Q. Can Mr. Coyne confirm that if short run growth forecasts cannot be relied on then mixing them with a long run growth rate in a multi-stage estimate simply reduces the bias but cannot remove it? If Mr. Coyne disagrees with this conclusion, please explain why in detail.

A. With regard to the use of the Constant Growth DCF model, the Corporate Finance textbook by Dr. Booth and Dr. Cleary indicates that the Gordon Growth form of the DCF was specifically designed for use in public utility regulation and is well suited for that purpose. The textbook states:

> *What has to be remembered is that Professor Gordon developed this model (the DDM) for use in public utility regulation where the allowed ROEs should be reasonable and we do not get the problem of rapid growth rates.*[1]

And

> *Although the DDM provides a great deal of insight into factors that affect the valuation of common shares, it is based on several assumptions that are not met by a large number of firms, especially in Canada.* ***In particular, it is best suited for companies that (1) pay dividends based on a stable dividend payout history that they want to maintain in the future; and (2) are growing at steady and sustainable rates. As such, the DDM works reasonably well for large corporations in mature industries with stable profits and an established dividend policy. In Canada, the banks and utility companies fit this profile, while in the United States, there are numerous NYSE-listed companies of this nature***.[2]

With regard to the Multi-Stage DCF model, according to Dr. Booth's Corporate Finance text, use of the two-stage DCF model mitigates concerns about analyst bias. The textbook states:

> *Finally, an important source of information regarding company growth, particularly for the near term, can be found in analyst estimates. Investors are often especially interested in "consensus" estimates, because market values reflect these estimates. However, a word of caution is in order: analysts have been shown to be biased—that is, they tend to be overly optimistic—in part because their major source of information is frequently the company itself. Research by Easton and Sommers has put the "optimism" bias in analysts' growth forecasts at an average of 2.84 percent.* ***As a result, analyst forecasts tend to be used with the two-stage growth model (discussed in the next section) to mitigate this optimism***.[3]

---

1 Laurence Booth and W. Sean Cleary, Introduction to Corporate Finance, 1st Edition (2008), at 785.
2 *Ibid*., at 269. [Emphasis added.]
3 Laurence D. Booth and W. Sean Cleary, Corporate Finance, 3rd Edition (2013), at 260. [Emphasis added.]