CVPL
CAMPBELL VALUATION PARTNERS LIMITED

Business Valuation Commentary

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To Infinity and Beyond

Examining the Terminal Value Calculation

The discounted cash flow ('DCF') methodology is a favored valuation methodology, both in theory and in practice. The in-depth analysis and projections that accompany DCF financial models often contribute to a more comprehensive understanding of the risks and opportunities faced by a business and, accordingly, a more supportable value conclusion. However, given this added degree of complexity, errors within a DCF valuation model are not uncommon, even when they are prepared by an experienced financial professional.

The DCF methodology uses future cash flow projections and discounts them to arrive at a present value. A DCF valuation model typically includes two distinct forecast components:

1. an explicit forecast period (often extending over a period of 3 to 7 years), in which the periodic cash flows are discretely forecast; and
2. a terminal value[1] component, in which the value of all cash flows beyond this explicit forecast period are captured.

Common Structure of a DCF Forecast

	Explicit Forecast Period					Terminal Value
	Year 1	Year 2	Year 3	Year 4	Year 5	→
Present Value of Cash Flow	$10	$12	$14	$16	$18	$200
% of Total Value	*3.7%*	*4.4%*	*5.2%*	*5.9%*	*6.7%*	*74.1%*

As a practical matter, the terminal value component often accounts for the largest portion of value in a DCF model. It follows that mistakes made within the terminal value calculation often have a greater impact upon the final value conclusion. Accordingly, well founded analysis is important when developing the terminal value's inputs and assumptions. The graphs which follow[2] indicate the terminal value's relative contribution to the total present value of cash flows pursuant to various assumptions about the DCF model.

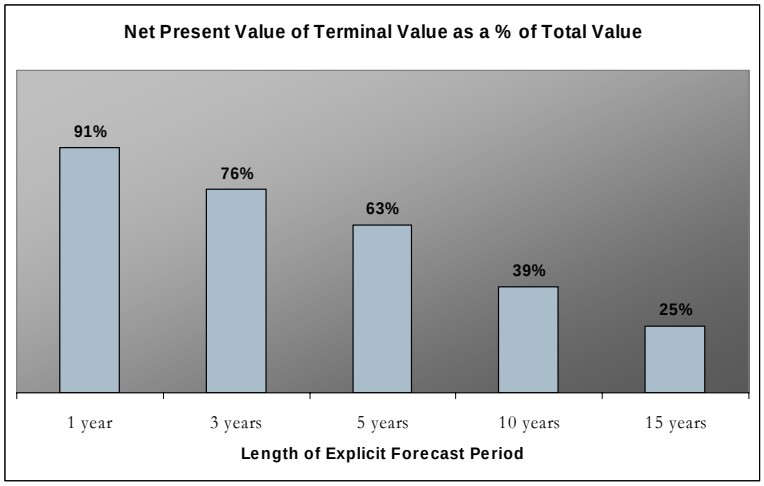
[1] This term is sometimes also referred to as the "post-forecast", "residual", or "continuing" value.

[2] Both graphs assume an explicit forecast period of 5-years length, with a 12% nominal discount rate, annual inflation of 2%, and no real growth (unless otherwise indicated).

