Trademark

Labor & Employment

Employment class actions

Discrimination

ERISA

Labor/management

Corporate

Antitrust

Bankruptcy appeals

Commercial contracts

Environmental

Insurance

Product liability

Real estate

Securities

Tax

• Tracking

Law Firms

Companies

Industries

Government Agencies

• News

Practice Areas

Appellate

Bankruptcy
Class Action
Commercial Contracts
Competition
Consumer Protection
Corporate
Employment
Environmental
Government Contracts
Insurance
Intellectual Property
International Trade
Mergers & Acquisitions
Privacy
Product Liability
Project Finance
Public Policy
Securities
Tax
White Collar

Industries
Aerospace & Defense
Automotive
Banking
Energy
Health
Hospitality
Life Sciences
Media & Entertainment
Private Equity
Real Estate
Technology

Regions
California
Florida
New Jersey
New York
Pennsylvania
Texas

Legal Industry

- Rankings
  FCPA Powerhouses
  Global 20
  Innovative Managing Partners
  Law360 400
  MVPs of the Year
  Most Feared Plaintiffs Firms
  Practice Groups of the Year
  Pro Bono Firms of the Year
  Rising Stars
  Top Female Trial Attorneys
Jobs

Overall

All cases

Advanced search

Key cases

Class actions

Public companies

Industries

Banking & finance

Consumer goods

Health

Hospitality

Life sciences

Media & entertainment

Oil & gas

Retail

Technology

Intellectual Property

Copyright

Patent

Trademark

Labor & Employment

Employment class actions

Discrimination
ERISA

Labor/management

Corporate

Antitrust

Bankruptcy appeals

Commercial contracts

Environmental

Insurance

Product liability

Real estate

Securities

Tax

Practice Areas

Appellate

Bankruptcy

Class Action

Commercial Contracts

Competition

Consumer Protection

Corporate

Employment

Environmental

Government Contracts

Insurance

Intellectual Property
International Trade
Mergers & Acquisitions
Privacy
Product Liability
Project Finance
Public Policy
Securities
Tax
White Collar

Industries

Aerospace & Defense
Automotive
Banking
Energy
Health
Hospitality
Life Sciences
Media & Entertainment
Private Equity
Real Estate
Technology

Regions

California
Florida
New Jersey
How Valuation Methods In M&A Litigation Are Evolving

Law360, New York (April 02, 2014, 1:07 PM ET) -- A recent study found that shareholders sue in 94 percent of merger and acquisition deals.[1] As a result, expertise in valuation methodologies has become increasingly important in civil cases. Key debates often hinge on the valuation methodologies used by experts to address materiality and damages. As such, it is critical for attorneys and experts to be aware of the latest professional and academic valuation literature to ensure that expert opinions follow commonly accepted
methodologies. Recent court rulings demonstrate the courts’ willingness to engage experts in their knowledge of the current understanding of key components of valuation methodologies, including:

- Estimating the equity risk premium,
- Using the buildup method, and
- Employing a small company premium.

We discuss the background and evolution of these components and their role in recent case decisions in the Delaware Court of Chancery. These examples suggest that other changes in economists’ current understanding of valuation may be at the forefront of future rulings.

**Equity Risk Premium: Background**

A central issue in any valuation model is accounting for the current value of future money, as measured by the “discount rate.” The equity risk premium is a key component of the discount rate. The ERP measures the incremental return demanded by investors to hold stocks instead of a risk-free asset, such as U.S. Treasuries.

In valuation, the ERP is often combined with a company’s exposure to market risk in order to compute a company-specific discount rate used to value the company’s cash flows. Given this key role, valuation models can be sensitive to the ERP that is employed, and as a result, the accuracy of the ERP can be a contentious issue.

Approaches to estimating the ERP have become increasingly complex as the academic literature has developed. In the 1960s and 1970s, economic modeling of the ERP generally ignored the possibility that market participants would demand a different level of the ERP over time. Correspondingly, economists typically estimated the ERP using long-run historical average returns. Seemingly following this approach, the Delaware Court of Chancery generally accepted valuations that relied on estimates of the ERP using the long-run averages reported by third parties such as Ibbotson Associates.[2]

As economic thought and modeling progressed, empirical evidence began to show that the ERP varied meaningfully over time.[3] The literature has recently buttressed this evidence with surveys capturing current market participants’ expectations of the ERP. This survey evidence also supports arguments in favor of variation in the ERP that differ from estimates based on simple long-run averages. Moreover, evidence began to mount that the time period used to calculate the ERP can substantially affect the estimate of the ERP.

