e., step two in the DCF method), this discussion focuses on the development and application of the projected future economic earnings utilized in the DCF method (i.e., step one in the DCF method).

In defining the estimated future economic earnings of a business, there are a number of common measurements, such as the following:

1. Dividends or partnership distributions
2. Net cash flow to equity or net cash flow to invested capital (i.e., total market value of company debt and equity)
3. Various accounting measures of income such as net income, net operating income, and numerous others

The valuation analyst's responsibility is to align the appropriate earnings measure to the subject of the valuation. Generally, if the subject of the valuation is the value of equity, then the appropriate earnings measure is net cash flow to equity. Similarly, if the subject of the valuation is the business enterprise, then the appropriate earnings measure is net cash flow to invested capital.

Once the valuation analyst determines the appropriate measure of economic earnings to apply in the DCF method, the next step is to estimate the estimated earnings over a defined future time period.

The judicially preferred method in estimating the future economic earnings of a business is to obtain from company management financial forecasts or projections of the company's profitability generated during the normal course of operations and utilized for general management planning purposes.

While it may seem unimportant, the simple labeling of the estimated future earnings of a business, as either a forecast or a projection, is a topic of discussion within the valuation industry.

As presented in *Understanding Business Valuation*[2] and *PPC's Guide to Business Valuations*,[3] the differentiation between a forecast and a projection is as follows:

1. Financial forecast. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's financial position, results of operations, and cash flows.

   A financial forecast is based on the responsible party's assumptions reflecting the conditions it expects to exist and the course of action it expects to take.

2. Financial projection. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows.

   A financial projection is sometimes prepared to present one or more hypothetical courses of action for evaluation, as in response to a question such as, "What would happen if . . . ?"

According to *Understanding Business Valuation* and *PPC's Guide to Business Valuations*, the valuation analyst should refer to the company management-prepared estimated future earnings as a financial forecast.

However, as mentioned, there exist differing points of view. For instance, as noted in *Valuing a Business*,[4] author Shannon Pratt prefers the term "projected" in defining the estimated future benefits of ownership of a business.

Similarly, as noted in *Financial Valuation Applications and Models*,[5] author James Hitchner applies the term "projections" to define estimated future cash flows or economic benefits.

PPC and Gary Trugman, author of *Understanding Business Valuation*, prefer to use the term "forecast" rather than "projection" based on the above definitions. For purposes of this discussion, the term "projection" will encompass all company management estimations of future cash flow, earnings, or benefits to be utilized in the income approach—discounted cash flow method.

Further, a valuation analyst typically should not use the term "forecast" unless he or she is prepared to be the "responsible party" for all of the financial information used to prepare the forecast.

A projection, however, generally means that the valuation analyst is utilizing data that has been provided by a third party (i.e., company management), and adjusted, if necessary, by the valuation analyst.

Shareholder Appraisal Right Actions—Use of and Reliance on Company Management-Prepared Projections as Proffered by the Delaware Chancery Court

As a large number of business entities within the Unites States are organized in the state of Delaware, the Chancery Court has become an influential voice in providing guidance related to business valuation issues. One of those valuation issues is the use of, and reliance on, management projections in shareholder dispute matters that utilize the DCF method.

There are several categories of shareholder disputes. Some of the common types include the following:

1. Dissenting shareholder appraisal rights (i.e., appraisal action)
2. Shareholder oppression
3. Minority shareholder "freeze-out"
4. Breach of noncompete agreements
5. Purchase/sale agreement dispute
6. Shareholder derivative action

This discussion focuses on the development and use of management projections when applying the DCF method in calculating an opinion of value within appraisal actions.

In an appraisal action, a minority shareholder has the right to object or dissent to certain extraordinary actions taken by the corporation, such as a merger. The appraisal remedy requires the corporation to repurchase the shareholder's stock at a price equivalent to the corporation's value immediately prior to the corporate action.

As documented in past opinions, the Chancery Court has demonstrated that the favored method in valuing a dissenting shareholder's stock is the DCF method. As opined in *Crescent/Mach I P'ship, L.P. v. Turner* and *Cede & Co. v. JRC Acquisition Corp.*, respectively:

> [T]he Court tends to favor the discounted cash flow method ("DCF"). As a practical matter, appraisal cases frequently center around the credibility and weight to be accorded the various projections for the DCF analysis.[6]
>
> In recent years, the DCF valuation methodology has featured prominently in this court because it "is the approach that merits the

> greatest confidence" within the financial community.[7]

It should be noted that according to valuation standards and practices, the valuation analyst should consider all available valuation approaches and methods when calculating the value of a dissenting shareholder's stock. Of course, the objective of using more than one valuation approach is to develop mutually supporting evidence as to the conclusion of value.

