Trados and *Rural* Decisions Turn on Discounted Cash Flow Method Value

Given the potential liability for acquisition target board members and their advisors, and Court's heavy reliance on the DCFM, I thought it helpful to briefly review the cases and the Court's preferred application of the DCFM.

Two recent Delaware Court of Chancery cases have highlighted the importance of determining a going-concern value in a fairness opinion analysis. In both *In Re TRADOS Incorporated Shareholder Litigation* (*Trados*) and *In Re Rural Metro Corporation Stockholders Litigation* (*Rural*) the Court relied upon the discounted cash flow method (DCFM) to develop a going-concern value. In *Rural*, the Court found RBC Capital Markets, LLC liable for approximately $75.8 million for aiding and abetting breaches of fiduciary duty. In *Trados*, the DCFM helped the defendants demonstrate the plaintiffs' common stock had no value before the merger, and no liability was found or damages awarded. Given the potential liability for acquisition target board members and their advisors, and Court's heavy reliance on the DCFM, I thought it would be helpful to briefly review the cases and the Court's preferred application of the DCFM.

Trados

Trados develops language translation software and solutions for individuals and the enterprise market. Trados was a private company and raised funds through a number of preferred share offerings from 2000 through 2003. The preferred shares provided an 8% accruing dividend, board seats, and a liquidation preference in the event of a sale. Several of the preferred share series were also participating (i.e. they shared in the sale proceeds with the common shares after payment of the liquidation preference). The company's performance could be best described as ordinary, with the preferred share investors essentially looking to exit their investment with little to no gain.

Trados was purchased by SDL plc for $60 million in July of 2005. After payment of $7.8 million into a recently-created management incentive plan, the balance of the funds, $52.2 million went to satisfy the preferred shareholders' liquidation preference. The common shareholders received no consideration. The plaintiff in the case sought appraisal of his common shares the same month. Based upon his discovery in the appraisal action, the plaintiff also filed suit alleging the directors of *Trados* breached their duty of loyalty by approving the merger.

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Vice Chancellor Laster found that the standard of review was entire fairness. Ultimately, though, even applying the most stringent review standard, the Court found the price received by the common was fair and found no breach of duty or liability on the part of the directors.

The central issue in the case was the fair value of Trados as a going-concern, without consideration of the sale. Interestingly, the board did not seek a fairness opinion before the close of the transaction that might have shed light on this issue. At trial, the defendants were able to produce an expert whose analysis and testimony Vice Chancellor Laster found convincing. The

expert utilized a discounted cash flow analysis to value Trados as a going-concern.

Rural

Rural/Metro Corporation (Rural) provides ambulance and fire protection services in more than 400 communities across 20 US states. Rural traded on the NASDAQ exchange from 1993 until it was purchased by Warburg Pincus LLC (Warburg) on June 30, 2011 for $17.25 per share. RBC Capital Markets, LLC (RBC) acted as financial advisor to Rural on the transaction and was ultimately found guilty of aiding and abetting breaches of fiduciary duty by the Board.

Based upon my reading of the Court's opinion (also written by Vice Chancellor Laster), RBC seems to have been conflicted primarily by the lucrative fees available by also providing debt financing to: i) the buyer of Rural; and, ii) the buyer of Emergency Medical Services Corporation (EMS), Rural's primary competitor, which, coincidentally, was being sold at the same time.

From a valuation perspective, the case is important because the Court discards the stock market's opinion of value of Rural, saying it didn't reflect "Rural's prospects." The Court went on to say that a premium over the pre-announcement stock price "did not mean that the merger was the best value reasonably available or that the stockholders were not harmed by RBC's activities."

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Vice Chancellor Laster went on to say that the Board needed to maximize Rural's value over the long-term for the benefit of its stockholders. That meant seeking strategic alternatives that would yield a value *exceeding* what the corporation otherwise would generate for stockholders over the long-term. The Court and all parties agreed the best method for determining the going-concern value of Rural was the DCFM. Not surprising as the Court had already rejected the other best measure of going-concern value – the public share price.

The Chancery Court's Use of The Discounted Cash Flow Method

The discounted cash flow method values a company by adding together the present value of all future cash flows. In fact, the method is easiest to apply to cash flows from a bond, where the cash flows are very predictable and have a finite term. For companies that have variable annual cash flows and an indefinite life, application of the method is a little more difficult, but still possible. The DCFM gives no weight to historical earnings (other than the guidance they provide to predicting future cash flows) and is completely forward-looking. This makes sense, as the investor is only going to receive future cash flows.

