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PROVIDING SUPPORT AND RATIONALE FOR THE ESTIMATION OF A COMPANY-SPECIFIC RISK PREMIUM

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The application of a company-specific risk premium (“CSRP”) when estimating the discount rate is controversial in the valuation of privately held businesses, ownership interests, and tangible or intangible assets. No generally accepted data source can be accessed to quantify the CSRP because the CSRP is specific to a subject company or asset. To estimate a relevant CSRP, the valuation analyst should perform a qualitative factor analysis and review quantifiable data sources that support the reasonableness of the CSRP. Failure to adequately support a CSRP could result in a conclusion that is under- or overvalued.

Introduction

The cost of equity (“COE”) capital is used in income approach methods where expected future cash flow to equity is discounted to a present value using an appropriate discount rate or capitalized using a direct capitalization rate. The COE is the risk-adjusted rate of return that the investor expects to earn on the equity capital that is invested in the subject investment.

In generally accepted COE models, the components are typically the: (1) risk-free rate, (2) general equity risk premium, (3) industry-specific risk premium, and (4) size risk premium. There are generally accepted data sources that the analyst can rely on to quantify each of these components. Therefore, including these components when estimating the COE is usually not controversial.

One COE model, the capital asset price model (“CAPM”), may be relied on when valuing a publicly traded security that is included in a diversified portfolio of liquid publicly traded securities.

The CAPM does not include an “alpha” component because an alpha component of risk cannot be diversified away. For a security within a diversified portfolio of liquid securities, the alpha risk component is eliminated through diversification.

The company-specific risk premium (“CSRP”), sometimes called an investment-specific risk premium or property-specific risk premium, is often referred to in finance literature as “alpha” or “a.” To incorporate the alpha risk of a privately held company, the CAPM was modified to add an alpha component that includes both the



company size adjustment and CSRP (i.e., the modified CAPM, or “MCAPM”). The application of the MCAPM is appropriate for measuring the COE of a privately held company, an ownership interest, a tangible property, or an intangible property.

The CSRP is a controversial issue in any type of valuation analysis. The CSRP is associated with unsystematic risk that pertains to a particular private company, ownership interest, or asset. It is not captured in any of the other components of the CAPM. The risk is company-specific, so there is no database to rely on to quantify the risk.

Because there is no generally accepted data source, empirical study, or formula for a valuation analyst to rely on to quantify the CSRP, this discussion is focused on the qualitative analysis and documentation the valuation analyst can perform to adequately support the estimation of a relevant CSRP within the context of a privately held business valuation.

Estimating and Documenting a CSRP

A valuation analyst may consider several qualitative factors to develop a supportable estimate of a CSRP. Qualitative factor analysis includes the: (1) National Association of Certified Valuers and Analysts (“NACVA”) factors, (2) subject company competitive analysis factors, and (3) subject company functional analysis factors.

NACVA Factors

NACVA has published various factors to consider when estimating a relevant CSRP for a privately held company, including: (1) competition, (2) financial strength, (3) management ability and depth, (4) profitability and stability of earnings, (5) national economic effects, and (6) local economic effects.

The first four factors are specific to the subject company.



The valuation analyst assigns a point value (1 point for lowest risk to 10 points for highest risk) to each factor. For the last two factors, the valuation analyst typically assigns a point value of -1 (strong economy), +1 (weak economy), or 0 (neutral).

To arrive at an indication for the CSRP, the valuation analyst calculates the sum of (1) all the point values in the first four categories (weighted by the number of individual factors in each category) and (2) all the point values in the last two categories. This type of analysis is considered a “numerical procedure.”

