

DO YOU KNOW?

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A free periodical to promote education and alert you to important areas of interest in the financial valuation, fraud and litigation services profession.

DO YOU KNOW...

...whether Ibbotson equity risk premiums are on a minority or control basis?

Morningstar's *Ibbotson SBBI 2011 Valuation Yearbook, Market Results for Stocks, Bonds, Bills, and Inflation 1926-2010* says the following on pages 61-62:

"Since most companies in the S&P 500 and NYSE are minority held, some assume that the risk premia derived from these return data represent minority returns and therefore have a minority discount implicit within them. However, this assumption is not correct. The returns that are generated by the S&P 500 and the NYSE represent returns to equity holders. While most of these companies are minority held, there is no evidence that higher rates of return could be earned if these companies were suddenly acquired by majority shareholders. The equity risk premium represents expected premiums that holders of securities of a similar nature can expect to achieve on average into the future. There is no distinction between minority owners and controlling owners."

"When performing discounted cash flow analysis, adjustments for minority or controlling interest value may be more suitably made to the projected cash flows than to the discount rate."

"Most public companies have no majority or controlling owner. There is no distinction between owners in this setting. One cannot assume that publicly held companies with no controlling owner have the same characteristics as privately held companies with both a controlling interest owner and a minority interest owner."

We recommend that valuation analysts read the entire section on this topic in the *2011 Ibbotson Valuation Yearbook* (www.global.morningstar.com/SBBIYearbooks).

DO YOU KNOW...

...that the Duff & Phelps Risk Premium Report contains a formula to convert Ibbotson industry risk premiums to Duff & Phelps industry risk premiums?

Duff & Phelps Risk Premium Report 2011, page 56, shows the following formula:

$$\text{“IRP}_{\text{adjusted}} = \text{SBBI IRP} \times (\text{ERP estimate used in Buildup 2} / \text{historical ERP estimate from 1926 to present)”}$$

The Buildup 2 referred to is from page 26:

$$\text{“COE}_{\text{Buildup 2}} = (\text{Risk Free Rate}) + (\text{Equity Risk Premium}) + (\text{Size Premium}) + (\text{Adjusted Industry Risk Premium)”}$$

Illustration of formula only:

Assuming an Ibbotson IRP of 2.5%, an Ibbotson equity risk premium of 6.7% (a) and a Duff & Phelps unadjusted equity risk premium of 4.4% (b) the Duff & Phelps IRP is as follows:

$$\text{IRP (D\&P)} = 2.5\% \times (4.4\% / 6.7\%)$$

$$\text{IRP (D\&P)} = 1.64\%$$

- (a) Morningstar’s *Ibbotson SBBI 2011 Valuation Yearbook, Market Results for Stocks, Bonds, Bills, and Inflation 1926-2010*, last page.
- (b) *Duff & Phelps Risk Premium Report 2011*, page 32.

We recommend that valuation analysts read the entire section on this topic in the *2011 Duff & Phelps Risk Premium Report* (www.bvresources.com/dp).



Cost of Capital Update: Things You Need to Know

By Robert C. Smith, Editor

As the cost of capital continues to rise, it is important for valuation professionals to stay up-to-date on the latest developments in this area. This issue of *Financial Valuation and Litigation Expert* provides a comprehensive update on the cost of capital, including the latest research, regulatory changes, and practical applications. The issue also includes a special section on the cost of capital for private companies, as well as a Q&A section with industry experts.

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Letter from the Editor

THE TEN KEY ECONOMIC DAMAGES CASES OF 2010

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