CAN YOU DEFEND YOUR CAP RATE?

By: George Hawkins, ASA, ABV, CFA

Introduction. Attorneys often review business valuations which employ the capitalization method where the earnings or net cash flow of the business are divided by a “capitalization rate” (cap rate) to arrive at a value estimate. The cap rate has a crucial impact on the total value, so it is essential to assess its reasonableness, regardless of whether the valuation is for estate planning, the review of a challenge by the IRS, for equitable distribution, or the sale of a client’s business. This is admittedly a dry but essential topic, so please drink caffeine if needed to see the article through, as you will be rewarded with useful knowledge of the subject.

The focus of this article. This article explains the elements of a cap rate and provides examples of factors entering into its determination. The article’s goals are to provide a better understanding of capitalization rates and how they are developed, identify problems or inconsistencies, and to distinguish professional valuations from those that are poorly prepared. It begins with an overview of where the capitalization method fits within the spectrum of the income valuation approach, followed by an explanation of the two key elements of (1) risk and (2) growth and how they are used to develop the all-important capitalization rate. Finally, the article shows how to use this knowledge to effectively assess the rate’s reasonableness by focusing separately on these two parts. This strategy will then be employed in an analysis of a valuation by the capitalization method of ABC Wholesale, a distributor of the Chug-em brand of beer in Collegeville, a university town.

Introduction to the income approach- necessary to understand a cap rate. To understand the capitalization rate and its reasonableness it is first necessary to more generally understand the income approach overall. Next, the nuts and bolts of critiquing the cap rate will be explained.

The income approach category includes several methods: (1) the capitalization method (e.g., of earnings, net cash flow, dividends, among others) and (2) the discounted future benefits method (e.g., of earnings, net cash flow, among others). The following sections provide a very brief overview of these methods within the income approach that are available. This article focuses on the capitalization method where the capitalization rate comes into play.

Capitalization method overview. The capitalization method estimates value by conversion of a company’s estimated future income stream into value. This is accomplished through application of an appropriate capitalization rate that incorporates both (1) an investor’s required annual rate of return for risk (a discount rate, or d) and (2) a factor for future sustainable annual growth rate (or g) in income (whether it be in the form of earnings, net cash flow, dividends, etc.). The result is that value is ultimately based on the present worth, in today’s dollars at the valuation date, of the anticipated future benefits the buyer believes her or she will receive. Simply put, the capitalization of an income...
**CAP RATE (continued)**

Benefit stream is a “single period” valuation method that employs the formula in Table 1:

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Capitalization Method Formula</th>
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</thead>
<tbody>
<tr>
<td>Value =</td>
<td>Income Stream ( (d-g) )</td>
</tr>
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</table>

Where:
- \( d \) = Discount rate - the required annual rate of return for risk
- \( g \) = Long-term sustainable annual growth rate in the income stream

In short, the “d-g” component in Table 1 is called the capitalization rate (or cap rate), determined by subtracting the estimated long term annual growth rate of income from the rate of return for risk required for that income. The capitalization method simply says that value is a function of the elements of a company’s income, the risk associated with that income (i.e., that it might not materialize as expected), and the income’s expected rate of future growth.

**Discounted future benefits method**-
In contrast to the capitalization method, the discounted future benefits (income) method separates the valuation into two pieces: (1) the valuation impact of the first part is captured by use of annual year-by-year forecasts, and (2) once earnings or cash flows are expected to stabilize to a mature long-term pattern, the method employs a capitalization method component in the final so-called terminal year. The results of the two are then combined to give an overall value estimate.

The discounted future benefits method involves projecting the possible future income streams (e.g., net earnings, net cash flow) on a year-by-year basis, usually for five or seven years. Future income streams during this forecast period are then discounted back to present value at the valuation date at an appropriate discount rate (required rate of return on investment for risk required by a buyer). At the final projection year, a “terminal value” is determined. This terminal value represents the capitalized value of the future earnings or net cash flow of the company from the final forecast year and forward. This final forecast year is when it is assumed that the company’s growth has achieved a more or less steady, or mature and sustainable rate. This terminal value is then discounted back (at the discount rate for risk) to its present value at the valuation date. The summation of the present value of both the (1) income streams and (2) the terminal value yields a fair market value estimate of the company.