Competitive Analysis Factors

A valuation analyst also can assess a privately held company’s competitive position to estimate an appropriate CSRP. This competitive analysis aggregates the CSRP factors into three categories, (1) macroenvironmental factors, (2) industry factors, and (3) company factors. Within these categories, the valuation analyst would consider the subject company’s strengths, weaknesses, opportunities, and threats (“SWOT”). The analyst can perform a SWOT analysis of a company based on Michael E. Porter’s “Five Forces.”¹

Functional Analysis Factors

To estimate a relevant CSRP, a valuation analyst may perform a functional analysis that focuses on the assets



employed, the functions performed, and the risks assumed by the subject company. Some of the more important company risk factors to consider include:

- Economic risks (e.g., how will changes in interest rates effect the subject company?)
- Business risks (e.g., does the subject company have sales and growth volatility?)
- Operating risks (e.g., what are the operating fixed and variable cost commitments?)
- Asset risks (e.g., are the subject company's assets new or obsolete?)
- Market risks (e.g., is the subject company geographically diversified?)
- Regulatory risks (e.g., does the subject company operate in a highly regulated industry?)
- Financial risks (e.g., can the subject company cover its debt obligations?)
- Product risks (e.g., does the subject company offer diversified products, and are the products competitive within the market?)
- Technological risks (e.g., is the subject company keeping pace with technological advancements?)
- Legal risks (e.g., is the subject company facing any pending litigation?)

The valuation analyst's assessment of all these company-specific factors is relevant in developing a CSRP estimate.

Whichever qualitative analysis model the valuation analyst decides to use to estimate a CSRP, support for the selection should be documented in the project work files or explicitly discussed in the valuation report.

The valuation analyst can document the selection using

Table 1
Example of CSRP Documentation Procedures

| Company-Specific Risk Factors | Numerical Documentation | Plus/Minus Documentation | Listing Documentation |
|--|--------------------------------|---------------------------------|------------------------------|
| 1. Obsolete product (i.e., newspaper print) | 2.0% | ++ | X |
| 2. Declining sales and profitability | 2.0% | ++ | X |
| 3. Diversification (new product introductions) | 1.0% | + | X |
| 4. Leverage | 1.0% | + | X |
| 5. Long operating history | -0.5% | - | |
| 6. Experienced management team | -0.5% | - | X |
| 7. Customer concentration | - | | |
| 8. Supplier concentration | - | | |
| Estimated CSRP | 5.0% | 5.0% | 5.0% |

the (1) numerical procedure, (2) plus/minus procedure, or (3) listing procedure. The numerical procedure assigns a specific number to a certain risk factor, and the CSRP is the sum of the individual values. The plus/minus procedure relies on a plus notation, which increases the CSRP, and a minus notation, which decreases the CSRP. The list procedure, the most general form of documentation, presents the various factors that the valuation analyst may consider in arriving at the CSRP estimate.

WHICHEVER QUALITATIVE ANALYSIS MODEL THE VALUATION ANALYST DECIDES TO USE TO ESTIMATE A CSRP, SUPPORT FOR THE SELECTION SHOULD BE DOCUMENTED IN THE PROJECT WORK FILES OR EXPLICITLY DISCUSSED IN THE VALUATION REPORT.

In table 1 is an example of the three documentation procedures for a small, privately held company operating in the newspaper printing and advertising industry.

Although the numerical procedure appears to offer a higher level of accuracy, it may require the analyst to justify each component of the CSRP if the analysis is scrutinized in a litigation environment. In cross-



examination, the opposing counsel may argue that each risk component can increase or decrease by a certain percentage point, thereby potentially significantly increasing or decreasing the overall discount rate because the assignment of the risk percentages is subjective and based on professional judgment.

Finally, in considering the qualitative factors that effect the subject company's CSRP, the valuation analyst should not add risk premiums to the discount rate that pertain to factors that have been accounted for elsewhere. For example, if the cash flow used in the income approach method already was adjusted to account for nonperformance risk, a risk of nonperformance should not be included in the CSRP. If the valuation analyst already included an industry risk premium as a separate element in estimating the COE, then the valuation analyst should not include an industry risk in the CSRP.

Reasonableness Test on the CSRP

No matter which qualitative factors and documentation procedure the valuation analyst employs to develop a CSRP, identifying the risk specific to the subject company is subjective and based on the valuation analyst's experience and judgment. Therefore, it is prudent for the valuation analyst to support the conclusion by finding other data to confirm the reasonableness of the CSRP and overall discount rate.