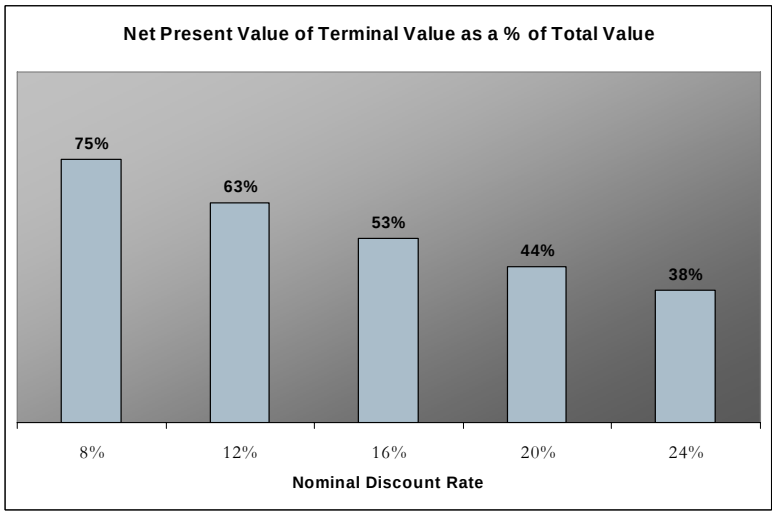
Limitations and Qualifications

This article is meant to encourage general best practices only and is not intended as a substitute for professional advice. Specific situations or circumstances may warrant alternative approaches.

In many companies there is little if any emphasis on long-term financial forecasting due to the inherent uncertainty associated with such forecasts and the impracticality of their use for operational planning purposes. In practice, very few financial forecasts exceed 5 years in length, and many tend to be 3 years or less. The absence of a reliable long-term financial forecast will place increased reliance upon the DCF model's terminal value estimate.

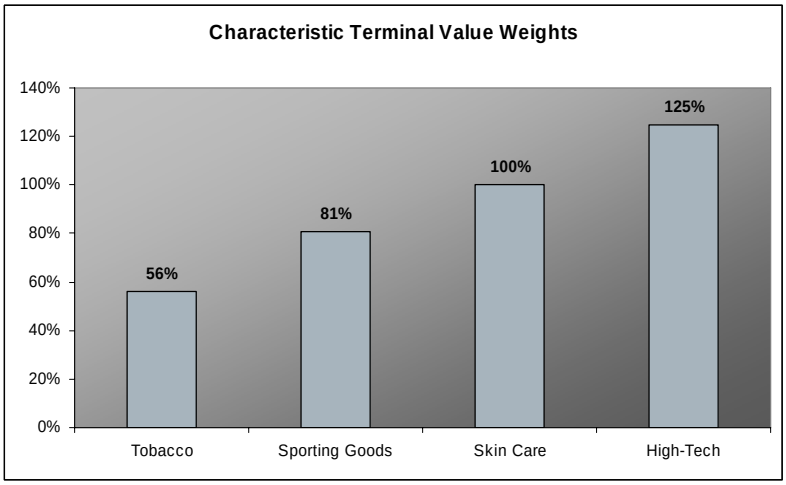


The risk inherent in an enterprise also influences the significance of the terminal value component. As the discount and capitalization rates applied to the cash flow forecast increase, the terminal value's relative contribution to the value conclusion decreases.



This makes intuitive sense, as the evaluation of relatively risky enterprises (e.g. software development startups or pharmaceutical research companies) often tends to place a heavier emphasis on the near-term financial performance of the company.

The unique risk profiles and forecast cash flow patterns of particular industries can also influence a terminal value's significance. Previous studies have determined the characteristic terminal value weights for some industries. For instance, tobacco industry participants tend to have terminal values which account for 56% of the total company value, in the sporting goods industry this figure is 81%, for a typical skin care business it is 100%, and for a high tech company the average is 125%.[3]



In light of these findings, it becomes clear that an accurate assessment of the DCF model's terminal value is of central importance. Small oversights and technical flaws in its calculation can result in a surprisingly material impact on the overall value conclusion. The remainder of this article will attempt to identify and briefly discuss some of the more frequent errors made in the derivation of a terminal value.

TERMINAL VALUE OVERVIEW

It would clearly be impractical to explicitly forecast a business' prospective cash flows year-by-year in perpetuity. Instead, practitioners usually apply a terminal value calculation which is representative of the value of all discretionary cash flows[4] expected to be generated after the explicit forecast period. In a typical DCF model the terminal value is determined through the use of a continuing value formula[5], in the form of:

$$V_n = \frac{D_{n+1}}{(R - i - g)}$$

Where:

V_n = Terminal value, n years from the present
D_{n+1} = Maintainable discretionary cash flow estimate, beginning one year after the explicit forecast period
R = Required nominal rate of return for investors
i = Expected rate of inflation
g = Real growth rate in discretionary cash flow

[3] Valuation: Measuring and Managing the Value of Companies (4th ed.): Koller, Goedhart, and Wessels (2005, p. 272). The weights were all calculated using a cash flow model horizon eight years into the future.