Table 2 shows the generalized formula description of the discounted future benefits method. The formula shows the indicated value to be the sum of the present values of the annual income streams and the capitalized future “terminal value” of the company.

A key point- when a company is at a mature growth rate-
If a company’s earnings or cash flows are growing at a constant or more or less steady state rate, the discounted future benefits method does not need to be employed, as the formula is then mathematically equivalent to the results achieved by the capitalization method discussed earlier.

When near-term growth is expected to be supernormal-
When a company is experiencing a faster near term rate of growth that is above a sustainable long term trend or where there are cyclical or unusual near term factors that are influencing results (and which can be reasonably predicted), the discounted future benefits method can more reliably capture the valuation impacts than a capitalization method.

Understanding the “value” of future income is essential to grasping the cap rate’s meaning. As
shown, there are two techniques to value the anticipated future income from an investment, (1) the discounted future benefits and (2) capitalization methods. Central to both is the key concept that they are based on determining the present value of anticipated future income streams (the buyer’s source of return on his or her initial investment to buy a company), a key element that must be grasped before understanding how a capitalization rate works.

An example using the capitalization method. A simple example demonstrates how the method results in a value estimate. Suppose XYZ Company had annual net income (earnings) for year 20XX of $1,000,000. Furthermore, net income is expected to grow long-term at the inflation rate (2.5%) plus 3.5% annually, or 6% (the “g”, or annual growth rate). After a full analysis of the business, the industry and other factors, the valuator has estimated the annual rate of return required by a buyer for the risk associated with the expected income stream to be 16% (the “d”, or discount rate). Consequently, the capitalization rate is obtained by subtracting the 6% annual growth rate from the discount rate of 16% to give a 10% capitalization rate (or 0.10). Therefore, the preliminary value of the company by the capitalization of earnings method is $10,000,000, calculated as shown in Table 3.

<table>
<thead>
<tr>
<th>Table 3 Calculating Value the Capitalization Method</th>
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<tbody>
<tr>
<td>Discount Rate (d)</td>
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<tr>
<td>- Long Term Annual Growth Rate (g)</td>
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<tr>
<td>Finding of Value of by Capitalization Method</td>
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<tr>
<td>Company Net Income</td>
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<tr>
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Thought of another way, a capitalization rate of 10% (as above) is the same as saying that the company is worth a multiple of 10 times earnings (inverse, i.e., 1/capitalization rate). By example, a cap rate of 20% applied to earnings, or 0.20, would be the same as a multiple of 5 times earnings, or giving a value of $5,000,000 in the previous earnings example. Because the cap rate has such a potentially massive impact on value it is crucial to make sure it is reasonable. As should be self-evident, the following rules are true:

Cap rate impacts on value:
- the lower the cap rate, the higher the value of an expected future income stream
- the higher the cap rate, the lower the value of an expected future income stream

Capitalization rate impacts are evident daily in the real world. Follow the stock market and see what happens to public company share prices. If a business comes out with a new product that brightens its future earnings outlook the share value rises as investors “capitalize” the higher anticipated future stream of income into a higher share price. Or consider two competitors in the same industry and with the same annual income. One has just become the target of a product liability lawsuit, calling into doubt its future survival. Thus, share value may be driven down through an increase in perceived risk (the “d” factor above), possibly combined with a diminished future earnings outlook. In this instance, the discount rate goes up (greater risk) and the expected growth rate for earnings (g) comes down, resulting in a higher cap rate and therefore a lower share price investors are willing to pay for the troubled public company’s earnings.

Values of private companies are impacted by the same factors. If two companies have the same risk profile (i.e., the d, or discount rate factor is the same), but one has a different growth rate of earnings (i.e., the g, or annual expected future growth is different), the investor will pay more for the one with greater growth. This is commonsense. Similarly, if two companies have the same income and growth outlook, but one is much riskier (i.e., the d, or discount rate factor is higher), the one with greater risk will be worth less.

