



Matching Revenue Stream with Cost of Capital

We have discussed three rates of returns in past issues. Those rates are: discount rate, capitalization rate, and the weighted average cost of capital. Our discussion will not get into which rate to use, or the process of how we decide which rate to use. That discussion is outside of the scope of this month's discussion. For the purpose of keeping things simple, our discussion will only take into account the cost of capital based on the Build-up Method. I encourage you to refer to previous education piece(s) to refresh yourself on the Build-up Method.

Our next step is to apply our rate of return to our revenue stream. This is an area that is vulnerable to error. It is incorrect to take the cost of capital from the Build-up Method and divide it into EBIT (earnings before interest and taxes). This cost of capital is based on net cash flow. At this time, I encourage you to review past issues on net cash flow to equity and net cash flow to invested capital.

The revenue stream of "net cash flow" is different than EBIT and EBITDA, as well as many others. You can not simply take the cost of capital, arrived at by the Build-up Method, and apply it to any revenue stream. In using the Build-up Method, to arrive at the cost of capital, we are using public information that is based on net cash flow. Therefore, the cost of capital needs to be adjusted to match or reflect the revenue stream.

The cost of capital should reflect the amount of risk associated with the revenue stream. A different risk is associated with each revenue stream. The most obvious example would be a revenue stream that is based on tangible and intangible assets. A revenue stream that is tied to tangible assets has less risk than a revenue stream tied to intangible assets. Therefore, the cost of capital used in the Excess Earnings Method, should not be the same cost of capital used in the Single Period Capitalization Method or Multiple Period Discounting Method. This example is comparing two different methods with different risks associated with the revenue stream. The adjustment is not based on the method; rather it is based on risks associated with a particular revenue stream.

There are several different ways that an appraiser can go about adjusting the cost of capital to match or reflect the risk associated with a given revenue stream. Unfortunately, we will not cover those methods this month. What do you expect; I need to create suspense in order to increase readership.

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