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Adoption Of Extended M&A Valuation Models Seems Unlikely

By **Nicholas Walter** (September 8, 2021, 5:32 PM EDT)

In a recent Law360 guest article, Bradford Cornell, a prominent valuation consultant, **suggests that courts conducting appraisals** of companies' stock should use extremely long-term projections — "25 years or more" — in discounted cash flow models.

To this litigator, who has some familiarity with appraisal law, Cornell's suggestion appears unworkable on its face. I am highly doubtful that any court would, or should, ever adopt such a proposal.

Cornell and his colleague, Richard Gerger, start by noting a common feature — they might say bug — of discounted cash flow models: They typically rely on three to five years of projections, which are forecast individually, and then assume that the company will grow at a steady rate, g , in a terminal period that stretches into perpetuity.



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Most, and sometimes all, of the company's value that is produced by the model can be ascribed to the terminal period. But isn't it unrealistic to assume that the company is growing constantly at g in 10, 15, 20 and 25 years' time? Wouldn't it therefore be better to forecast what the company's cash flows in those years will actually be?

The answer to the first question is, of course, "yes." The answer to the second is an emphatic "no."

Companies virtually never produce forecasts extending past five years, for good reason: They have little idea what the company is going to be looking like past that time — the very limited exceptions to this rule are companies that do in fact have cash flows that can be predicted to a reasonable degree of certainty, such as those making patent-protected drugs or that have stable long-term contracts.

So in any appraisal action using extended cash flow projections, the projections will come from the hired expert, not the company. This is already a yellow flag for those who value accuracy in modeling.

But suppose that a truly neutral expert, such as the court itself, were to embark on making the projections. That would not make things any better. For a start, how long should the extended forecast period last? In the Business Valuation Review article on which his Law360 piece is based, Cornell proposes an astonishing 70 years.[1]

Even adopting a marginally less impracticable 25-year projection period, it is still extremely difficult to project macroeconomic factors over this period, and projecting industry-specific factors is harder yet — projecting firm-specific factors is impossible, although the standard discounted cash flow model as used in appraisal actions, rightly or wrongly, ignores them.

For each year, the court would have to calculate various scenarios, based on its best guess as to the state of the world at that time, and then assign probability weights to those scenarios.[2] Each scenario from each year would have to take into account the scenarios from the previous year.

The result would be a model growing exponentially more complicated and unwieldy by the year,

generating thousands of values in the final year that would have to be probability-weighted and discounted back to the present — using yet more assumptions of discount rate, which would require even more probability weighting.

Let's assume, against all odds, that our judge can approximate the factors that will drive the growth of the subject company over the next several decades. This is something that might be beyond the ken of professional economists. But how can she decide how much weight to put on each scenario?

Should the judge assign a 60% chance to a flattening of the yield curve, a drop in population growth, and widespread adoption of nuclear fusion technology in two decades' time, or only a 40% chance? There's only one option: to cross-check the value produced by the extended-guesswork model against something else. Relying on such a model without a cross-check would be worse than literally reading tea leaves.

But here's the rub. The only thing that the judge can cross-check the 25-year-plus model against is another valuation produced by a less speculative method. Maybe it will be one of the approaches used in the traditional Delaware Block method — market value, asset value, earnings value.

Or maybe it will be a traditional cash flow model that only uses four years of projections and then applies a fixed growth value to the terminal period. In fact, in his Business Valuation Review article, Cornell takes exactly this latter approach. So the supposedly superior extended model, at bottom, relies on the other valuation technique it is meant to supplant.

If this were all, perhaps it wouldn't be so bad. The extended model would in the end produce results no different from the other, less speculative, valuation methods. The sole downsides would be an increase in litigation expenses — borne by the litigants, but ultimately savers and investors — and extra judicial effort. But the problem wouldn't stop there.

Humans conflate precision with accuracy, and trust a result that looks precise more than one that doesn't. For this reason, the original surveyors of Mount Everest, having calculated the height of the mountain after years of painstaking labor at 29,000 feet exactly, chose to add on another two feet — just so they would be believed.

It's easy to imagine a situation where an expert in an appraisal case produces a range of values using different methods, all somewhat close to each other but with the extended discounted cash flow as the highest or the lowest.

The expert could justify the extended cash flow as being close to the others, but could also urge the judge to adopt this supposedly more precise method as the final valuation — thereby getting a higher or lower result than he would otherwise.

But if Cornell's model obviously isn't workable, why should we be satisfied with discounted cash flow models that use perpetual growth rates after only short periods?

Are we really happy to say that the company's growth rate will be the precisely same in year seven as in year 27? No, because that's not the claim when using a discounted flow in an appraisal action. The claim of a perpetual growth rate applied following a three- to five-year projection period is that, on average, and taking into account factors such as the risk-free rate and long-term inflation, the company will grow at a certain speed.

We can adopt certain refinements: For example, perhaps we can taper the growth rate down over a period of years before adopting a steady-state rate. But that is often as accurate as long-term financial modeling of equity values can get. And, when used in conjunction with other valuation metrics, it is as precise as equity valuation in an appraisal should get, too.

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[1] Bradford Cornell & Richard Gerger, Is It Time To Terminate the Traditional Terminal Value?, 40 Business Valuation Review at 13, Winter 2021.

[2] *DFC Global Corp. v. Muirfield Value Partners, L.P.*, 172 A.3d 346, 380 (Del. 2017).

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