

Best Practices

Considering the Subject Industry in the Discounted Cash Flow Method for Dissenting Shareholder Appraisal Actions

Justin M. Nielsen

The consideration of the subject company's industry (the "subject industry") when applying the income approach—discounted cash flow method—is an important issue for the valuation analyst, specifically as it relates to shareholder appraisal rights actions. The Delaware Chancery Court regularly provides guidance as to the proper consideration of the subject industry when applying the discounted cash flow method within a dissenting shareholder appraisal rights action. This discussion highlights several recent Delaware Chancery Court decisions, and it provides insights into the analyst's role in properly addressing the subject industry when applying the income approach 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 (DCF) method—is based on the calculation of the current (i.e., present) value of the business' anticipated future economic benefits, or earnings.

There are two components of the DCF method:

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 earnings back to present value

While many independent factors influence the estimation of the subject company's future economic earnings and the appropriate risk-adjusted

required rate of return (i.e., discount rate), an often under-analyzed aspect regarding the completion of the DCF method is the subject industry. Specifically, consideration of the subject industry is appropriate in the application of the DCF method 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 compensate minority stockholders who object to certain actions taken by the corporation, such as mergers. 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 pro rata value immediately prior to the corporate action.

Generally, in an appraisal action, the standard of value is *fair value*, which is typically defined as the pro rata, business enterprise value that is not discounted for illiquidity or lack of control by the shareholder. Further, fair value takes into account all relevant factors known or ascertainable as of the valuation date, including the historical and current state of the subject industry, excluding any synergistic value.

The Delaware Court of Chancery (the “Court”), which decides on matters concerning shareholder equity claims, generally is viewed as an important forum for ruling on dispute litigation, including matters related to shareholder dissent. With its significant influence on valuation-related matters, attorneys and valuation analysts alike frequently look to the Court for guidance regarding the appropriate methodology to value business interests for appraisal actions.

This discussion describes the role of the subject industry within the income approach—DCF method, and specifically aligns the subject industry with (1) company management-prepared projections, and (2) the estimated long-term growth rate applied in the calculation of a subject company terminal value. This discussion considers several subject-industry-related issues that have been addressed by the Court in the recent past and reviews proposed steps the valuation analyst can perform to ensure the appropriate consideration of industry data in applying the DCF method in an appraisal action.

THE RELATIONSHIP BETWEEN THE DCF METHOD AND THE SUBJECT COMPANY INDUSTRY

Within the income approach, there are a number of generally accepted valuation methods, each based on the principle 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 earnings stream, and the application of an appropriate risk-adjusted, present value discount/capitalization rate.

The DCF method is 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 earnings of a business, and (2) estimating an appropriate, risk-adjusted required rate of return used to discount the estimated future earnings back to present value (i.e., discount rate). In applying the DCF method, many times the analyst will assume that the estimated economic earnings will eventually stabilize. This long-term stabilized benefits stream can then be capitalized into perpetuity and discounted back

to the valuation date. Generally, the value of the long-term stabilized benefits stream is labeled the terminal value (TV).

While there are many issues an analyst should consider to estimate the future earnings of a business and the appropriate discount rate to apply to the future earnings, it is important that the valuation address the subject industry when applying the DCF method. Specifically, the subject industry is integral in (1) assessing the reasonableness of company management-prepared projections, and (2) estimating the appropriate long-term growth rate used in the TV calculation.

A subject industry analysis can provide a useful portrait of how the company fits within an industry by providing a road map of where the industry has been, and where the industry is likely going. As presented in *Financial Valuation Applications and Models*, some questions that can assist the valuation analyst in developing a subject industry road map, which can be used in considering the subject industry when applying the DCF method, include the following:

1. What are the prospects for growth?
2. What are the industry’s dominant economic traits?
3. What competitive forces are at work in the industry and how strong are they?
4. What are the drivers of change in the industry and what effect will they have?
5. Which companies are in the strongest/weakest competitive positions?
6. What key factors will determine competitive success or failure?
7. How attractive is the industry in terms of its prospects for above-average profitability?
8. How large is the industry?
9. Is the industry dominated by a few large companies?
10. Are there many public companies in this industry?
11. How much merger and acquisition activity is occurring?
12. What are the barriers to entry?
13. Is it a regulated industry?
14. Who are the customers? Is that base growing?²

The analyst’s responsibility is to align the appropriate earnings measure and risk-adjusted discount rate with the subject industry historical, current,

and projected economic performance. The following section provides some common resources used within the valuation profession to obtain industry data and information.

Sources of Industry Information

There are many sources of industry information and data, including fee-based sources, trade associations, and free data and information resources. While it is not practical to list all available sources of industry data in this discussion, some of the more frequently referenced sources of industry data and information include the following:

1. Standard & Poor's Industry Surveys
2. IBISWorld Industry Reports
3. First Research Industry Profiles
4. MarketResearch.com
5. Risk Management Association Annual Statement Studies.

