One of the most elusive areas in the valuation of a privately held company (PHC), is the company specific risk premium (CSRP), which is used in the modified capital asset pricing model (MCAPM) and Buildup Method (BUM). Valuators from all backgrounds have different opinions regarding the proper way of deriving the CSRP. As business valuation becomes more of a science, driven by objective statistical inputs, the CSRP will become less of an art based on the valuator’s judgement. The goal of this article is to demystify the CSRP, the methodologies currently used by valuators to compute CSRP, and opinions by the courts at various levels as to the applicability or inapplicability of this premium.

**THE CSRP DEFINED**

The CSRP is an adjustment to the discount rate, or cost of equity capital (COE), intended to capture unique risks associated with a particular investment. In business valuation, it is used in the Income Approach. The two most common methods of deriving the COE for a PHC, the BUM and MCAPM, are attempts to value a single privately held investment based on publicly held comparables. The BUM is an additive model in which the return on an asset is estimated as the sum of a risk-free rate plus one or more risk premia. MCAPM, slightly different than the traditional CAPM, includes risk premia also included in the BUM like the size premium and CSRP.

Including a CSRP to the BUM and MCAPM is an attempt by the valuator to establish the required rate of return a hypothetical and willing investor requires for an undiversifiable asset. The MCAPM cannot be used to value a single company’s operating assets because it was developed for fund managers investing in publicly traded securities to determine the hurdle rate for portfolio investments. In a well-diversified portfolio, company specific risks can be eliminated through diversification. However, this is impossible for an investment in one PHC. Therefore, adding the CSRP to the MCAPM or BUM makes logical sense because it represents the risks both methodologies omit.

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1 The formula for the BUM is as follows. COE = rf + ERP + IRP + SP + CSRP where: rf = risk free rate of return of a risk-free security; ERP = expected equity risk premium, or the amount by which investors expect the future return on equity securities to exceed the risk-free rate; IRP = expected industry risk premium for subject company’s industry; SP = size risk premium; and CSRP = specific company risk.

2 The formula for CAPM is as follows. COE = rf + β* ERP where rf and ERP mean the same as the BUM definition and β = market beta of the valuation date of the subject security.


QUALITATIVE AND QUANTITATIVE RISK
Valuators have identified a variety of qualitative and quantitative company specific risks, with each professional having a personal spin on classification. For instance, Parnell Black and Robert Green disaggregate the CSRP into six categories: competition, financial strength, management depth and ability, profitability or stability of earnings, national economic effects, and local economic effects. Warren Miller (Miller) conversely separates the CSRP into three categories: macro-environmental, industry, and company. Miller suggests delving even deeper into these categories through the lens of Michael E. Porter's five competitive forces. Another valuator, Gary R. Trugman (Trugman), differentiates eighteen financial and non-financial CSRP factors: operating, economy, asset, market, regulatory, business, financial, product, technological, legal, economic conditions, business location, management depth, barriers to market entry, industry conditions, competition, quality of management, and the bottom line. Duff and Phelps (D&P) bases the CSRP on financial metrics: profitability based on operating profit, operating profit's volatility, and volatility of return on equity.

DERIVING THE CSRP
Given that valuators have identified many different company specific risks, without a consensus, there is also a variety of methodologies to deriving the CSRP. One technique is creating a numeric procedure to score the identified CSRP factors on a scale (typically between zero to five), add the total, and then include it with the BUM or MCAPM. Other valuators rely on a less numeric method and simply list the unsystematic risks the PHC has based on personal judgement. A third technique is the plus/minus methodology, a process involving the valuator assigning a + or – to the identified unsystematic risks, and then arbitrarily assigning an additional risk premia to the COE. While these three methodologies may appear reasonable, they are flawed. None permit the valuator to impartially quantify the CSRP.

A different technique to derive the CSRP, the Butler Pinkerton Model (BPM), created by Peter Butler (Butler) and Keith Pinkerton (Pinkerton) tries to solve this issue. This model, which has detractors and supporters, empirically quantifies the CSRP and COE for publicly held companies utilizing total beta rather than market beta used in the MCAPM. Butler and Pinkerton assert that total beta has the advantage of delivering the risk profile of a single PHC valuators seek to derive in valuation, captures the complete historical risk of the selected publicly held comparable companies, is often more stable than other betas, and enables a better comparison between truly comparable publicly held companies (rather than the industry average). Market beta, conversely, fails to capture the total risk (systematic and unsystematic) of a security, Butler and Pinkerton contend, and therefore results in an understated COE for PHCs.