Using this knowledge in reviewing a business valuation. This knowledge of how the capitalization rate is constructed and works can be used to assess the validity of a specific valuation’s findings of value by the capitalization method. Since it is clear that the finding by the capitalization method is a function of 3 broad variables, (1) anticipated income to be capitalized, (2) risk, and (3) growth, it is necessary to individually examine the reasonableness of each element and how it was determined. This enables the reader of a valuation to make crucial judgments as to the potential strengths or weaknesses of the cap rate and the associated valuation findings. The following narrative focuses on critiquing the risk and growth elements of the cap rate.
Breaking the cap rate into its components.
As previously noted, the capitalization rate is mathematically equal to the discount rate \((d)\) minus the growth rate \((g)\). Suppose the valuator indicates he or she has used a capitalization of earnings method, employing a cap rate of \(7\%\) (same as implying approximately 14.3 times earnings multiple, the inverse). Most valuations (and certainly those of any accredited business appraiser) should actually show the discount and growth rates used in calculating the cap rate, so the reader is able to focus directly on the validity of the \(d\) and \(g\) components that were used. If the valuation does not show these individual components alarm bells should go off that the valuator might be unqualified or attempting to mask something to be purposefully misleading.

Beginning the assessment- an example. In a divorce, a valuator has valued ABC Wholesale, an exclusive wholesaler of the Chug-em brand of beer in a territory that encompasses Collegeville, a town that is the home of University of Collegeville. The university and its students and staff, and the associated bars, restaurants and businesses are largely what drive the college town. ABC Wholesale’s trucks distribute Chug-em to the grocery and convenience stores and bars located in the area.

The appraiser has stated that a cap rate of \(7\%\) was used in a valuation of ABC Wholesale, resulting in a value by the capitalization method of over $14.2 million as shown in Table 4.

<table>
<thead>
<tr>
<th>Table 4</th>
<th>Capitalization Rate for ABC Wholesale</th>
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<tr>
<td>Risk-Free Rate (U.S. Treasury Bond)</td>
<td>2.0%</td>
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<td>+ Equity Risk Premium</td>
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<tr>
<td>+ Company Specific Risk Premium</td>
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</tr>
<tr>
<td>Discount Rate ((d))</td>
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</tr>
<tr>
<td>- Long Term Annual Growth Rate ((g))</td>
<td>(10.0%)</td>
</tr>
<tr>
<td><strong>Capitalization Rate</strong></td>
<td><strong>7.0%</strong></td>
</tr>
</tbody>
</table>

**Finding of Value of by Capitalization Method**

| Company Net Income | $1,000,000 |
| Divided by Capitalization Rate | .07 |
| **Value of Company** | **$14,285,714** |

By focusing on each of the elements in Table 4 one might then target questions designed to assess the reasonableness of the constituent pieces. First focus on the discount rate portion.

**Equity risk premium.** The sources of data for equity risk premiums and how they should be interpreted are too complex for this article. However, the equity risk premium, properly developed, is based on objective data from historical returns demanded by investors in the shares of publicly traded companies over and above that of a risk-free rate (like a U.S. Treasury Bond), such as reported by Duff & Phelps Risk Premium Calculator, a widely used resource in the valuation field. Since there are a number of ways to develop the equity risk premium using Duff & Phelps data, the reviewer of a valuation report will want to make sure that this was done properly, something that will likely require the advice of a skilled valuator. This does not, however, leave the non-valuator reviewer without hope.

**Enter the subjective company specific risk premium.** Whenever subjectivity enters the picture, the skill and experience of the valuator comes into play, the possibility of differences in the views of a particular situation, and unfortunately in some instances, the potential for manipulation in the hands of an unscrupulous valuator trying to manufacture a desired high or low value for a client. Also, something may have been overlooked that, had the valuator known about it, might have changed his or her assessment of the need for and magnitude of any specific company risk premium. Finally, the valuator may simply be overly optimistic or pessimistic about how a particular issue(s) might impact a company. This is where the lay user might have a real impact. Here, the valuator used a subjective 1% additional company specific risk premium for ABC Wholesale. Was this high, low, or about right? Since this is a part of what makes up the discount rate it is an element that is impacted by the assessment of risk.