Some additional sources of industry data and information include the following:

1. Integra Information Benchmarking Data
2. Encyclopedia of Associations
3. National Trade and Professional Associations of the United States
4. Hoovers Company Database (Hoovers.com)
5. Factiva (factiva.com)
6. American Society of Association Executives
7. Various search engines or websites such as Google (google.com), *The Wall Street Journal* *MarketWatch* (marketwatch.com), and so on

APPRAISAL ACTIONS— CONSIDERATION OF THE SUBJECT INDUSTRY AS PROFFERED BY THE COURT

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

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

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

This discussion focuses on the proper consideration of the subject industry when applying the DCF method in calculating an opinion of value within an appraisal action.

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 several opinions, the Court has demonstrated that the favored method in valuing a dissenting shareholder’s stock interest is the DCF method. As opined in *Crescent/Mach I P’ship, L.P. v. Turner, Cede & Co. v. JRC Acquisition Corp.*, and *Andaloro v. PFPC Worldwide, Inc.*, 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.³

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.⁴

. . . noting that “[t]he DCF method is frequently used in this court” and that the method may be given “great, and sometimes even exclusive, weight when it may be used responsibly.”⁵

It should be noted, however, that generally accepted valuation practices and professional standards require an analyst to consider all available valuation approaches and methods when calculating the value of a dissenting shareholder’s stock. The objective of using more than one valuation approach is to develop mutually supporting evidence as to the conclusion of value. Standards, do, of course, emphasize the need to consider court precedents.



Prior to 1982, the “Delaware Block” was employed by the Court as the method to 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 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 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. . . .⁶

Nevertheless, while the 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.

Subject Industry Consideration within an Appraisal Action Context

The Court has a consistent history of addressing subject-industry-related issues within an appraisal action context, specifically the importance of analyzing the subject industry regarding (1) company management-prepared projections, and (2) the esti-

mation of the long-term growth rate applied in a TV calculation.

The following two sections highlight several recent Court opinions that address subject-industry-related issues within the context of an appraisal action.

Industry Consideration—Management Projections

Based on historical and recent opinions, the Court expects the analyst to perform appropriate due diligence regarding the subject industry, including as it relates to the reasonableness of management-prepared projections when applying the DCF method. The analyst should review management projections and confirm that the assumptions on which the projections are based are reasonable and appropriate given the historical, current, and future outlook of the subject industry.

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

In this case, it is undisputed that JQH operated in a very competitive *industry* [emphasis added]—the hotel business. JQH had no competitive advantages, such as brand names or proprietary technology. Worse still, a large portion of its portfolio is located in secondary and tertiary markets, which have lower barriers to entry than primary markets. Hotels in secondary and tertiary markets face significant competition because of the lower barriers to entry. . . . And JQH’s hotels were even subject to competition from their own franchisors in many of the markets where JQH operated. Dr. Kursh’s expert report failed to take into account some of these factors affecting JQH, and his report is significantly impaired as a result.⁷

The above decision highlights the fact that by neglecting to appropriately consider the subject industry, the analyst is at risk of having the Court dismiss the opinion of value entirely.

In explaining the decision to disallow the application of the income approach—DCF method in *Doft & Co., et al. v. Travelocity.com, Inc., et al.*, the Court relied on, in part, the state of the subject industry as testified to by Anwar Zakkour, Solomon Smith Barney’s managing director:

Q. Did Salomon Smith Barney prepare a discounted cash flow analysis of Travelocity in connection with this transaction?

A. Absolutely Not.

“. . . the valuation analyst should cross-reference a detailed analysis of the subject company with a broader view of the subject industry, specifically highlighting where the subject business may fall within the industry, and why.”

his conclusions, and his conclusion is within the range of rates identified by Respondent’s expert and appears to be reasonable based on the evidence, I adopt Bailey’s estimate of a 4.5% perpetuity growth rate.¹¹

As opined by the Court in the above appraisal action decisions, when applying the DCF method the state of the subject industry clearly should be considered (1) in assessing the reasonableness of company management-prepared projections, and (2) when estimating the appropriate long-term growth rate to be used in a TV calculation. Further, neglecting to appropriately consider the subject industry may lead to the Court dismissing the violating valuation analyst’s opinion in its entirety.

GUIDANCE FROM THE VALUATION INDUSTRY

It is intuitive that the value of a business is influenced by the operational efficiencies, products, and competitive advantage of the individual company within the context of the historical, current, and projected state of the subject industry. It is important that the analyst not be myopic in estimating the value of a business. Rather, the valuation analyst should cross-reference a detailed analysis of the subject company with a broader view of the subject industry, specifically highlighting where the subject business may fall within the industry, and why.

The Court has opined that, in applying the DCF method to a subject company involved in an appraisal action, the analyst’s due diligence process should include detailed consideration of the subject industry. As presented in *Understanding Business Valuation*, the general factors that the valuation analyst may consider in analyzing the subject industry include the following:

1. Who makes up the industry? Are there many companies or are there very few companies that control everything?
2. Is it a cyclical industry?

