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A little bit of growth is a big deal

When valuators use the income approach, long-term sustainable growth is an important assumption. That's because a small difference in the projected growth rate can have a big impact on business value.

Why growth assumptions matter

Here's a simplified example of why long-term sustainable growth rates matter. Suppose an appraiser values a business at $6.5 million as of Dec. 31, 2013, using the capitalization of earnings method.

Let's look at the math underlying this value. The company's normalized cash flows were $1 million in 2013. The valuator estimates the cost of capital at 20% and the long-term sustainable growth rate at 4%. Using the Gordon Growth Model, expected cash flows in 2014 are $1.04 million ($1 million times 104%) and the capitalization rate is 16% (20% minus 4%). Therefore, the company's value is $6.5 million ($1.04 million divided by 16%).

But, what if the appraiser used a 3% long-term sustainable growth rate instead? Then the value would be approximately $6.1 million ($1.03 million divided by 17%). Here, a 1% difference in the long-term sustainable growth rate translates into a difference in business value of more than $400,000.

How growth rates measure up

One benchmark for long-term growth is *The Livingston Survey*, published by the Federal Reserve Bank of Philadelphia. As of June 2013, the survey reports that its long-term outlook for real gross domestic product (GDP) growth for the next ten years is 2.6%. The Consumer Price Index (CPI) is expected to grow by 2.5% over the same period.

When reviewing an appraisal, ask yourself: Does the valuator's assumption make sense in light of government statistics? Because inflation is factored into the cost of capital, valuators also include the rate of inflation in their long-term sustainable growth rates. If a company is expected to only keep pace with inflation into perpetuity, the long-term sustainable growth should theoretically equal the expected rate of inflation.

But if real growth is expected — beyond that of the overall market — the company may warrant a long-term sustainable growth rate above the GDP and CPI metrics the government publishes. But some companies in declining industries or generating income from wasting assets (such as oil, gas or coal reserves) may warrant a lower long-term sustainable growth rate.

What you can do

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Whenever a valuator makes assumptions about expected growth, ask yourself whether it makes sense compared with other economic indicators. Companies typically can't sustain extremely high growth rates into perpetuity.

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