

# PREFACE

If there is one element that is a part of almost every business valuation, it is cost of capital.

The essence of business, real estate, or intangible asset valuation is that the property is worth the future benefits that it is expected<sup>1</sup> to generate, each discounted to a present value at the cost of capital. This book is about how valuation practitioners estimate and apply the cost of capital (discount rate) in valuations, and the errors most commonly encountered in its estimation and application.

## **Organization of the Book**

The first ten chapters present the basics of cost of capital applicable in almost any situation. The next ten deal with special aspects of cost of capital found in various specialties of the practice of law, such as taxation, corporate law, and family law. The final two chapters present frequently encountered errors we find in valuation reports and questions to ask when examining witnesses (yours and the opposition's) in litigation.

There is also an extensive bibliography (including data sources), a thorough glossary of terms associated with the cost of capital, and a table of cases.

## **Pervasiveness of Cost of Capital**

Cost of capital is arguably the most important concept in all of finance. Cost of capital is the pricing of risk. The cost of capital estimate is the essential link that enables us to convert a stream of expected income into a present value. This enables us to make informed decisions about pricing for prospective purchases or sales and to compare one prospective investment against another.

Yet despite the simplified approaches often presented in texts, valuation practitioners continue to face challenges in estimating the cost of equity capital:

In the beginning, there was chaos. Then came CAPM. . . . The anomalies erupted and there was chaos again . . . Discount rates vary a lot more than we thought. The puzzles and anomalies that we face amount to discount rate variation we don't understand. Our theoretical controversies are about how discount rates are formed . . . Theories are in their infancy . . .<sup>2</sup>

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1. John H. Cochrane, *American Finance Association Presidential Address: Discount Rates*, 56(4) J. FIN. 1047-1108 (2011).

2. *Id.*

It is easy to understand why the courts often struggle with cost of capital estimates proffered by valuation experts.

### **Discounting Versus Capitalizing**

In *discounting*, we project a stream of benefits out into the future and discount them back to a present value by the cost of capital, sometimes called the *discount rate*.

In *capitalizing*, we divide a single year's benefits by a capitalization rate to derive an estimate of present value. Capitalizing is just a short form of discounting. Given the same set of assumptions, the present value should be the same whether discounting or capitalizing.

This book shows the simple steps of discounting and capitalizing and their variations. It demonstrates with an example why, given the same set of assumptions, the discounting method should yield the same result as the capitalizing method.

This book shows the traditional procedures for developing discounts and capitalization rates applicable to *net cash flows*. It also presents the steps to take to convert net income to net cash flow. It also shows how to modify discount and capitalization rates to be applicable to other measures of income, such as net income. It even shows a process for developing a discount rate applicable to pretax adjusted income (an exercise that many analysts do incorrectly).

### **Cost of Capital in the Courts**

There are ten chapters on specific nuances of cost of capital in different court venues, including extensive reference to precedent-setting cases:

- Estate, gift, and income taxes
- Corporate restructuring and other federal tax matters
- Damages calculations
- Intellectual property matters
- Bankruptcy
- Fairness and oppression cases
- Family law matters
- Ad valorem (property taxes)
- Ratemaking in regulated industries

### **Cost of Capital and the Lawyer**

Many billions of dollars' worth of financial decisions are made every year, most of which involve cost of capital and most of which involve lawyers. Many lawyers could better serve their clients by being more familiar with cost of capital. Roger and I have written this book to be both a primer for the financially uninitiated and a reference for the experienced lawyer.

We have tried to write it in straightforward language, avoiding financial jargon as much as possible while still being precise when it matters. The first time an arcane abbreviation or financial term is used in a chapter, it is defined or at least identified in context. The book is extensively cross-referenced, especially in the ten chapters on cost of capital in specific contexts.

We welcome any comments.

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