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**We Value Both Real Estate and Businesses
Including Machinery & Equipment**

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Discount and Capitalization Rates

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I was recently asked a question that required a great deal of consideration in order to answer it fairly and completely. The question was: "If a manufacturing business has EBITDA of about $3,000,000 what discount rate would you consider reasonable? I was thinking 20-25%."

This question is a tough one, since the discount or capitalization rate is tied directly to the risk associated with the likelihood of achieving the forecasted income stream expected to be received by the business. Without knowing a lot more about the business, any answer is likely to be a guess (and of course, no appraiser would ever simply guess!)

Included in the question are some clues – first, the business is a manufacturing business; second, it has Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) of about $3,000,000. There are numerous problems associated with answering the question correctly without simply making an "educated guess" based on a "typical" company.

Discount and capitalization rates used in most business valuation assignments are typically "built-up" using a risk free rate and some rates of returns for the public stock market as a base. Added to the base is a "specific company risk premium" incorporating the appraiser's opinion of the additional risks associated with the specific company being valued. Some considerations taken into account in this process are as follows:

1) Industry and economic risk;
2) Financial position of the company;
3) Level of diversification;
4) Depth and quality of management;
5) Competition;
6) Barrier to funds (difficulty for small businesses to borrow funds);
7) and Expected growth or decline of the business.

In my opinion, the most critical of these important factors is the "Expected growth or decline of the business." Inherent in this factor is the risk associated with the income forecast used in the appraisal. The income forecast may be prepared either by management or the appraiser. There are, of course, advantages and disadvantages inherent within this process, and these advantages and disadvantages vary depending on who prepares the forecast and the purpose of the appraisal. Sometimes when management, or others, have an ax to grind for any reason, the income forecast can be unrealistically high (often considered a hockey stick forecast, i.e. one that takes off for the moon!) or unrealistically pessimistic (i.e. the business will fail next week) depending on the motivations of the maker. The appraiser should adjust the discount or capitalization rate accordingly – if the income forecast is unrealistically high, the discount or capitalization rate should be increased; sometimes dramatically. Conversely, if the income forecast is too low, the discount or capitalization rate may be decreased accordingly. Often, the appraiser must prepare his or her own income forecast, or multiple forecasts to account for possible differences in outcomes

particularly when there are some large uncertain factors in play, for example, possible loss of a major customer. An income forecast can be done assuming retention of the major customer and another done assuming the relationship is lost – the value conclusions are then weighted according to the appraiser's opinion as to the likelihood of each scenario actually occurring. In this way, a major adjustment to the discount or capitalization rate can be avoided.

There is no easy solution to the problem of what should the discount or capitalization rate be. The following is taken from IRS Revenue Ruling 59-60 – often cited as the business appraiser "Bible":

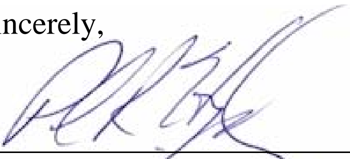
Sec. 6 Capitalization Rates. [Note: Also applied to Discount Rates]

In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization [or discount] rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization [or discount] rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization [or discount] rate in a particular case are: (1) the nature of the business; (2) the risk involved; and (3) the stability or irregularity of earnings [specifically forecasted earnings].

Again the question: "If a manufacturing business has EBITDA of about $3,000,000 what discount rate would you consider reasonable? I was thinking 20-25%." The correct answer is: It Depends! The only way to correctly answer the question is to do an appraisal in which all of the risks are explored and quantified. An asset approach and a market approach will also be prepared to support the income approach conclusion(s).

Valuations play a part in all strategic transactions, tax, and many litigation matters. For additional information or advice on a current situation, please do not hesitate to call. **We value real estate, businesses, and personal property including livestock and machinery & equipment.**

Sincerely,



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