[4] This article will contemplate discretionary cash flows to the firm (see next section), although alternative approaches exist. Much of the content here will also be relevant when examining the alternative approaches.

[5] A continuing value formula determines the present value of a perpetual cash flow stream.

Pursuant to this formula, a maintainable discretionary cash flow estimate is divided (or "capitalized") by an appropriate capitalization rate. The rates of return used in a DCF analysis (both the discount and capitalization rates) and the discretionary cash flows to which they are applied are interrelated. A capitalization rate is reflective of the risk associated with achieving the maintainable discretionary cash flows projected within the terminal value determination, as well as the inflation and real growth expectations.

Given a maintainable discretionary cash flow that is receivable one year after the end of the explicit forecast period, and the assumption that the rate of real growth remains constant,[6] this formula solves for the present value of an infinite series of future cash flows (as at the end of the explicit forecast period). The value of this term is then further discounted (using the same rates applied within the explicit cash flow forecast) back to the valuation date.

Errors related to the terminal value can be broadly categorized by the three stages of terminal value calculation:

A. The calculation of maintainable discretionary cash flows (D_{n+1});

B. The calculation of the capitalization rate (R- i - g); and

C. Discounting the terminal value to the valuation date ($V_n/(1+R)^n$).

Remarks on terminal value errors have been grouped by the relevant stage (i.e. either A, B, or C above) in the pages that follow.

MAINTAINABLE DISCRETIONARY CASH FLOWS

Developing the maintainable discretionary cash flow estimate is one of the most difficult and time-consuming elements in preparing a terminal value estimate. It is also (arguably) the most likely of the three stages examined to contain an inappropriate assumption. In order to be satisfied regarding this estimates' reasonability, the valuation professional must develop a full understanding of the business' operations and marketplace opportunities.

Discretionary cash flows are defined herein as EBITDA (Earnings before Interest, Taxes, Depreciation and Amortization) less cash income taxes, capital investment requirements[7] and any incremental net trade working capital[8] necessary to generate the projected cash flows.

Discretionary Cash Flow Calculation

EBITDA	$150
Less:	
Cash income taxes	(55)
Capital investment requirements, net of tax shield	(35)
Incremental net trade working capital	(10)
Discretionary cash flow	$ 50

[6] Because the model simplistically assumes a constant growth rate, it is generally applied only once the company has matured to the point where it is anticipates stable (low-to-moderate) growth rates.

[7] Both sustaining and growth expenditures, net of their related CCA tax shields.

[8] Defined as the amount by which current assets related to the principal operating activities of the business exceed current liabilities that have arisen from the business' operating activities.

This definition of discretionary cash flow has been determined before debt servicing costs and, accordingly, the discounted value of the prospective discretionary cash flows and terminal value (together with certain adjustments to account for items not contained within the projections, such as the present value of existing tax pools) represent the 'enterprise value' of the business. Interest bearing debt and equivalents must then be deducted from enterprise value to arrive at the en bloc equity value of the business.

Some of the most common errors made in the estimation of a maintainable discretionary cash flow component are discussed below:

i) The maintainable EBITDA estimate is not reflective of prospective operating results

Prospective operating results are often derived from historical operating results. However, in certain circumstances it may be appropriate to adopt EBITDA levels not previously achieved where a potential for cash flow growth (or decline) exists. In particular, historical results may not be indicative of prospective operating cash flows where:

- there have been major changes in the industry, such as substantial consolidation of companies, the entrance of new competitors, or a significant change in consumer behavior;
- there have been significant changes in the business' principal operations, such as the addition or disposition of a major division, substantial changes in management personnel or philosophy, or a considerable capital (capacity) expansion; or
- the business operates in a cyclical industry and historical operating results are reflective of a 'peak' or 'trough' within this operating cycle.

Nevertheless, historic operating results are often an effective source of information from which to develop prospective operating results. When historical results are relied upon to assist in the estimation of prospective maintainable EBITDA, there must be reasonable assurance that historical results are reflective of future maintainable results.