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A DCFM is comprised primarily of three inputs: i) the cash flows generated over the projection period (usually three to five years); ii) the terminal or residual value of the company at the end of the projection period; and, iii) the discount rate (used to determine the present value of the projection period cash flows and residual value).

Source of the Projections
A very important input to the DCFM is the forecast of future cash flows, or the projections. Obviously, the larger the expected cash flows, the greater the value of the company, everything else being equal. Predictions of future cash flows, however, are almost never 100% accurate, even when developed by the most informed and unbiased analyst. However, this feature doesn't detract from the usefulness of the method, but does require some vetting of the source and the timing of the development of the forecast.

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The Court has been fairly consistent in saying the best source for the forecast is a management (versus expert) forecast prepared before the transaction in the ordinary course of business (*Gearreald v Just Care, Cede & Co. v. Technicolor, Inc., Muoio & Co. v. Hallmark, In Re Orchard Enters., Inc., In Re Rural Metro Stockholders Litigation*). The Court has also given weight to whether the projection was used in the proxy statement (*Global GT LP v. Golden Telecom. Inc.*). In *Cede & Co. v. Technicolor, Inc.*, Chancellor Chandler describes the Court's belief that "post hoc, litigation-driven forecasts have an untenably high probability of containing hindsight bias and other cognitive distortions." In general, I think the Court's bias is warranted provided the company has experience developing long-term forecasts and the forecast is used for internal purposes, not, for example, to raise equity financing.

Cash Flow Projection Period
Another issue that arises in applying the DCFM is the length of the projection period. The Court has demonstrated a very good understanding of the importance of the projection period as it relates to the terminal value assumptions. The important consideration is that the company be at a "normalized" growth rate at the end of the projection period. This is another way of saying the company shouldn't be in a strong growth phase where cash flows are growing at 10% or more annually. This is because the residual period value assumptions require the use of a growth rate that is sustainable *in perpetuity*. And if a company is growing at a rate above the economy as a whole, the implicit assumption is that it will *become* the whole economy over a *very* long period of time. I'll discuss this issue in more detail in the Residual Value Method section.

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The Court, in general, has accepted the projection period as presented in management projections prepared before the transaction (*Global GT LP v. Golden Telecom. Inc., Muoio & Co. v. Hallmark)*. But the Chancery Court has also allowed the extension of the forecast period in circumstances where the growth rate of the company has not reached a normalized state by the end of the projection period (*In Re Trados Inc. Shareholder Litigation, In Re Rural Metro Stockholders Litigation*). Chancellor Laster in the *Rural* case has the sagest advice saying "the technique of extending the projections deals with the valuation difficulties more forthrightly by making its assumptions explicitly and enabling them to be evaluated and tested."

Discount Rate Derivation Method
The Chancery Court has a fairly strong preference for the responsible use of the capital asset pricing model (CAPM) to develop the discount rate (*In Re Orchard Enters., Inc., In Re Rural Metro Stockholders Litigation, Del. Open MRI Radiology Assocs., P.A. v. Kessler, Cede & Co. v. JRC Acquisition Corp.*). An alternative method, called the build-up method, was discredited

by Chancellor Strine as "a method larded with subjectivity, and it incorporates elements that are not accepted by the mainstream of corporate finance scholars."

CAPM Inputs

CAPM calls for a number of inputs, each one requiring careful consideration. The equity risk premium (ERP) input represents the amount that the stock market is expected to return *above or in excess of* risk-free investments. This can be measured historically, or can be estimated for the future. The Court has accepted both historical and future estimates (*In re PNB Holding Co. S'holder Litig., In Re Rural Metro Stockholders Litigation*), but is now leaning towards the forecast equity risk premium as the better of the two (*Global GT LP v. Golden Telecom. Inc., In Re Orchard Enters. Inc., Merion v. 3M Cogent*). Discussing the issue at length in *Global GT* then Vice Chancellor Strine said "[a]lthough that data is far from perfect, it does reveal that the weight of academic thinking at our nation's finest finance departments places the ERP much nearer to" the estimated than the historical ERP.

