Problems in estimating a discount rate for valuing small enterprises

As it is seen from the current case, in order to find the present value of the projected company's dividends, an appropriate discount rate has to be determined using the capital asset pricing model (CAPM). It uses beta factor which companies does not usually have if they are not quoted on the market. It is possible to "borrow" the beat from surrogate quoted companies operating in the same sector with similar business risk. However, there is a risk premium of small enterprises which is difficult to be anticipated.

As mentioned previously, the beta of a company's share reflects the risk of its equity and this depends on the level of gearing. (accaglobal.com, 2015) Consequently, differences in gearing levels between the small firm and the comparable quoted company (see Appendix 2) can cause further complications. Moreover, if one company is not using debt and needs to "borrow" the beta of a company which is using significant levels of debt, the beta of the company using debt needs to be ungeared which leads to more complications in finding proper discount rate. (acowtancy.com, 2015)

The company in question is using debt as well as the two surrogate companies. Therefore it is not necessary ungearing the beta. However the level of debt used by the surrogate companies and Nutec plc is different. Consequently, there may be some inaccuracy when using "borrowed" beta in valuating Nutec Ltd.

Additionally, another good strategy to find a discount rate is applying the WACC method. However, when valuing small, unquoted companies, the main problem is the lack of market values of debt and equity, because neither of them is traded. (Titman, et al., 2011)