When considering historical performance in the formulation of a maintainable discretionary cash flow, individuals will also sometimes fail to adjust the historic operating results to remove the impact of unusual, non-recurring and non-arm's length transactions. Examples of such adjustments may include instances where:

- owners of privately-held businesses draw compensation and benefits disproportionate to the time and effort they expend in the business. These excessive drawings are a form of return on investment. On the other hand, inappropriately low drawings contribute to a profit overstatement. Economic compensation for services performed must be segregated from return on investment. Accordingly, EBITDA should be adjusted up or down to reflect appropriate owner/management salaries;

- there are non-recurring items within the business' financial statements. This might include expenses relating to the launch of new product lines, capacity expansion, moving expenses, losses caused by labour problems, pension plan service liabilities, and so on. A thorough analysis and understanding of all income and expense items is essential when determining whether or not EBITDA needs to be adjusted;

- a business deals on a non-arm's length basis with other parties. In these cases it often is difficult to ascertain whether costs and revenues equivalent to arm's length costs and revenues are being paid and received. Where non-arm's length transactions are being consummated at non-commercial rates, cash flow (and possibly asset) adjustments may be necessary. These adjustments are particularly important in situations where the business interest on only one side of the non-commercial transaction is being valued. A skewing of the operating income to one organization or the other may result in erroneous value conclusions; and

- the business has cash flows related to its redundant assets. Because the net realizable value of redundant assets is added to the enterprise value of the business, it is assumed the prospective revenue and expense streams associated with these assets will terminate. The revenues and expenses relating to the redundant assets should be removed from historical results.

As absolute accuracy is not a reasonable expectation in this input, maintainable EBITDA is often expressed as a range which encompasses the spectrum of operating cash flow expectations.

ii) Income tax assumptions are not consistent with the prospective taxable income

Income taxes are deducted from EBITDA to determine operating after-tax cash flow. The tax rate utilized in this calculation is normally the effective corporate tax rate on active business income. However, where EBITDA does not approximate taxable income[9] before consideration of capital cost allowance[10] a more detailed income tax calculation may be required. For instance, estimated maintainable EBITDA may include certain items that are not fully deductible for income tax purposes (e.g. meals and entertainment expenses), or where there is a timing difference between an expense for financial accounting purposes and an allowable deduction for income tax purposes (e.g. warranty reserves).

It is also important that the income tax rate applied is appropriate to the business considered when determining terminal value. For example, the Canadian corporate income tax system provides for various situation-specific income tax rates, including tax reduction opportunities such as the 'Small Business Deduction' and the 'Manufacturing and Processing Profits Deduction'.

iii) Capital expenditures are not consistent with the prospective cash flow levels

The sustaining capital expenditure estimate represents the expected annual investment in fixed assets that a business must make to enable it to continue to generate the estimated maintainable EBITDA and projected growth. Estimating the appropriate level of sustaining capital reinvestment requires an understanding of the business' operations combined with thorough analysis of its historic and prospective capital and repair and maintenance spending in relation to its operating capacity. Although this task is an important (and often material) consideration in many valuations, errors will sometimes occur when an inappropriate capital expenditure estimate is adopted.

Determining the appropriate level of future capital reinvestment must be done on a basis that is internally consistent with the estimate of maintainable EBITDA and the capitalization rate. This generally requires the following:

- an analysis of past and prospective repair and maintenance expense. In this regard, note that privately owned businesses (which tend to be influenced by income tax minimization opportunities as opposed to enhancing earnings per share) are prone to expense what a public company (whose managers are driven in part to report enhanced earnings) is prone to capitalize;

- a review of past and prospective fixed asset additions and a segregation of the amounts between maintaining existing practical capacity and expenditures related to real growth in capacity. This process requires some insight where a specific capital expenditure combines elements of both replacement capital and incremental capacity expansion;

[9] The deductibility of interest payments for tax purposes is ignored at this point in order to present discretionary cash flows which reflect no bias regarding the firm's capital structure.