Prior to 1982, the so-called Delaware Block method was employed by the Chancery Court as the method of valuation in an appraisal hearing. The Delaware Block method entailed assigning specific weights to certain "elements of value," such as total assets, current market price, and company earnings.

The Chancery Court ultimately opined that the Delaware Block method was archaic and excluded other generally accepted valuation approaches and methods that were being utilized by the financial community and the courts.

In critiquing the previous Delaware Block method, the Chancery Court opined in *Weinberger v. UOP, Inc., et al.*:

> Accordingly, the standard "Delaware Block" or weighted average method of valuation . . . employed in appraisal and other stock valuation cases, shall no longer exclusively control such proceedings. We believe that a more liberal approach must include proof of value by any techniques or methods which are generally considered acceptable in the financial community and otherwise admissible. . . ."[8]

Nevertheless, while the valuation analyst should consider all available valuation approaches and methods, the DCF method is generally viewed by the court as the favored method in valuing a dissenting shareholder's stock, assuming the company can reasonably project performance beyond the next fiscal year.

To Adjust or Not to Adjust Company Management-Prepared Projections

The Chancery Court has a consistent history of preferring management-prepared projections of the subject company to any alternative projections. Therefore, any valuation analysis that does not incorporate company management-prepared projections, when available, is at risk of being rejected by the Chancery Court.

In many instances, the Chancery Court has rejected alternative financial projections that were created solely for litigation purposes.

". . . a valuation analyst can, and in many instances should, adjust management projections based on due diligence procedures."

As explained in *Agranoff v. Miller*:

> [C]ontemporary pre-merger management projections are particularly useful in the appraisal context because management projections, by definition, are not tainted by post-merger hindsight and are usually created by an impartial body. In stark contrast, post hoc, litigation-driven forecasts have an "untenably high" probability of containing "hindsight bias and other cognitive distortions." When management projections are made in the ordinary course of business, they are generally deemed reliable. Experts who then vary from management forecasts should proffer legitimate reasons for such variance.[9]

The Chancery Court has recently affirmed its opinion that management projections produced during the ordinary course of business will typically be deemed reliable.[10]

However, it is important to note that a valuation analyst can, and in many instances should, adjust management projections based on due diligence procedures. The Chancery Court simply explains that, in varying from management projections, the valuation analyst should provide legitimate and cogent reasons for the variation.

As opined by the Chancery Court in *Prescott Group Small Cap, L.P., et al., v. The Coleman Company, Inc.* and *In re Appraisal of the Orchard Enterprises, Inc.*, respectively:

> [Respondent's expert witness firm] has failed to "proffer legitimate reasons" to vary from the projections that management prepared and delivered to [the acquiring Company's] banks on January 31, 2000, and that were ascertainable on the merger date.[11]
>
> The fact that [Respondent] has not offered any straightforward explanation of why [Respondent's expert] alterations to his model in between the fairness opinion and the valuation report make any sense,

> coupled with the fact that these unexplained alterations had the effect of benefiting [Respondent's] litigation position, precludes me from finding [Respondent's expert] most recent NOL adjustments warranted.[12]

Therefore, the valuation analyst should provide compelling data in order to substantiate any normalization or other adjustments made to management projections used in an appraisal action.

Additionally, the Chancery Court expects the valuation analyst to perform appropriate due diligence in regard to management projections, regardless of whether they are adjusted by the valuation analyst.

Typically, the valuation analyst may review management-prepared financial projections and may confirm that the assumptions on which the financial projections are based are reasonable and appropriate.

As explained by the Chancery Court *In re John Q. Hammons Hotels Inc. Shareholder Litigation*:

> Generally, management projections made in the ordinary course of business are considered to be reliable. In this case, however, testimony at trial established that management's projections were not created in the ordinary course of business. [Plaintiff's expert], nonetheless, performed no independent analysis of the assumptions underlying management's projections and did nothing to determine whether those projections were prepared by management in the ordinary course of business.[13]

The Chancery Court has further opined a preference for contemporary management projections that benefit from being relied upon by independent third parties. Projections that are prepared for purposes of obtaining financing, or for fairness opinions in preparation of a potential merger, are viewed as independent and unbiased (e.g., non-litigation-driven).

