



Rates

In the last issue, I asked you to remember the discount rate we had calculated, which was 29%. If you do not remember or did not receive the previous issue, call my office and my assistant will send you a copy. The reason I asked you to remember the discount rate is because we use the discount rate to figure the capitalization rate.

Capitalization (rate of return)

To determine the Capitalization Rate, you simply subtract the projected growth rate from the discount rate. Sounds simple? There is more involved in the growth rate than meets the eye. As I mentioned in the last issue, the Specific Company Risk Premium is an area that can and is contested in court. Reason, is that it is largely based on the opinion and experience of the appraiser. The growth rate has the same potential. The appraiser must be able to support and defend the projected growth rate. It is not simply a matter of taking managements word that the growth rate is achievable and sustainable. Can you imagine cross examining an appraiser who said they took the word of management. Have fun! But I digress. Why is the growth rate subtracted from the discount rate to arrive at the capitalization rate? If it were not subtracted, the growth rate would be overstated. Let's pause for a moment and stop the spinning in our heads. (Pause) When we multiplied the future revenue stream by the discount rate, we calculated the present value of a future revenue stream that presumably had the growth rate included. The capitalization rate is divided into a future revenue stream (presumably, the future revenue stream has been adjusted for growth). If the growth rate was not subtracted from the discount rate to arrive at the capitalization rate, the growth rate would be overstated as it would be included in both the capitalization rate and the future revenue stream.

When should you use the discount rate as opposed to the capitalization rate? You would use the discount rate when the growth rate is not expected to be constant. The discount rate is applied to the projected future cash flow to determine the present value. In the term year, it is assumed that the growth rate would become constant. At this time, you would take the term year projected cash flow and apply the capitalization rate. The figures from each year are added together to calculate the value.

When the growth rate is expected to be constant and remain constant, either the discount or capitalization rate can be used. In theory, the same value should be achieved. It is common practice to use the capitalization rate when the growth rate is projected to be constant as it is easier for the readers of the appraisal report to understand.

It is possible to determine the capitalization rate from the market as opposed to the build-up method that we have explained. This process will be explained in a latter edition.

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.