3. Is it a new industry with many new companies entering it, or is it a mature industry that has reached its saturation point?
4. What are the barriers to entry, if any, into the industry?
5. Is this a self-contained industry, or is it dependent on another industry?
6. Is the industry dependent on new technology? If so, is the appraisal subject keeping up with the industry?
7. Is the industry expected to change? If so, how will that affect the appraisal subject?
8. What is the forecast for growth within the industry?¹²

As further presented in *Understanding Business Valuation*, Trugman reproduces a list from the American Society of Appraisers (ASA) that presents industry factors that the analyst may consider in analyzing management projections within the context of the subject industry, such as the following:

1. Growth prospects for the subject company’s industry at the national and local level
2. Demand factors
3. Maturity of the industry
4. Structure of the industry and level of competition
5. Technological or economic obsolescence factors
6. Barriers to competitor entry¹³

It is important that the analyst vet the assumptions used in the DCF method to ensure they are reasonable as compared to the historical, current, and projected economic state of the subject industry.

To help ensure the industry data obtained is applicable to the subject company, the analyst should classify the business activities of the company. Two common methods used to classify businesses are the (1) Standard Industrial Classification (SIC) system, and the (2) North American Industrial Classification System (NAICS). Upon determining the appropriate classification of the subject company, the analyst can use the industry resources to obtain data and information for companies or industries in the same classification.

Therefore, valuation profession best practices indicate that the analyst appropriately consider the subject industry. Specifically, the analyst should ensure the company management-prepared projections and estimated long-term growth rate applied in a TV calculation are:

1. consistent with the industry's growth prospects;
2. reasonable as compared to the industry's historical financial results; and
3. achievable based on the industry's geography, and expected future outlook of the regional, domestic, and international (if applicable) economy within the industry's geographic outline.

It is important to also consider the geographic economic influences on the subject industry historical, current, and projected economic performance. Namely, the regional, national, and international (if applicable) economies can exert a direct impact on the subject industry economic performance. It is prudent for the analyst to consider and incorporate, as appropriate, geographic economic influences when analyzing the subject industry.

SUMMARY AND CONCLUSION

The DCF method is based on the calculation of a present value of a business's anticipated future earnings.

The Delaware Court of Chancery is generally regarded as a 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 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 pro rata value immediately prior to the corporate action.

The consideration of the subject industry, when applying the DCF method in a dissenting shareholder appraisal action, is an important step in the valuation process. Based on guidance from the Chancery Court, when applying the DCF method, the subject industry should be considered (1) in assessing the reasonableness of company management-prepared projections, and (2) when estimating the appropriate long-term growth rate to be used in a terminal value calculation. Neglecting to address the subject industry may lead to dismissal of the analyst's opinion in its entirety.

Consistent with valuation profession best practices, the valuation analyst should ensure that company management-prepared projections, and

the estimated long-term growth rate applied in a terminal value calculation, consider the Subject Industry's growth prospects, historical financial results, and economic geography.

Failure to (1) analyze whether the Subject Industry's growth prospects are consistent with company management-prepared projections, (2) compare the Subject Industry's historical financial results to company management-prepared projections, and (3) analyze the expected future outlook of the regional, domestic, and international (if applicable) economy within the Subject Industry's geographic reach can lead to the Court dismissing the valuation analyst opinion entirely.

By following these guidelines, the valuation analyst can maneuver through many of the issues involving the subject industry 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. James R. Hitchner, *Financial Valuation Applications and Models*, 3rd ed. (New York: John Wiley & Sons, 2011), 64–65.
3. Crescent/Mach I P'ship, L.P. v. Turner, 2007 WL 1342263, at *9 (Del. Ch. 2007).
4. Cede & Co. v. JRC Acquisition Corp., No. Civ.A. 18648-NC, 2004 WL 286963, at *2 (Del. Ch. Feb. 10, 2004).
5. Andaloro v. PFPC Worldwide, Inc., 2005 WL 2045640, at *9 (Del. Ch. Aug. 19, 2005).
6. Weinberger v. UOP, Inc., 457 A.2d 701 (Del. Ch. 1983)
7. In re John Q. Hammons Hotels Inc. Shareholder Litigation, No. 758-CC, 2011 WL 227634 (Del. Ch. Jan. 14, 2011).
8. Doft & Co., et al., v. Travelocity.com, Inc. et al., 2004 WL 1152338 (Del. Ch.)
9. Ibid.
10. Towerview, LLC, et al., v. Cox Radio, Inc., 2013 WL 3316186 (Del. Ch.)
11. Merion Capital, L.P., et al., v. 3M Cogent, Inc., 2013 WL 3793896 (Del. Ch.)
12. Gary Trugman, *Understanding Business Valuation*, 4th ed. (New York: American Institute of Certified Public Accountants, 2012), 246.
13. Ibid., 247.

Justin Nielsen is a manager in our Portland, Oregon, practice office. Justin can be reached at (503) 243-7515, or at jmnielsen@willamette.com.