In the BPM total beta and the COE capture the unsystematic and systematic risks of a set of guideline publicly traded businesses, thereby enabling a valuator to have a reference point for the CSRP of the PHC it is valuing. In calculating the COE for the BPM, the total beta replaces the market beta used in the CAPM formula:

\[
\text{COE} = \text{risk-free rate} + (\text{total beta} \times \text{ERP}) + \text{Sp} + \text{CSRP}\]

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11 The lower the operating margin, the greater the risk of the investment.
12 The greater the coefficient of variation in the company’s operating profit indicates greater risk.
13 Volatility for both metrics is indicated by the coefficient of variation, which formulaically is equal to the standard deviation divided by the average.
14 The greater the coefficient of variation in the company’s equity indicates greater risk.
16 Ibid.
17 Some of the supporters include Trugman and University of West Virginia Professor Ashok Abbott. Detractors include Pratt, Grabowski, Larry Kasper, Daniel L. McCaughy, and Vincent Corgi.
18 Butler and Pinkerton in their creation of the BPM use the term total cost of equity (COE). Just as the COE is meant to capture the risk profile of a PHC, COE’s intention is to more precisely capture the PHC’s risk.
19 Total beta is the quotient of the standard deviation of the comparable publicly held stock divided by the standard deviation of a market index. It was created by Aswath Damodaran, PhD of New York University.
21 The CSRP for a set of guidelines publicly held comparables is the point of reference because every private and public business has some level of company-specific risk according to an analysis of the Dow 30 Butler and Pinkerton completed.
By dividing a guideline company’s stock price standard deviation by the standard deviation of the market, total beta isolates the total risk of that company by removing it from a portfolio-risk perspective to a standalone perspective. This is the viewpoint valuators seek in deriving the COE for a PHC.

Despite the distinct advantages of total beta Butler and Pinkerton affirm, the CSRP derived using the BPM still relies on market beta:

\[ \text{CSRP} = (\text{total beta} - \text{market beta}) \times \text{ERP} - \text{Sp} \]

Where:

i. Total beta = stock's standard deviation (market beta, \( \beta \), or \( \sigma_{s,m} \)) / standard deviation of the market (\( \sigma_{m} \) or R)

ii. Risk-free rate = 20-year U.S. Treasury yield

iii. ERP = Equity risk premium

iv. Sp = Size premium

v. CSRP = Company specific risk premium

To demonstrate the BPM, the following example is presented:

\[ 24.51\% = \left[ 4.00\% + (2.47 \times 5.00\%) + 2.76\% \right] + \left[ (2.47 - 5.71\%) \times 5.00\% - 2.76\% \right] \]

Where:

i. Public Comparable #1: Vandelay Industries

ii. Risk-free rate: 4.00%

iii. Equity risk premium: 5.00%

iv. Effective date: 1/7/2015

v. Size premium as of valuation date: 2.76%

vi. Weekly standard deviation: 5.71%

vii. Levered beta: 0.37

viii. Correlation coefficient (R): 0.15

ix. Total beta: 2.47

Going forward, the BPM cannot be ignored. One of the BPM’s creators, Butler, passed a Daubert challenge in a December 2010 economic damages case in which the opposing side sought to exclude the BPM. This method is the closest technique valuators have to impartially quantifying the CSRP in discount rates.

**ANOTHER WAY OF THINKING ABOUT THE CSRP**

An alternative perspective on unsystematic risks included in the CSRP is that they cannot be accounted for through the derivation of an additional risk premia. Instead, company specific risks for a PHC should be considered in modeling future cash flows. For instance, if a business runs a manufacturing facility and there is necessary environmental remediation, the business valuator could model the cost to cure this risk, or others, into its future cash flows.

Quantifying company specific risks based on costs to cure is objective and can explain certain risks. However, if the risk-adjusted future cash flows are based on the valuators opinion instead of costs to cure, then this approach becomes as subjective as the other partial methods mentioned before.

**AN UNNECESSARY COMPONENT**

Some valuation professionals, such as Ted Israel and Dr. Shannon Pratt, believe that large CSRs may be unwarranted in the COE. Instead, they argue some of the CSRP components valuators contend are company-specific, in fact are accounted for in the size risk premium. The companies included in D&P’s *Risk Premium Report* portfolio twenty-five include entities with many unsystematic risk characteristics, and thus including the CSRP in the MCAPM and BUM would inflate the COE.