As opined in *WaveDivision Holdings, LLC v. Millennium Digital Media Systems, LLC*:

> [Plaintiffs] Base Case projections that it provided to its lenders are the fairest representation of [the Company's] expectations in the record. . . . the Base Case projections provided to the bank provide a sound, conservative estimate of [Plaintiffs] expectations at the time of the breach. These estimates have the added benefit of having been relied upon by a party—the bank—with a strong interest in getting repaid.[14]

Therefore, based on guidance from the Chancery Court, management projections used in an appraisal action should be:

1. created by management or with management's in-depth input;
2. prepared as close to, but not subsequent to, the valuation date;
3. created in the ordinary course of business for general management planning or non-litigation-driven purposes;
4. fully supported and documented if adjusted by the valuation analyst; and
5. appropriately reviewed by the valuation analyst for reliability and reasonableness.

The Chancery Court has also expressed a preference for management projections that have been prepared for independent, third-party purposes, such as to obtain financing or for pre-merger fairness opinions.

Guidance from the Valuation Profession

It is intuitive that wholesale acceptance of management projections, when applying the DCF method in an appraisal action, eliminates the valuation analyst's objectivity.

If the data provided by management are naively accepted by the valuation analyst, then any conclusion of value may be tainted by management's lack of impartiality.

The Chancery Court has opined that, in applying the DCF method to a subject company involved in an appraisal action, the valuation analyst's due diligence process may include a detailed analysis of the assumptions on which management's projections are based.

As presented in *Understanding Business Valuation*, several general factors that the valuation analyst may consider in analyzing management projections include the following:

1. Company-specific factors
2. Economic conditions
3. Industry trends[15]

In looking at company-specific factors, *PPC's Guide to Business Valuations* suggests several company-specific assumptions related to management projections that the valuation analyst may examine, including the following:

1. Assumptions about revenue and receivables
2. Assumptions about cost of sales and inventory
3. Assumptions about other costs (such as selling, general, and administrative costs)
4. Assumptions about property and equipment, and related depreciation
5. Assumptions about debt and equity
6. Assumptions about income taxes[16]

While it is important that the valuation analyst vet the assumptions on which management projections are based, it is equally important that the valuation analyst document and justify any changes made to management-prepared projections.

Valuation profession best practices suggest that the analyst assess the reasonableness of management-prepared projections by considering if the projections are:

1. consistent with the company's growth prospects;
2. reasonable as compared to the company's historical financial results;
3. achievable based on the company's operating capacity and expected future capital expenditures;
4. reasonable as compared to the company's client and supplier projected financial results;
5. reasonable based on the industry's historical and projected financial results;
6. reasonable based on the expected future outlook of the regional, domestic, and international (if applicable) economy; and
7. extensively documented and justified if the projections are adjusted or revised by the valuation analyst.

Summary and Conclusion

The discounted cash flow method is fundamentally based on the calculation of a present value of a business's anticipated future economic earnings.

The Delaware Court of Chancery is generally regarded as an important forum for ruling on dispute litigation involving matters related to shareholder dissent. Of the several categories of shareholder disputes, this discussion focused on dissenting shareholder appraisal right actions.

In a shareholder appraisal action, a minority shareholder possesses the right to object to certain extraordinary actions taken by the corporation, such as a merger. The appraisal remedy requires the corporation to repurchase the shareholder's stock at a price equivalent to the corporation's value immediately prior to the corporate action.

"The Chancery Court has . . . expressed a preference for management projections that have been prepared for third-party purposes. . . ."

Typically in an appraisal action, the standard of value is fair value. Fair value is generally defined as the pro rata, business enterprise value that is not discounted for illiquidity or lack of control by the shareholder, but it does take into account all relevant factors known or ascertainable as of the valuation date, excluding any synergistic value.

Based on guidance from the Chancery Court, management projections used in an appraisal action should be:

1. created by management or created with management's extensive input;
2. prepared as close to, but not after, the valuation date;
3. created in the ordinary course of business for nonlitigation purposes;
4. fully supported if adjusted by the valuation analyst; and
5. examined for reasonableness by the valuation analyst.