[10] Or 'CCA', being the term used in the Canadian Income Tax Act for depreciation and amortization allowed for income tax purposes.

- assessing industry trends in terms of capital spending. Where competitors are undertaking aggressive capital expansion programs, the business being valued may have to increase capital spending in order to maintain its market share and generate prospective EBITDA at the levels estimated;

- inquiring about the current condition and technology of the business' operating equipment, and prospective changes to that equipment; and

- discussing any necessary sustaining and growth capital investment with management and, where considered necessary, with industry equipment and related technology experts.

iv) Forecast capital expenditure and working capital requirements are inconsistent with real growth projections

Where the capitalization rate includes an element of real growth (that is, growth in excess of inflation), annual capital expenditures beyond those accrued to maintain existing EBITDA levels are likely required. Therefore, estimated annual capital requirements should reflect an amount for the capital acquisitions necessary to generate the anticipated real growth rate.

Any estimate of incremental capital requirements should also take into account factors such as practical capacity limitations of the existing facilities and equipment, when additional capacity will be required, and what the cost will be. It may also be prudent to review the fixed assets currently held within each CCA class and obtain an estimate of their remaining useful life and replacement cost.

Where the capitalization rate used in the terminal value formula reflects a real (i.e. net of inflation) weighted average cost of capital, an adjustment for annual net trade working capital normally is not required. This assumes that existing net trade working capital levels will only increase at the annual rate of inflation assumed within the determination of the capitalization rate.

However, where the capitalization rate considers an element of real growth in the post-forecast period some incremental net trade working capital is required to finance that growth. That portion of after-tax operating cash flow required to finance incremental net trade working capital requirements is not discretionary, and should be deducted from the determination of maintainable discretionary cash flow.

Capitalization Rates

A discount rate is used to convert a (finite) series of distinct forecast cash flows to their present value. This rate is applied to the cash flows within the explicit forecast period and the terminal value estimate in a DCF calculation. Conversely, a capitalization rate is used to convert a single, perpetually-recurring cash flow into a point estimate of its present value. The capitalization rate is applied to the maintainable discretionary cash flow estimate in the determination of terminal value. The inverse of the capitalization rate is referred to as the 'multiple'.

The capitalization rate (or rates) adopted should be reflective of a weighted average cost of capital[11] and must also be adjusted to reflect any real and inflationary growth expected above the level of maintainable discretionary cash flow chosen in the terminal value determination.

The capitalization rate formula can be expressed as:

Capitalization Rate = (Cost of Capital) - (Inflation) - (Real Growth)

The derivation of capitalization rates involves a significant degree of subjectivity, but there are a handful of areas which can be identified as sources of recurring errors. The most common problems noted in the derivation of this component are addressed below:

i) Mistakes in the application or calculation of the Cost of Capital

In some cases the cost of capital adopted is inappropriate given the type of maintainable discretionary cash flow being capitalized. For instance, where discretionary cash flows reflect the proceeds to all stakeholders in the firm, terminal values are sometimes mistakenly capitalized using only a cost of equity capital, resulting in a significant understatement of value.

Where maintainable discretionary cash flows have been determined before interest expense (as they have here), the capitalization rate should reflect a weighted average cost of capital ('WACC'). This is a rate of return on the blended capital of the business, including both its equity and debt components.

Mistakes in the calculation of WACC adopted within the terminal value are sometimes seen. One familiar formula for determining this WACC relies upon three independent pieces of information:

- the unlevered return on equity. This is the rate of return required by equity holders assuming no debt in the business. Stated another way, the unlevered return on equity is a function of the business' operating risks not its financial risk;

- the debt to equity ratio. This is the extent to which the capital structure of the business includes interest-bearing debt or other financial leverage.[12] The debt to equity ratio used in calculating WACC should be reflective of a long-term capital structure that is considered appropriate given the circumstances and prospects for both the business and the industry in which it competes. Note that this ratio should be determined using the market value of the equity (rather than its book value) and may differ from the existing debt to equity ratio of the business being valued; and

- the income tax rate. The tax rate used should be the marginal rate at which interest expense is deducted. When properly calculated, the WACC formula accounts for the tax deductibility of interest expense.