**Determining if the risk element (the discount rate) is reasonable.** Determining the risk is a key part of the effort in valuing any company. In order to properly make this assessment the valuator must undertake a thorough analysis of the company. This includes consideration of a multitude of factors that provide insight into potential threats to the business, both internal and external, as well as opportunities. While the risk factors and the relevant issues differ for each company, the following provides just a limited sampling of the many items often considered:
CAP RATE (continued)

Management:
- Strengths and weaknesses
- Key person issues
- Succession planning
- Retention and turnover
- Coverage of key personnel by non-competes
- Depth of management and the ability to support future growth

Products/Marketing:
- Stage of the product’s life cycle - start-up, growing, mature, declining
- Chain of distribution, reliance on key salespersons or outside representatives
- Impacts of technological change and if other potential products present competitive threats
- Future level of research and development required.
- Has the company made needed investments in new products and technology or has it paid out cash flow to shareholders currently at the expense of its future viability?

Customer Base:
- Concentrations of sales to one or several large customers
- Diversification of customer base by product line, industry and geography
- Favorable or unfavorable long term customer contracts
- Credit-worthiness of customers, anticipated bad debts, aging of receivables
- Current order backlog - growing, stable or declining
- Terms of sale extended to customers

Suppliers:
- Dependence on one or several suppliers for a key resource
- Bargaining power of suppliers
- Long term supply contracts at favorable or unfavorable prices
- Long term outlook for availability of raw materials, prices
- Vulnerability by company to competition from its own suppliers
- Terms of purchase offered by suppliers and any shifts in these terms

Competitive Environment:
- Who is the competition?
- Relative strengths and weaknesses of competitors
- Barriers to entry (if any) into the entry by new competitors (e.g., licensing, large capital requirements, training, degrees, etc.)
- Impact of freight and other costs on the ability to compete
- Market share of industry participants and the risk implied

Intangible Assets:
- Patents or other proprietary technology that limit competition
- Trademarks
- Skilled, trained workforce
- Location
- Customer list, patient records
- Name, reputation

Financial Risks:
- Liquidity and sufficiency of working capital to withstand setbacks
- Reliance on leverage (debt) and associated debt service requirements
- Trends in profitability and individual income and expense items
- Future profit outlook
- Cash flow generation
- Historic and anticipated future capital expenditures
- Need for additional capacity to support growth
- Analysis of individual asset and liability categories
- Off balance sheet liabilities
- Efficiency of asset utilization
- Revenue trends
- Bad debt experience
- Return on equity
- Dividend history
- Comparison of performance to industry peer averages

Access to Credit:
- Compliance with loan covenants
- Ability to meet collateral requirements for working capital credit facilities
- Sufficiency of credit facilities in place to support growth related capital needs
- Threats to continued access to credit

Contingent Liabilities:
- Pending or threatened litigation
- Guarantees of other obligations
- OSHA, ERISA, IRS and other regulatory problems
- Environmental and hazardous waste issues
- Warranty or repurchase liabilities
- Unfunded pension plans or health care benefits

Other Possible Red Flags:
- Frequent turnover of key management
- Turmoil among management or shareholders
- Increases in the interest rate charged on company credit facilities
- Loss of key customer accounts
Cap Rate (continued)

- Inability to supply timely financial statements
- Turnover of outside audit or accounting relationships

Contractual Issues:
- Employment agreements, covenants-not-to-compete
- Deferred compensation arrangements
- Supplier and customer contracts
- Distributorship contracts and their assignability
- Buy-sell and shareholders’ agreements
- Voting rights, bylaw restrictions

Other External Forces:
- Economic and industry outlook, trends
- Governmental regulation
- Global competition

Substantial time and effort required. The previous list is a very limited sampling of the many issues that might need to be examined to properly assess risk for valuation purposes. Since every company is unique the potential risks and issues can and will vary substantially and can only be ascertained by a full review. There is no magic list of every item that will or might be relevant to a particular company situation. Nonetheless, Banister Financial has created as close to one as possible and has made it available on the Valuation Tools page at our website (www.businessvalue.com/business-valuation-tools/) under the tab Sample Questions for Management Interview in Business Valuation of a Company. This list not only provides a framework to identify risk that might be present in a company, but also to fully understand what makes the company tick and to assist in identifying its possible future opportunities. This list is equally applicable in developing a list of questions for a company’s management in taking depositions in litigation involving valuation matters.

Back to the ABC Wholesale example. Assuming the equity risk premium of 14% was properly supported using objective data, what about the reasonableness of this 1% specific company risk premium? After covering all of the previous issues and reviewing the valuation’s discussion of risk factors, the attorney finds that the valuador apparently overlooked a potentially major risk factor unique to the market ABC Wholesale serves.

