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Editor's Column – WACCy Problems: When is the Use of a Weighted Average Cost of Capital (WACC) Appropriate?

Paul R. Hyde, EA, MCBA, ASA, BVAL

There are a number of methods available to business appraisers to compute the cost of capital when valuing a business. When valuing equity directly, many appraisers use some type of a build-up method to derive their discount or capitalization rate. When valuing equity indirectly, i.e. valuing investment capital, the appropriate rate to use is the Weighted Average Cost of Capital, often referred to as the WACC. Equity is typically valued indirectly when the subject business has an atypical capital structure and it is reasonable to expect that a willing buyer would change it.

In simple terms, the WACC is comprised of a cost of equity component and a cost of debt component. The weighted cost of each of these components at market value is combined to obtain the WACC. Inherent in the concept is the assumption that the equity owners of the business are not personally responsible for the debt nor are personal assets required to be pledged for the debt.

There is some debate as to whether or not it is appropriate to assume that a buyer would change the capital structure when valuing a company. I am not as concerned with this issue as I am about the size and strength of the company being valued. I believe that many appraisers are using the WACC inappropriately to value the investment capital of very small companies. Very small companies and small companies rarely have the ability to borrow funds without the owners pledging personal assets, often personal real estate, and providing a personal guarantee of the debt. If a personal guarantee and pledge of personal assets are required, does the debt component (which is lower than the cost of equity) really represent the actual cost of capital for that portion of the business's investment capital? No. In my opinion, the requirement of a personal guarantee and pledge of personal assets results in the same cost of capital as the equity component. Some might debate the issue if only a personal guarantee is required, however, what is the difference of borrowing funds personally and contributing them to the business as capital and borrowing funds in the business name and providing a personal guarantee of the debt?

If the real cost of the debt including personal guarantees and pledge of personal assets is not considered in the valuation of closely held businesses, I believe that we are often overvaluing the subject business.

The concept of the WACC and valuing investment capital or equity indirectly is theoretically sound and very appropriate when the business is large enough and strong enough to borrow funds from lending institutions without personal guarantees or pledge of personal assets. I believe this concept is very appropriate for use in valuing large privately owned businesses of the size often called "middle market" companies. Middle

market companies are those with annual revenues in the $20 million and up range, however, sometimes companies with smaller annual revenues are included in this category.

When valuing small and very small businesses, we must consider the cost of personal guarantees and pledge of personal assets. The equity in these smaller companies should be valued directly as the use of the WACC in valuing the equity indirectly will typically result in overvaluing them.

Paul R. Hyde, EA, MCBA, BVAL, ASA is the President of Hyde Business Properties and Valuations, Inc., a business and commercial real estate appraisal and business brokerage firm with offices in both Boise and Parma, Idaho. His firm is also a member of the National Business Valuation Group network.

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