QUANTIFIABLE DATA SOURCES, SUCH AS BOND SPREADS, CAN PROVIDE A REASONABLE RANGE THAT SUPPORTS THE ESTIMATION OF THE CSRP.

The valuation analyst may consider several data sources to provide guidance as a proxy for the CSRP. Although these proxy data sources do not directly measure the CSRP, they test the reasonableness of the estimated CSRP. One procedure that the analyst may consider for guidance on the estimation of the CSRP is an analysis of the spread between observed investment-grade corporate bonds and high-yield "junk bonds."

A high-yield bond has a credit rating below that of an investment-grade corporate bond. It pays a higher yield

Table 2
Yields as of September 30, 2024

| Treasury Bills and Bond Indexes | Yield |
|---|--------------|
| 6-month U.S. Treasury Bill | 4.38% |
| 10-year U.S. Treasury Note | 3.81% |
| Moody's Aaa Corporate Bond Index | 4.72% |
| Moody's Aa Corporate Bond Index | 4.98% |
| Moody's A Corporate Bond Index | 5.13% |
| Moody's Baa Corporate Bond Index | 5.44% |
| ICE BofAML BB U.S. High Yield Index | 6.03% |
| ICE BofAML B U.S. High Yield Index | 7.30% |
| ICE BofAML CC & Below U.S. High Yield Index | 12.02% |

than an otherwise similar investment-grade bond due to higher repayment risks, such as the issuing debtor company potentially experiencing financial distress. Riskier bonds offer a higher yield, while investment-grade bonds are less risky and offer a lower yield.

The valuation analyst may consider the difference in the bond yields when estimating a reasonable range for the CSRP. As presented in Table 2, at the lowest level of risk are Treasury bills and notes issued by the U.S. Department of Treasury, which are typically considered to be risk-free securities.

The next tranche of debt securities are investment-grade bonds (i.e., Aaa-, Aa-, A-, and Baa-rated long-term corporate bonds) rated by Moody's. Corporate debt obligations rated Aaa, Aa, and A are of high quality and subject to low credit risk. However, Baa-rated corporate debt obligations may possess some speculative characteristics.

At the highest level of default risk (i.e., CCC and below) are junk bonds. Junk bonds are typically issued by financially distressed companies. The incremental return between the junk bond index (12 percent) and the B-rated bond index (6 percent) may provide an indication of the incremental return that debt investors expect as compensation for factors pertaining to the company-specific risks, such as financial distress, liquidity risk, access to capital, and so forth.

While quantifiable data sources, such as bond spreads, can provide a reasonable range that supports the estimation of the CSRP, providing a sanity check on the overall discount rate can also provide support for the CSRP estimate.

Kroll, LLC ("Kroll") publishes the Kroll Cost of Capital Navigator: International Industry Benchmarking Dataset



for industries based on Global Industry Classification Standard (“GICS”) codes. For each GICS code, Kroll presents historical growth and profitability, financial ratios, betas, leverage, valuation multiples, COE rates, and weighted average cost of capital rates based on various models (i.e., CAPM, MCAPM, build-up, Fama-French, Kroll Risk Premium, and discounted cash flow) for the industry.

Using the Kroll Cost of Capital Navigator dataset, the valuation analyst can provide a reasonableness check by comparing the subject company’s estimated discount rate with the industry discount rates. For example, the dataset for GICS code 502010 (media industry) as of December 31, 2023, included 45 companies with sales ranging from \$67 million to \$54 billion. Eighteen of the companies were considered to have high financial risk. The median COE indications ranged from 9.8 percent to 13.8 percent for the overall industry. For smaller companies, the COE indications ranged from 13.5 percent to 15.5 percent. For companies with high financial risk, the COE indications ranged from 24.5 percent to 27.1 percent.

THE APPRAISAL FOUNDATION FORMED A WORKING GROUP TO DEVELOP A VALUATION FOR FINANCIAL REPORTING ADVISORY ON THE TOPIC OF THE CSRP FOR FINANCIAL REPORTING PURPOSES.