“Get out of my yard- go play in your own yard.” As a child, a neighbor (who fortunately later moved away) used to get mad and yell at the neighborhood children when we played in his yard, not liking the noise. It seems the full-time residents of Collegeville may be starting to have similar feelings to my childhood neighbor, but probably for good reason.

Agitators at the town council meetings have been calling for rules to force bars and restaurants to stop selling alcohol at 11 p.m. and to limit the sale of high alcohol content beer, such as with Chug-em. As any adult who graduated from college knows, many college kids do not even go out to “party” until 11 p.m. on Thursday through Saturday nights, the traditional nights out, so a change in the hours bars can sell alcohol might negatively impact the sales of Chug-em. So far, the council has resisted doing so, but the risk to ABC Wholesale is still potentially present. It turns out that while Collegeville has a population largely dominated by students, they simply do not vote in material numbers (either not caring or failing to register locally) and do not read the local newspaper (what is that?- the students get their news from Instagram and Twitter) to even know this issue is present. By contrast, townsfolk are mad and motivated voters who might replace the town council in the next election with more sympathetic leaders.

Consequently, this significantly increases the specific company risk associated with ABC Wholesale and warrants a material increase in the company specific risk premium. Suppose the appropriate adjustment is 5%, not the 1% used by the valuador. It is not certain that a new law will happen, nor is it entirely safe that it will not. Consequently, the 1% specific company risk premium that was used was too low. Keep that revised 5% specific company risk premium number in mind for later.

The growth element- is it reasonable? The reader of the valuation report smells a possible rat because ABC Wholesale has not been growing at or near 10% per year, the annual growth rate (or g) used by the valuador. Instead, it has historically been a profitable, but mature business, growing at about 4% annually, and there are no new products or reasons to suspect the change to a rapid growth in the future (except for the potential risk of a law to limit beer sales, a factor included in the risk portion, or discount rate). One might then seriously question the validity of a 10% per year growth assumption. Also, this article later provides concrete examples of why high long-term growth rates are usually unrealistic.
CAP RATE (continued)

Bringing risk and growth rate changes together for ABC Wholesale. By changing the discount (via the change in the company specific risk premium) and growth rates to reflect the circumstances of ABC Wholesale, a capitalization rate and value by the capitalization method can be calculated as shown in Table 5, comparing the before and after results.

<table>
<thead>
<tr>
<th>Table 5</th>
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<tbody>
<tr>
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Finding of Value of ABC Wholesale by Capitalization Method

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<td>$5,882,353</td>
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</table>

Almost all children take the $1 offer, failing to understand the value of compounding. Accepting the initial $0.01 offer, increasing over the month instead would result in total proceeds of over $10.7 million! Compounding also has relevance to business valuation, illustrating why a high annual growth rate in a company’s earnings cannot be sustained long-term and results in ludicrous results as explained below.

Rapid growth taken to its logical extension- Even if a company were rapidly growing at present, is 10% annual growth reasonable on a very long-term basis? Under the easy to remember “Rule of 72s,” dividing 72 by the annual rate of return gives a very rough estimate of how many years it will take something to double at that rate of return. Dividing 72 by 10 indicates that the company’s earnings will double and double again approximately every 7.2 years. At that rate of growth long-term, the revenues of many companies will grow in the future to a level that exceeds the entire dollar demand of their whole industry (and perhaps the economies of whole states), clearly not reasonable!

The industry and company lifecycle effect and where a company stands in it- In the typical lifecycle of an industry and the companies in it, a product or service category initially grows rapidly as it begins to fill a new demand. Over time additional competitors, attracted by the growth, come into the industry. As the potential for the product begins to reach maturity and the rate of growth slows, maintaining a company’s growth becomes increasingly difficult as companies fight to differentiate themselves from competition to gain the market growth that remains. Eventually it becomes difficult to grow by taking market share from others, leading to intensification of price competition. This ultimately leads to market share wars where brands with the most economies of scale (spreading fixed costs over a larger revenue base to have cost advantages) and with the ability to sustain intense pricing competition survive.
CAP RATE (continued)

often leading to a shakeout of many of the remaining participants. Eventually, the market becomes a mature, slow growth market, usually with a limited number of large remaining participants.