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25. The amount investors expect the future return on equity securities to exceed the risk-free rate.
27. This data is fictitious and not derived from any particular data source. Its single intended purpose is to illustrate to the reader how the BPM is determined.
COURT RULINGS

Given the lack of consensus in the valuation community to identifying CSRP factors, quantifying the CSRP and its applicability in the COE, the viewpoint of courts can help guide practitioners in the future.

The Delaware Court of Chancery

Historically, there have been instances in which the Delaware Court of Chancery has rejected the inclusion of the CSRP in discount rates and disregarded the theory behind this additional premium. For example, in 2003 in *Union Illinois 1995 Investment LP v. Union Financial Group* the Delaware Chancery questioned the concept of a CSRP and ruled it was inapplicable to the subject case. Instead, the court favored addressing unsystematic risks in cash flow projections. Two years prior, in *Union Illinois v. Korte*, the court again doubted the concept of an additional risk premium accounting for unsystematic risks and proceeded to disallow its inclusion when the valuator admitted the CSRP is incorporated into projected future benefits.

In other cases, the CSRP was excluded because of the Delaware Chancery’s belief it was included with prejudice to satisfy client expectations. Three cases in which the CSRP was added to the discount rate: 2002’s *Solar Cells Inc. v. True N. Partners*, 2006’s *MRI Radiology v. Kessler*, and 2008’s *In re Loral Space & Communications Consolidated Litigation*, resulted in the Delaware Chancery’s rejecting the inclusion of this additional risk premia. Rather than relying on qualitative and quantitative defensible facts about the subject company, the valuator’s in these cases computed discount rates to fit a specific conclusion. These cases created an elevated burden of proof on behalf of the valuator to provide data and information that support a CSRP.

Conversely, there have been occurrences in which the Delaware Chancery did accept the concept of an additional premium to account for unsystematic risks of the entity being valued. In 1998, the court disallowed in *Hintmann v. Weber Inc.* the CSRP when the valuator added in the weighted average cost of capital rather than including it in the COE, despite accepting the concept of this premium. That same year, in *Le Beau v. M.G. Bancorporation*, the Delaware Chancery was unpersuaded that two company specific risks, supplier dependence and pending litigation, were significant enough to impact the discount rate. Furthermore, in 2006 citing the *Hintmann* ruling, in *Gessoff v. IIC Industries*, the court accepted the concept of the CSRP in circumstances with supportable qualitative or quantitative facts. However, the Delaware Chancery held that the case at hand lacked such information. In 2010’s *re Sunbelt Beverage Corp. Shareholder*, the Delaware Chancery accepted the theory behind a CSRP, but deemed the CSRP used by the controlling shareholder’s valuator to buyout a minority shareholder was inapplicable. Instead, the court believed other risk premia capture unsystematic risks.

Despite the strong trend of Delaware’s Chancery Court rejecting the CSRP, there have been instances of accepting the inclusion of the CSRP in discount rates. In *Wacht v. Continental Holdings Ltd.*, the court accepted the defendant’s expert appraisal which included a five percent CSRP in the discount rate; however, reducing it to three percent. Similarly, the plaintiff’s expert’s two percent CSRP included in the COE in *Reis v. Hazelett Strip-Casting Corporation* was chosen over the defendant’s expert six percent.

Courts Outside of Delaware

Courts in states other than Delaware have also opposed including the CSRP in the discount rates for a variety of matters. The Tax Court of Minnesota, for example, sided with the Commissioner of Revenue’s conclusion of value because it excluded a three percent CSRP in its discount rate, whereas the claimant’s valuator included a CSRP to represent the taxpayer’s lack of product diversification. The Commissioner of Revenue’s valuator opined that such unsystematic risk should be incorporated into expected future cash flows because the valuation industry lacks a consensus on deriving such premia.

Judge Jorge L. Alonso of the U.S. District Court for the Northern District of Illinois Eastern Division disallowed the inclusion of a five percent CSRP in Robert Reilly’s COE calculation. Judge Alonso ruled that because the CSRP was “... not supported by any reliable formula or quantitative analysis,” and instead based on Reilly’s instinct, it should be excluded.