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However, the Court seems to have more flexibility with regard to the determination and adjustments to the beta input to CAPM. Beta is a measure of risk and is the component that makes CAPM so appealing. By using beta, the model adjusts the required return of companies by their risk level. The market as a whole has a beta of 1.00. A low-risk, grocery store chain may have a beta of 0.60, while a biotechnology company with no approved products may have a beta of 2.00 or more. In the capital asset pricing model, the beta is multiplied by the ERP, so a high beta leads to a high discount rate. Low discount rates lead to high values, and vice versa, everything else being equal.

One of the issues with calculating betas is selecting the period over which to calculate them. Historically, betas were calculated over five years with observations every month. Over time however, shorter observation periods have become accepted with data examined every week (*In Re Rural Metro Stockholders Litigation, Merion v. 3M Cogent*).

The Court has also become quite sophisticated in its understanding of how the trading volume of a company's shares can impact its beta. Low trading volume tends to decouple a company's shares from overall market movements, which is really what beta measures (i.e., the company's risk level relative to the market). In *Rural* Vice Chancellor Laster stated "average weekly trading of . . . 1% [of shares outstanding] would justify a substantial presumption of market efficiency [and a meaningful beta].

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Residual Value Method

The residual value often represents the majority of the company's value in a discounted cash flow analysis as it represents the value of cash flows from the end of the discrete projection period to the end of time. It is not unusual for the residual value to represent over 90% of the total value in high-growth companies. In *Union III v Union Finl. Group* then Vice Chancellor Strine points out that in an expert's DCFM analysis 97% "of the value… was derived from the terminal value." Strine went on to reference *Gray v. Cytokine Pharmasciences, Inc.,* where it "was noted that the results of a DCF valuation must be regarded with great suspicion and given little weight when the terminal value accounts for over 75% of a DCF analysis." Although I don't

agree that the DCFM can't be used reliably when the residual value represents more than 75% of the total value, it certainly should cause the analyst to take great care in selecting the residual value method and inputs.

The Court has accepted (and there are generally only) two methods to determine the residual value – the Multiple Method and the Gordon Growth Model (*In Re Trados Inc. Shareholder Litigation, In Re Rural Metro Stockholders Litigation, Merion v. 3M Cogent, Gholl v. Emachines, Inc.*). The Multiple Method uses current multiples, such as the value of debt and equity, less cash, divided by earnings before interest, taxes, depreciation and amortization (EBITDA) derived from comparable companies in transactions, or trading on stock exchanges. This method has the benefit of being relatively straight-forward, but is often criticized because the analyst is applying multiples from today, to the company several years in the future. As we all know, the stock market is fickle, and what was fashionable yesterday, can be passé today. The Court seems more comfortable applying the Multiple Method when the actual sale of the company is expected to occur at the end of the forecast period (*In Re Trados Inc. Shareholder Litigation*).

Given the current litigious environment, target company boards should seek a thoughtful, well-documented, going-concern DCFM valuation from their fairness opinion provider.

The Gordon Growth Method (GGM) is most often used with more mature companies whose growth rate has slowed and stabilized, or at the end of long discrete projection periods (*In Re Trados Inc. Shareholder Litigation, Global GT LP v. Golden Telecom. Inc., Gearreald v Just Care, Muoio & Co. v. Hallmark, Merion v. 3M Cogent*). The GGM divides the cash flows expected at the end of the forecast by a capitalization rate (the discount rate less the long-term growth rate). Small changes in the discount rate and long-term growth rate can have a dramatic impact on the residual value, so these components are usually well-researched but can be contentious issues at trial. The long-term growth rate is usually determined by examining the expected rate of growth in the nominal (including inflation) gross domestic product of the US. Other rates have been accepted though. Some based upon the historical growth rate in the US economy since World War II, and some based on the rate of inflation (*In Re Trados Inc. Shareholder Litigation, Global GT LP v. Golden Telecom. Inc., Lane v. Cancer Treatment Ctrs. of Am., Inc.).*

Final Thoughts

Application of the DCFM within the context of an acquisition to demonstrate the going-concern value of a company is a relatively straight-forward proposition provided the opinion provider understands the perspective of the Delaware Court of Chancery. The Court, to its credit, has become quite sophisticated in evaluating the merits of the DCFM inputs. Given the current litigious environment, target company boards should seek a thoughtful, well-documented, going-concern DCFM valuation from their fairness opinion provider.

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