BUILD-UP OF CAPITALIZATION RATE AND DISCOUNT RATE

The applicable rate for valuing an entity under an income capitalization method is the capitalization rate. If the entity is being valued under the discounted cash flow method (DCF model) then the applicable rate is the discount rate. The difference between the manner in which a capitalization rate or a discount rate is calculated, is that the capitalization rate is determined by subtracting a growth rate from the discount rate. Both the discount rate and the capitalization rate are comprised of the first four elements listed below. Both rates function from the premise that the lower the rate is, the higher the value of the company will be. In contrast, the higher the capitalization or discount rate then the lower the value will be. This is because both the capitalization and discount rates function as multipliers. See below discussion on how this works. The elements used to calculate the capitalization or discount rate are as follows:

	Risk-Free Rate	x
	Equity Risk Premium	x
	Size Premium	x
	Specific-Company Risk Premium	x
	Total	Discount Rate
Less:	Sustainable Growth Rate	(x)
	Equals	Capitalization Rate

A further description of the elements above is as follows. The Risk-Free Rate is often considered to be equal to the return on a 20 year U.S. Treasury Bond. The Equity Risk Premium is the additional rate of return an investor would expect to receive for investing

in equity securities instead of a Risk-Free instrument. It is calculated by comparing stock market returns over a historical period to the rate of return on U.S. government bonds. The Size Premium is based on the premise that companies with smaller capitalization can be expected to have higher rates of return on an investment than companies with larger capitalization because smaller companies have greater risk associated with them. The first three factors above (i.e. Risk Free Rate, Equity Risk Premium and Size Premium) can be found in Duff and Phelps Valuation Handbook. Accordingly, they do not involve significant subjective judgment by the valuator.

In contrast, the last item above, which is the Specific Company Risk Premium is primarily determined by the subjective judgment of the valuator. In certain respects, this is kind of the "wildcard" so to speak, in business valuation, because there is a marked lack of empirical data for valuators to use to arrive at the Specific Company Risk Premium. The process of determining the Specific Company Risk Premium involves determining the "Risk" that is "Specific" to the individual company being valued. It involves an assessment of such factors, including but not limited to, the degree of competition in the market, how easy or difficult it is to enter the industry, the characteristics and experience of the owners of the entity, how the entity prices and products compare to the competition, the degree of overall employee satisfaction and stability of the entity, the degree of financial stability for the company, and a wide host of any other factors that may impact upon the entity's future and success in the market.

For the most part, as indicated above, in determining value, both the capitalization rate and the discount rate function as multipliers. As an example, a capitalization rate of 20%, results in a multiplier of 5 (calculated as 100/20). Similarly, a capitalization rate of 25%, results in a multiplier of 4 (calculated as 100/25). Accordingly, since the Specific Company Risk Premium is an element of both the capitalization rate and the discount rate, the higher the Specific Company Risk Premium is, the lower the value of the entity will be. Virtually all entities have Risk that is "Specific" to their characteristics and which extends beyond the Risk of the general industry and economy.