A lifecycle example- the smartphone- This lifecycle plays out in companies throughout the economy. Remember when few consumers had a smartphone. Then, in June 2007, Apple came out with the iPhone. This captured the imagination of consumers and smartphone demand exploded, not only for iPhones, but also for Android and Windows phones. As demand took off, more and more companies worldwide began producing smartphones, with most initially basking in the rapid growth and beefy profit margins as average consumers flocked to buy their first smartphone. This easy money attracted even more manufacturers into the industry.

However, as a growing percentage of the population had smartphones, the rate of growth in demand began to slow. Before long, profit margins began to narrow and only the strongest, largest players had the name recognition and economies of scale to make money for the market share growth that remained. Fast forward to the present and smartphone demand growth is mature in the United States and beginning to mature in developing countries. Most consumers now have a smartphone and its demand has slowed to largely become a replacement market. This has led to a massive shakeout of smartphone manufacturers, with Apple, Samsung, Huawei, LG and only a handful of companies left in the business. Most other lower tier brands are either out of business or are losing money and struggling to survive.

Relevance of the lifecycle to a specific company valuation. This saga is not unique to smartphones and can be seen repeatedly in virtually every industry and company at some point in time. The key is to find out where the specific company being valued stands in its lifecycle as this may potentially drive the relevant valuation approaches and methods used and in assessing them in a valuation report. In addition, this knowledge assists in discerning the reasonableness of where a company stands in its growth curve.

What if the near or intermediate growth rate is expected to be high? Suppose the company being valued is still in the rapid growth phase of its lifecycle, where near or intermediate term growth is expected to be high. In that instance, use of the capitalization method may be an inappropriate choice. Instead, this is the perfect situation for the use of the discounted future benefits method described earlier. The discounted future benefits (income) method separates the valuation into two pieces: (1) the valuation impact of the first part (the high growth phase) is captured by use of annual year-by-year forecasts, and (2) once earnings or cash flows are expected to stabilize to a mature long-term pattern, the method employs a capitalization method component in the final so-called terminal year. The results of the two are then combined to give an overall value estimate. As is obvious, even in the discounted future benefits method the “d” (discount rate) and “g” (growth rate) elements still must be assessed by the skilled valuation reviewer.

The drivers of a company’s long-term growth rate-demand and price- Assuming an industry is mature, the growth rate will typically be determined by two elements, (1) the annual growth in demand for the product or service, and (2) long-term changes in the price of the product or service.

How can these two demand and price factors be determined? The answer will depend on the specifics of the company and its industry. For example, suppose the valuation is again of ABC Wholesale that distributes Chug-em brand beer products in a given region (Collegeville) by rights granted under a distributorship agreement. The demand for beer is largely mature, with a relatively steady per capita rate of consumption annually in Collegeville. Therefore, forecasted population growth in the beer wholesaler’s territory will likely drive demand growth in some relationship. This, of course, assumes ABC will continue to realize its share of the overall market growth and share and that Chug-em will not become less popular in the future. The risk of these and other factors is instead captured in the discount rate part of the capitalization rate calculation! Separately, over the long-term it is likely reasonable that the prices ABC realizes for its products will more or less increase with inflation.

 Assuming the long-term forecasted annual population growth in the Collegeville territory is 1.5% and inflation is forecasted at 2.5% annually, this implies a long-term, sustainable growth rate of about 4% annually, the sum of the two. While there may be other factors at work that lead to a differing result, once the figures began to go markedly above these levels there had better be a very
good reason. Note- this is not referring to a one, three or even five year growth rate, but instead a very long-term sustainable growth rate, essentially into perpetuity.

**Conclusion.** Capitalization rates can be demystified and understood, and by doing so the attorney can more adequately advise his or her client with a valuation issue regardless of whether it is for estate planning, dispute resolution, or mergers and acquisitions. By properly focusing the analysis on the review on the elements of risk, growth and income the attorney is in a better position to assess the underlying consistency and reasonableness of the capitalization rate used. This is why it is so important for the critical reviewer of a valuation report to fully understand the risk and growth elements that are actually present and how this relates to the validity of the valuator’s decisions on these issues. Failure to discuss or effectively articulate these factors should be a significant red flag of a potentially unqualified valuator, or a hasty and cursory review of the company. ♦

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