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Explaining the Build-up Method

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The Build-up method is one of the most commonly used techniques, for estimating the risk rate applicable to the valuation of a privately held business. As business appraisers, we know where to get the data to provide the Risk-free rate, the Equity risk premium, the Size premium, and all about what goes into the selected Specific company risk premium (SCRP). I know we all love the SCRP!

But…when one of our readers asks us, "what do all these different rates mean and how do they apply to the valuation of my business?"

Here is how I answer that question:

"The value of a business is equal to its expected future earnings divided by the risk of achieving those earnings. On the one hand, we have our forecast of expected future earnings, now we just need to figure out what the hypothetical, willing and able buyer might expect and a hypothetical, willing and able seller might accept."

"To do that we can start with what investors in publicly traded markets are seeing for the various investments they are buying, because those are trackable and documented. Let's assume we have an investor, who has $100,000 to invest in …'something'. If our investor is happy with a risk-free investment, such as the US Treasury bonds, well, we can look up what the rate is for those as of our effective date, so that is easy. But the Risk-free rate is only a couple of percent, typically. It is likely that our hypothetical investor would be expecting a higher return on their investment then just that 2.5 to 5% a year. Therefore, let's add to that the overall equity risk premium for the S&P 500 as if that were a portfolio that one could invest in. Again, that is a rate that we can look up and reference for the year prior to our effective date. But, many investors tend to believe that the smaller the business is, the more risky it is. And the subject business we are appraising, is not equivalent to the operating risk of the S&P 500 as a whole anyway. **We can look up and select one of the various size premiums that are calculated**, in order to add that to our rate of return we are going to use to determine the fair market value of the subject ownership interest in the subject privately held business.   Which will give us the overall rate of return we are looking for, right? A risk-free rate, plus the equity risk premium, plus the size premium, and we are done?"

"Not quite. As all of those different rates are still only measuring the associated risk of smaller, publicly traded businesses. Most of the businesses we are asked to appraise, are even more risky a potential investment, than those smaller publicly traded companies. Therefore, we need to add one more premium called the Specific company risk premium. This fourth rate is designed to show how much more risky the subject business is, over and above the publicly traded investment opportunities."

This is where my client tends to ask me how I developed that Specific company risk premium. What factors I considered and what the business owner could do to lower that rate going forward. I typically end up telling them something like this:

"I look at the subject business compared to itself over time. I want to see if the business has been improving or declining in its profitability, earnings, and asset base. I compare the subject business to its industry average to see if the subject is stronger or weaker than the average business in the same industry. I consider risk drivers from the overall economic outlook and the industry itself specifically.

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I look at the approximate market share the business has, and anything else I can include in my analysis that would affect an investor's judgment of the applicable investment risk. I know the subject is a privately held business, and therefore is typically going to be considered to be more risky, but how much more risky an investment is the question. A strong, privately held business might have a Specific company risk premium of about 3 to 6%. A business with more risks associated with it, such as an increased debt load, or it operates in a very competitive industry, or has only a few people involved in its management team, I might assign a Specific company risk premium of somewhere between 5 and 12%. An owner operator business, I might assign a rate between 8 and 30% for specific company risk, depending on where it lands within all those factors I mentioned above."

The sum of all those rates is called the Discount rate, and when used appropriately allows the appraiser to determine a supportable indication of value under the income approach. Remember, this rate comes mainly from publicly traded companies and their shareholders' receive their Returns on their investments on an after tax basis, therefore we must also use this rate on an after tax income stream equivalent to the subject business' dividend paying capacity. "Capacity", not actual dividends paid as most privately held businesses do not actually pay dividends, but if the subject business did decide to pay them, what would be the amount of cash the business could distribute, without negatively impacting operations? It's not the Earnings before interest, taxes, depreciation, and amortization (EBITDA) income stream. How would a business' future look if it stopped paying on its debt service and no longer paid its obligations to Uncle Sam? Might that scenario change the outlook for the subject business a bit?

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Gary Trugman's book, Understanding Business Valuation, is my favorite textbook on business appraisals! He goes into great detail on calculating Net cash flow, which is the private company equivalent of dividend paying capacity we need to use when we are applying the build-up method to derive our valuation risk rate.

Oh, one follow-up question I often see is to ask about how the Build-up method compares with the Capitalized asset pricing model (CAPM). The Build-up method is basically exactly like the CAPM, with one exception. The Equity risk premium in the CAPM model is modified by Beta. Beta is a measure of volatility of the subject stock as compared to the overall market. If a Beta is less than 1, the subject stock is less volatile or of the Beta is greater than 1, the subject stock is more volatile than the market as a whole. Since there is no exchange for privately held businesses, I don't know how one can calculate a Beta for a privately held business since one would need to know what the pricing volatility is for the stock prices of all the privately held businesses offered for sale over time. (Also, most privately held businesses sell as asset deals, not stock deals, so that is another hurdle.) My response is always to say something like this: "I assume a Beta of 1, which means equal volatility to the market overall, but if I believe there is some additional risk associated with the investing in the subject business, that extra risk is included in my estimation of the Specific company risk premium."

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