For example, while stocks outperformed U.S. Treasuries in real terms by roughly 12 percent from 1946 through 1965, that outperformance declined to less than 2 percent from 1982 through 2004.[4] Likewise, research has shown that since the early 1800s, stocks outperformed long-term Treasury bonds by approximately 4.5 percent in real terms.[5]

These results have caused many to question whether estimates of the ERP based on returns data in the early 20th century are representative of what can be expected in the future — a key issue driving asset valuations today.[6]
Equity Risk Premium: Case Example

The academic debate over the size of the ERP was a key consideration in a case involving Golden Telecom.[7] The case was a typical appraisal proceeding in the Delaware Court of Chancery involving allegations that GT was undervalued in a merger. The petitioner’s expert argued for a share valuation of $139, while the defendant’s expert argued for a much lower value of $88 per share.

As Chief Justice Leo E. Strine Jr. (then vice chancellor) discussed in his opinion, a key difference between the two experts’ figures was their beliefs about the appropriate value of the ERP. Whereas the defendant’s expert relied on the Ibbotson historic ERP, which is based on historical returns data since 1926, the petitioner’s expert cited to the academic literature and surveys of professional forecasters in arguing that the expected future ERP at that time was approximately 6 percent, a figure roughly 1 percentage point lower than that derived by Ibbotson. [8]

Strine agreed with the petitioner and rejected the Ibbotson historic ERP, despite its prevalence in prior cases. This ruling appears to have set an important precedent in the Delaware Court of Chancery, which since then seems to have moved in favor of ERP estimates that are consistent with current academic literature.[9]

Buildup Method: Background

While experts use different methods to compute discount rates for valuation, not all are grounded in academic theory, and it is important that experts be aware of what methods are and are not supported by the literature. One of the most common methods that lacks academic support is known as the buildup method.

This approach arrives at a discount rate by adding together various so-called risk premia for each key characteristic of a company. Each premium is typically computed by taking a simple average of returns for the stocks of other companies with the corresponding characteristic.

Despite its use in litigation, the buildup method has been criticized as having several flaws. One issue is the potential double counting of risk premia. Another issue is that there is no consensus on which characteristics of a firm deserve a premium. This permits a great deal of subjectivity, as the expert is free to choose which premia to include. Finally, and most importantly, there is simply no peer-reviewed work to our knowledge that has studied the accuracy of the buildup method, or established a scientific protocol to follow when applying this method.

Buildup Method: Case Example

The lack of rigorous academic support for the buildup method makes it vulnerable to criticism. Indeed, a recent decision in the Delaware Court of Chancery regarding a merger appraisal dispute for the Orchard Enterprises Inc. highlights the importance of employing a methodology with academic support.

In forming his opinion, Strine ignored all analyses performed using the buildup method, concluding that “[t]he buildup model is a method larded with subjectivity, and it incorporates elements that are not accepted by the mainstream of corporate finance scholars.”[10] It remains to be seen to what extent this ruling will serve as a precedent for future cases, but at a minimum, this decision demonstrates the risk of employing an analysis that lacks academic support.
Small-Company Premium

Another component of valuation methodology likely to have important implications for litigation involving valuation relates to the ongoing debate over the existence of a small-company premium.

One of the most highly cited academic discoveries about asset prices made in the 1980s was that small companies’ stocks had systematically higher returns than would be predicted by their exposure to the market. This observation became one of the key building blocks in developing the Fama-French three-factor model.[11]

As a result, some academics believed that small companies’ stock returns could not be captured by their exposure to market returns alone, and a small company premium should be added to the cost of equity for small companies.[12] This approach of adding a small cap premium to the discount rate has been often used and accepted in the Delaware Court of Chancery.[13]

Several recent challenges to the existence of a small company premium, or a size premium, have furthered the debate. One of the most significant critiques is that the size premium is merely a construct of poor statistical methods, and when those methods are corrected, there is no evidence of a size premium.[14]

Another strand of literature has found that the size premium has disappeared since 1980.[15] Thus, even if a size premium does exist, its magnitude is likely to change over time, and as with the ERP, it may be inappropriate to use a simple historical average. Finally, others have argued that the size premium exists only for a few select firms, which calls into question whether the size premium should be applied to all small firms.

While, to our knowledge, this debate has not played out in the courts, it will be imperative for valuation experts to be fully aware of the debate and how these issues affect the analyses being performed.

—By David Marcus, Frank Schneider and Joseph B. Doyle, Cornerstone Research

David Marcus is a vice president, Frank Schneider is a senior manager and Joseph Doyle is an associate in the Boston office of Cornerstone Research.

Cornerstone Research was retained by counsel for the petitioner in the matter of Global GT LP v. Golden Telecom Inc., C.A. No. 3698-VCS (Del. Ch. Apr. 23, 2010).

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.


Related Articles

- Guidance On Discounted Cash Flow Analysis