If the subject company reported sales less than \$67.0 million, it is reasonable to believe that the subject company could have as much risk as, or more risk than, the smaller-capitalized companies in the GICS code. In general, smaller companies have fewer financial, operational, and human resources.

In addition to size, the valuation analyst also can compare the profitability, growth, and leverage of the



subject company to the industry dataset to identify whether additional risks exist for the subject company. If the subject company is small, it is reasonable to expect that the company’s overall discount rate may be comparable to the discount rates for the composite small-company subset. If the analyst identifies additional risks based on growth, profitability, and leverage, the overall discount rate (including the CSRP) of the subject company may increase and be comparable with the discount rates reported for the high-financial-risk companies in the industry.

The Appraisal Foundation Advisory

The CSRP is often subjectively applied without quantification or support. Because no published literature provides specific guidance or best practices to quantify the CSRP, many valuation analysts do an inadequate job of providing support for the estimated CSRP. At the American Society of Appraisers Fair Value Conference in New York City in May 2024, a panel of Big Four leaders stated that auditors want more quantifications for the CSRP.

The Appraisal Foundation (“TAF”) formed a working group to develop a Valuation for Financial Reporting (“VFR”) Advisory on the topic of the CSRP for financial reporting purposes. The VFR Advisory will provide voluntary guidance and specific procedures for identifying and quantifying the elements of a CSRP.

The TAF issued Valuation Brief 2023-2,² which provided a summary outline of certain key areas that would be explored in greater detail in the VFR. In a survey of valuation practitioners on cost of capital inputs and



the CSRP used in the estimation of discount rates for financial reporting purposes, the working group observed that there is diversity in the practice of developing a CSRP for discount rates used in fair value measurement analyses.

THE CSRP SHOULD BE SUPPORTED BY FACTS AND CIRCUMSTANCES; HOWEVER, IT STILL FALLS WITHIN THE ART VERSUS THE SCIENCE OF VALUATION WORK.

The working group received responses from 452 participants, including individuals and institutions. Ninety-five percent of the respondents said they use a CSRP in their valuation analyses. SurveyMonkey hosted the survey, which was accessible to practitioners digitally for five months from April 28, 2022, through September 30, 2022.

Some feedback from the survey included the following:³

- The CSRP acts as a device for valuation analysts to reach a desired result.
- Any guidance should emphasize the importance

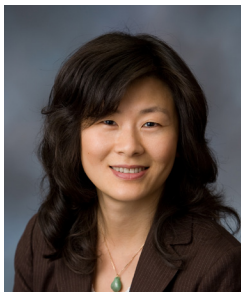
of quantifying the CSRP based on observable data.

- The CSRP should have adequate support and cannot amount to goal-seeking for a valuation.
- CSRPs are highly subjective, and available data do not and will not exist.
- Standards and uniformity are crucial on this component in the industry's body of knowledge.
- Although subjective, the CSRP should be supported by facts and circumstances; however, it still falls within the art versus the science of valuation work.

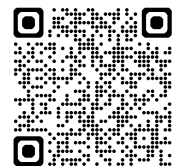
Conclusion

The CSRP component of the discount rate is one of the most subjective areas of business valuation because no objective data source properly quantifies the CSRP. The CSRP can be significant, zero, or a negative number, but it should be considered in the valuation of a privately held company, equity interest, tangible asset, or intangible asset. Although the valuation analyst can analyze qualitative factors specific to the subject company or asset, the CSRP is estimated based on the valuation analyst's professional judgment. Fortunately, various data sources are available for performing a reasonableness test on the estimated CSRP.

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References:

- 1 Businesses use Porter's Five Forces, (1) competitive rivalry, (2) supplier power, (3) buyer power, (4) threat of substitution, and (5) threat of new entrants, factors that influence every industry, to analyze their competitive landscape, identify opportunities, and make informed decisions to solidify their position in the market.
- 2 The Appraisal Foundation, "Valuations in Financial Reporting: Company-Specific Risk Premium," Valuation Brief 2023-2. (July 2023).
- 3 The Appraisal Foundation Working Group, "Overview of the Survey on the Company-Specific Risk Premium (CSRP)."