In most cases, the marginal income tax rate is readily determined, but the appropriate capital structure and the unlevered rate of return on equity will require careful analysis and judgment.

[11] Where maintainable discretionary cash flows have been determined before interest expense.

[12] Excluding trade payables and similar non-interest bearing trade or 'normal course' debt.

ii) The capitalization rate fails to make an appropriate adjustment for inflation

The maintainable discretionary cash flow estimate set out within the continuing value formula is unavoidably static. Hence, the estimate of ongoing cash flow will necessarily be expressed in real terms (i.e. net of inflation). The WACC component is often determined on a nominal basis for use as a discount rate within the explicit forecast cash flow period. In some instances the individual preparing the DCF model will forget to adjust the WACC calculation to remove the element of inflation, resulting in a potential understatement of the terminal value.

Adjusting the capitalization rate for inflation makes the assumption that a business is able to increase its prices to offset any reduction in currency value. It should be noted that this is not always the case - particularly in very competitive industries.

iii) The real growth assumption is not reflective of an ongoing, sustainable level

As above, the static cash flow estimate adopted will not reflect any future growth above and beyond the inflation rate (i.e. real growth). Where a modest level of continuing real growth can be expected, the capitalization rate should be adjusted accordingly.

However, in order to do this the explicit forecast period must be long enough such that the business reaches a 'stable state' of operations by the end of the period. The steady state concept anticipates that certain key financial attributes of the company hold in perpetuity. This is necessary because any continuing-value formula relies upon a handful of important assumptions in order to be effective. These assumptions include:

- the company earns constant margins, maintains a constant capital turnover, and, therefore, earns a constant return on existing invested capital;
- the company grows at a constant rate and invests the same proportion of its gross cash flow in its business each year; and
- the company earns a constant return on all new investments.

These can be difficult assumptions, particularly for firms anticipating significant near-term growth (e.g. start-up software) and firms within cyclical industries (e.g. pulp and paper). If any of these assumptions are found to be unreasonable, the terminal value estimate may result in an unrealistic forecast of the company's performance after the explicit cash flow forecast horizon.

Where near-term growth is expected to be high, with subsequently sustainable growth being maintained at modest (or non-existent) levels, it is generally preferable to extend the explicit forecast approach in contrast to adopting a capitalization of discretionary cash flow methodology which uses a 'blended' capitalization rate comprised of a high short term real growth component and a low (or non-existent) long term real growth component.

iv) Capitalization rates are derived from poor comparable data.

Public equity markets and capital transactions will sometimes provide a relative measure of corporate value by expressing price as a multiple of some financial metric, such as EBITDA or EBIT. These indications of value can sometimes be dissected using principles similar to those introduced herein in order to determine their underlying assumptions.

In some cases financial professionals will rely upon the data derived from public equity markets or transactions involving allegedly comparable businesses to provide an implied capitalization rate. This can be a hazardous approach as there are rarely two perfectly comparable organizations and sources of publicly-available information are often incomplete and clouded by peripheral factors (e.g. strategic purchaser premiums and minority interest discounts).

DETERMINING THE NPV OF THE TERMINAL VALUE ESTIMATE

Capitalizing an estimate of maintainable discretionary cash flow will produce the terminal value, which is representative of the value (as at the end of the explicit forecast period) of all post-forecast discretionary cash flows. The terminal value must then be adjusted to reflect its present value by discounting it at the same rate applied to the explicit cash flow forecast.

There are two common mistakes seen when discounting the terminal value to present value:

i) Failure to adjust for the inherent discounting effect of the continuing value formula

The present value of the terminal value estimate should be determined using a discount factor identical to the one applied to the last year of the explicit forecast period. This is because the capitalization rate inherently assumes a perpetual stream of discretionary cash flows beginning one year forward. That is, the act of capitalizing a cash flow effectively discounts that cash flow by one additional year. For example, if the explicit cash flow forecast is five years in length, followed an estimate of the maintainable discretionary cash flow (for the sixth year and thereafter), it would be appropriate to discount the resulting terminal value estimate by 5 years (assuming end-of-year cash flows).

ii) Failure to consider the intra-period timing of the prospective cash flows

The timing of a business' cash flows within each discrete forecast period needs to be considered when developing the discount factor, although in practice this is not always done.