The Chancery Court has additionally expressed a preference for management projections that have been prepared for third-party purposes, such as to obtain financing or for pre-merger fairness opinions.

Further, according to the valuation profession practices and procedures, management projections used in the DCF for purposes of an appraisal action should typically be consistent with the company's expected future growth prospects and reasonable in comparison to the company's historical operations. In order to ensure transparency, all adjustments to management's projections that were initiated by the valuation analyst should be adequately documented. Management projections should also be juxtaposed to the company's client and supplier projected financial results, the industry's historical and projected financial results, and the expected future outlook of the regional, domestic, and international economy.

By following these guidelines, the valuation analyst can avoid, or even eliminate, many of the issues involving management-prepared projections in an appraisal action.

Notes:

1. Shannon P. Pratt, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 56.
2. Gary Trugman, *Understanding Business Valuation*, 4th ed. (New York: American Institute of Certified Public Accountants, 2012), 237–38.
3. Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith, James H. Hitchner, Stanton L. Meltzer, Mark W. Wells, and Eric G. Lipnicky, PPC's *Guide to Business Valuations*, 22nd ed., (Fort Worth, TX: Thomson Reuters/PPC, 2012), 5–7.
4. Pratt, 57.
5. James R. Hitchner, *Financial Valuation Applications and Models*, 3d ed. (New York: John Wiley & Sons, 2011), 138.
6. Crescent/Mach I Partnership, L.P. v. Turner, No. Civ. A. 17455-VCN and 17711-VCN, 2007 WL 1342263, at *9 (Del. Ch. May 2, 2007).
7. Cede & Co. v. JRC Acquistion Corp., No. Civ.A. 18648-NC, 2004 WL 286963, at *2 (Del. Ch. Feb. 10, 2004).
8. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Ch. 1983).
9. Agranoff v. Miller, 791 A.2d 880, 892 (Del. Ch. 2001).
10. In re BJ's Wholesale Club, Inc. Shareholders Litigation, C.A. No. 6623-VCN 2013, WL 396202 (Del. Ch. Jan. 31, 2013).
11. Prescott Group Small Cap, L.P., et al. v. The Coleman Company, No. Civ. A. 17802, 2004 WL 2059515 (Del. Ch. Sep. 8, 2004).
12. In re Appraisal of the Orchard Enterprises, Inc., C.A. No. 5713-CS, 2012 WL 2923305 (Del. Ch. July 18, 2012).
13. In re John Q. Hammons Hotels Inc. Shareholder Litigation, No. 758-CC, 2011 WL 227634 (Del. Ch. Jan. 14, 2011).
14. WaveDivision Holdings, LLC, et al. v. Millennium Digital Media Services, LLC, et al., C.A. No. 2993-VCS, 2010 WL 3706624 (Del. Ch. Sep. 17, 2010).
15. Trugman, 239.
16. Fishman, 5–9.

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Discount Rates

Continued from page 40

The comparison of the WACC to the WARA allows the analyst to reconcile the rates of return required by providers of capital with the rates of return earned by the various classes of assets. Thus, the WARA calculation assists in assessing the reasonableness of the asset-specific returns for identified intangible assets and the implied (or calculated) return on goodwill.

For financial reporting purposes, goodwill is a residual value and the rate of return on goodwill is calculated as an implied rate of return. Within the context of the WARA, the rate of return on goodwill can be implied by reconciling the weighted average rates of return of all the identified assets to the WACC of the acquired company.

Summary

This interrelatedness of the WACC and the WARA within the context of a purchase price allocation is an important concept for the analyst performing a purchase price allocation valuation analysis. The failure to understand this relationship can lead to inaccurate estimates of value for the acquired assets.

The selected intangible asset rates of return utilized in the valuation of the subject intangible asset and the application of CACs should be reviewed for reasonableness through a WARA analysis.

Understanding the nature and risk of the expected cash flow (of the enterprise and specific assets) is important to ensuring consistency throughout the analysis.

Notes:

1. *Ibbotson SBBI 2012 Valuation Yearbook* (Chicago: Morningstar, 2012), 21.
2. Best Practices for Valuation in Financial Reporting: Intangible Asset Workgroup, *The Identification of Contributory Assets and the Calculation of Economics Rents* (Washington, DC: The Appraisal Foundation, 2009).

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