



## Demystifying the Discount Rate

As business valuation experts, we talk a lot about discount rates. But what are they? And how do we arrive at them?

According to the American Society of Appraisers, the discount rate is the “rate of return used to convert a future monetary sum into present value.” In other words, a discount rate recognizes that a dollar today is worth more than a dollar tomorrow. A discount rate may be thought of as an interest rate, opportunity cost or the cost of capital.

In business valuation practices, the discount rate is how we account for risk. The higher the risk, the higher the discount rate. All business valuation efforts ultimately try to measure value by assessing the expected potential benefits of ownership relative to the associated risks involved.

### Building a Discount Rate

Discount rates for business valuations are often built using a relatively standard formula, starting with a risk-free rate of return based on the yield of long-term U.S. Treasury bonds. An equity risk premium is then added to reflect the additional risk of an equity investment over a risk-free instrument — a number derived from publicly traded securities data.

An adjustment is then taken to convert historical returns to an expected future rate of return on the business (see sidebar). At this point in the calculation, the discount rate equals the expected market return based on the S&P 500. That number is then adjusted to reflect various other risk factors:

**Size:** The risk premium for size is determined by examining data from companies in the tenth decile of the major exchanges. Since most of these publicly traded companies are much larger than a closely held businesses, a further rate adjustment is often taken to reflect a smaller size. Smaller size generally means more risk.

**Industry:** The industry risk adjustment, again based on data from publicly traded securities, can be positive or negative. In highly stable situations, the industry may be considered a plus.

For example, metal mining, agricultural production and food manufacturing are among industries that are historically considered lower risk. More volatile industries — or those with less established markets — involve more risk, and therefore would add a premium to the discount rate.

*Company-Specific Risks:* Many factors contribute to company-specific risks — management depth, competition, customer relationships, service specialization, government regulation and labor relations, to name just a few. Valuation experts examine these specific risks relative to the risks of the market in general. Some of these factors add a premium to the discount rate, while others adjust it downward.

Once all of these premiums and adjustments are accounted for, the resulting number equals the rate of return required by the hypothetical investor. This is the discount rate used to assess the value of a given business.

As much as business valuation experts try to eliminate subjectivity from the equation, arriving at an appropriate discount rate obviously involves a fair amount of judgment. To ensure the most accurate discount rate, valuation professionals are careful to avoid “double counting” of risks in various categories and always use the most current data available.

*If you would like more information about discount rates, please contact our valuation experts today.*

#### **Expected vs. Historical Rates of Return**

Valuation theory is constantly being refined. One recent development involves the question of how to compare the forward-looking, long-term sustainable equity return to historical returns. Current thinking is that the forward-looking or expected rate of return is less than the historical average rate of return by a factor of approximately 1.25 percent.