There are two common methods for reflecting cash flow timing:

End-of-year payments – This method is applied when cash flows are received as a single payment at the end of a year. The terminal value estimate, along with the explicitly forecast cash flows, are discounted by a whole number which is representative of the distance (in years) from the valuation date. Alternatively, a payment that is due at the beginning of Year t may be treated as a payment due at the end of Year t-1. For example, payments due at the beginning of Year 2 and Year 3 will be treated as if they are due at the end of Year 1 and Year 2.

$$NPV = \frac{\text{Explicit Cash Flow}}{(1 + \text{Discount Rate})^1} + \frac{\text{Explicit Cash Flow}}{(1 + \text{Discount Rate})^2} + \frac{\text{Explicit Cash Flow}}{(1 + \text{Discount Rate})^3} + \frac{\text{Terminal Value}}{(1 + \text{Discount Rate})^3}$$

Mid-year payments – This method is applied when cash flows are received as a single payment mid-year or when payments occur at regular intervals throughout the year. The terminal value estimate, along with the explicitly forecast cash flows, are discounted by a number which is representative of the average distance from the valuation date (where t = 0.5, t+1 = 1.5, and so on). Where cash flows are received unevenly over the course of a year (and this pattern of distribution can be reasonably estimated) a more elaborate weighting process may be necessary.

$$NPV = \frac{\text{Explicit Cash Flow}}{(1 + \text{Discount Rate})^{0.5}} + \frac{\text{Explicit Cash Flow}}{(1 + \text{Discount Rate})^{1.5}} + \frac{\text{Explicit Cash Flow}}{(1 + \text{Discount Rate})^{2.5}} \frac{\text{Terminal Value}}{(1 + \text{Discount Rate})^{2.5}}$$

Conclusions

The preparation of a reasonable terminal value estimate is among the most challenging tasks within any DCF model. A cursory analysis of the business' operations or a technical mistake can result in a materially adverse impact on the value conclusion. Those who regularly rely upon or prepare valuations in the course of their profession would do well to familiarize themselves with the issues raised within this article.

It is my hope that this article will achieve two things. In the first instance I hope to increase the level of professional vigilance applied in the preparation and application of the terminal value component by drawing attention to its significance within a DCF valuation, and its inherent challenges. The onus is squarely on the professional to determine the fundamental reasonability of each assumption made within this calculation. This is no small task, and indeed should require in-depth analysis of both the business and the industry in which it operates.

Secondly, I have attempted to make this material accessible to the end users of an estimate of value, whether they be financially savvy individuals or otherwise. A better understanding of the various considerations which underlie a calculation of economic value will ultimately lead to more insightful contributions during the valuation process and an improved ability to assess the quality of the final product. An informed and knowledgeable client can only serve to improve the quality and efficiency of the valuation process.

About the Author

Chris is qualified as a Chartered Financial Analyst and Chartered Business Valuator in Canada. Chris' scope of experience includes providing valuation and related advisory services for buy/sell and related party transactions, fairness opinions, acquisition/divestiture mandates, shareholder disputes, and employee stock ownership/option plans. Early in his career, Chris has been called upon to give expert testimony at the Court of Queen's Bench, Alberta.

Chris holds an Honours Bachelor of Commerce with Distinction from McMaster University. He is currently pursing the Chartered Management Accountant designation and a Masters of Business Administration through Queen's University.

CAMPBELL VALUATION PARTNERS LIMITED

We have recently re-branded our firm and introduced a new logo. As our firm enters it's 30th year we are in the midst of introducing a new corporate website in 2006 which will still be found at www.cvpl.com. The updated website also highlights the company's new logo with stronger lines and brighter colors which integrates with our new subsidiary, Veracap Corporate Finance Limited.

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