The U.S. Eastern District Court of Virginia’s Judge Leonie M. Brinkema disallowed adding a CSRP to the COE in an ESOP valuation because the unsystematic risks were already accounted for in management’s growth projections and an adjustment to beta the valuation expert made. In a 2014 business divorce case, the U.S. Southern District Court of New York accepted the concept of adjusting a discount rate for firm-specific factors, but disallowed the defendant’s
inclusion of a ten percent CSRP. Judge William H. Pauley III instead was persuaded by the plaintiff’s expert, Jeffrey Risius, who argued that the cash flow projections were already risk-adjusted and that the appropriate CSRP was zero percent.\textsuperscript{40} Judge Fish of the U.S. Northern District Court of Texas opposed the plaintiff’s expert’s discounted cash flow model because a CSRP was included in the COE. The trier-of-fact found that since the cash flow projections were adjusted downwards, including a two percent CSRP, constituted double-counting.\textsuperscript{41}

Courts outside of Delaware have conversely approved of including the CSRP in discount rates. In 2011, the U.S. Tax Court in the \textit{Estate of Giustina v. Commissioner}, permitted the petitioner’s expert including a CSRP; however, adjusted it from 3.5 percent to 1.75 percent under the assumption a hypothetical buyer would diversify the unsystematic risk associated with the investment. The Ninth Circuit Court of Appeals reversed and remanded this ruling, thereby raising the allowed CSRP to 3.5 percent. Additionally, the U.S. Bankruptcy Court of Ohio approved of the inclusion of a CSRP the plaintiff’s valuator admitted was subjective in deposition. The expert stated the computed CSRP was based on an extensive review of the debtor’s financial records, to which the court deemed a justifiable process to quantify an additional risk premium.\textsuperscript{42}

In \textit{CNB International v. Kelleher}, the U.S. Bankruptcy Court for the Western District of New York ruled that the subject company had specific risk attributes unaccounted for by the size risk premium, thus warranting the presence CSRP in the discount rate.\textsuperscript{43} Similarly, in \textit{LaSalle National Bank Association v. Paloian}, the presiding judge deemed the subject company warranted the inclusion of a CSRP in the COE to compensate for risks such as fraud, poor management reputation and depth, regulatory concerns, and others.\textsuperscript{44} Michigan’s Court of Appeals permitted the addition of a four percent CSRP in the COE its appointed expert assigned in a marital dissolution case of a small and privately owned agriculture business. The spouse that owned and operated the business claimed that this level of CSRP was extremely low given the lack of second-line management and customer concentration risks. The court appointed expert however, argued that CSRPs are usually between three and six percent, which the trial and appeals court agreed with completely.\textsuperscript{45}

Even the BPM was successfully used to estimate the CSRP for a discount rate in \textit{Village at Camp Bowie I}, a bankruptcy case involving a group of real estate investors that purchased the notes at auction to a development project. The debtor and group of investors had divergent plans for the reorganization, so the U.S. Bankruptcy court heard evidence from appraisal experts to assess the debtor’s plan. One appraisal expert proved a reasonable rate of return for the debtor’s planned investment relying on the BPM that accounted for investment-specific risks such as the debtor, the property, and the loan agreements.\textsuperscript{46}

**CONCLUSION**

The rulings by judicial systems at different levels and for different matters vary in terms of agreeing with the logic behind a CSRP, and permitting or excluding it in discount rates. As can be seen in the most business-friendly court, the Delaware Chancery Court, the CSRP has been mainly disallowed, but also allowed. In the instances the courts prohibited the CSRP, they mentioned reasons such as its subjective and qualitative nature and instead supported adjusting expected future cash flows to account for unsystematic risks. Additionally, there have been instances that other courts permitted including the CSRP in the COE, based on the valuator’s judgement. The valuation community lacks an agreed upon empirical and objective methodology for deriving a CSRP to incorporate into the BUM or MCAPM. Any valuator including this additional premium in its discount rate should be prepared to defend the identified unsystematic risks and the method used to derive this premium. Until this Holy Grail of valuation is found, practitioners beware.

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\textsuperscript{40} \textit{Charron v. Sallyport Global Holdings, Inc.}, No. 12cv6837 (S.D.N.Y. Dec. 24, 2014).


\textsuperscript{43} \textit{In re CNB Intern.}, Inc., 393 B.R. 306 (Bankr. W.D.N.Y. 2008).

\textsuperscript{44} \textit{LaSalle National Bank Association v. Paloian}, 2009 WL 721510 (N. D. Ill.).


\textsuperscript{46} \textit{In re Village at Camp Bowie I, LP}, 454 B.R. 702 (Bankruptcy. N.D. Tex. 2011).