



Rates

Over the next four months we will discuss different rates. As you may have noticed, business appraisal tends to give different means to the same term. An example is the term “discount”. In this piece, discount means a rate of return or what is expected to be earned. In a later piece, discount will mean just that, to discount or lower the value of an interest in the business. Those of you fearing that this will be an in-depth discussion in finance fear not. That is the purpose of finance text books.

Discount (rate of return)

The discount rate is simply the rate of return that is expected from an investment to induce an investor to invest based on risks associated with the investment. For example, if someone wanted you to invest \$100,000 in their business and you expected a return of 36%, the investment would have to earn \$36,000 for you to be enticed into the investment. Let us apply that to cash flow. You would take your \$36,000 cash flow (revenue stream) and divide it by 36%. The result would be a value (notice the term “value”) of \$100,000. In this example, since it was an investment, I used a rate that an investor (that would be me) would require.

But what about a fair market value appraisal in which, if you remember, is based on a hypothetical buyer. How do you arrive at a discount rate? Awe, this is one of those times the appraiser earns their keep. In past issues, I mentioned that the key to an appraisal is the appraiser’s ability to defend and support their opinion of value. You just can’t pull a discount rate out of thin air. There are several methods of determining the discount rate. The most common is known as the Build Up Method, which the formula for is provided below. The percentages are from an appraisal I performed with an effective date of December 31, 2005. All rates are based on a specific point in time.

<u>Description</u>	<u>Rate</u>	<u>Source(s) of Rate</u>
Risk-Free Rate of return	4.6%	20 year U.S. Treasury Bond rates
Large Company Equity Risk Premium	7.10%	Ibbotson
Small Company Risk Premium	5.80%	Ibbotson
Industry Specific Risk Premium	3.42%	Ibbotson
Specific Company Risk Premium	8.00%	Appraisers informed judgment

The first four items are set in stone (no pun intended) or considered facts that few can argue. It is the “appraisers informed judgment”, as you may have guessed, is the target of discrepancy. This is one area of the appraisal that will be argued if the appraisal is used in court. Based on the formula above, our discount rate is 29.00%. Remember this number as we will use this number next month when we discuss the capitalization rate.

This is a monthly business appraisal educational piece. The purpose for the educational series is to introduce, educate, and serve as a source of information. The information contained is current with federal laws and regulations at time of printing. Such information is subject to change. This should not be used as evidence or fact in a court of law.