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HOW VOLATILE INTEREST RATES AFFECT THE COST OF CAPITAL AND COMPANY VALUATIONS

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Spiraling inflation over the last several years prompted the Federal Reserve to raise interest rates significantly. Higher interest rates can influence business valuations by increasing the inputs used to develop a company's cost of capital, particularly the risk-free rate and the company's cost of debt capital, resulting in a higher discount rate and a lower business value indication.

Introduction

During the COVID-19 pandemic, federal stimulus checks contributed to an increase in consumer spending in the United States. At the same time, a labor shortage, with many workers staying home, contributed to supply chain disruptions worldwide. These events caused inflation to surge, beginning in 2021.

To control inflation, the Federal Open Market Committee ("FOMC"), the monetary policymaking body of the Federal Reserve, increased the federal funds rate 11 times, totaling 525 basis points, between March 2022 and July 2023. Although the FOMC began lowering rates in September 2024 and has since decreased the federal funds rate by 175 basis points (as of December 31, 2025), it has been hesitant to decrease interest rates faster because of persistently high inflation.

The federal funds rate is the interest rate at which depository institutions trade federal funds (balances held at Federal Reserve banks) with each other overnight. The federal funds rate affects other interest rates, such as the prime rate, which is a benchmark that banks use to determine loan rates they charge their business customers. Additionally, the federal funds rate indirectly influences the interest rates charged for mortgages and other types of consumer loans, as well as interest rates on certificates of deposit and savings account balances.

The economic aftermath of the COVID-19 pandemic has had far-reaching implications, including in business valuation. Higher inflation, which led the FOMC to aggressively raise interest rates, can affect the cost of capital of an enterprise. Higher interest rates affect business valuations by increasing the discount rate used to discount the future cash flow of a business to a present value. The higher the discount rate, the

lower the present value of the cash flow and, thus, the business's value.

When valuing a business, three generally accepted valuation approaches are considered: (1) the income approach, (2) the market approach, and (3) the asset-based approach. This article will discuss how higher interest rates affect the discount rates used in income approach methods. In particular, this article will discuss two components used in the estimation of a company's discount rate: (1) the risk-free rate ("RFR") and (2) the subject company's cost of debt capital.

Higher interest rates caused by inflation have led to an increase in the RFR and the cost of debt for a company, thereby potentially increasing the estimated discount rate of that company. A higher discount rate results in a lower present value of future cash flow and, therefore, a lower business value. Understanding this dynamic is essential because it influences everything from the timing of estate tax planning to litigation outcomes and transaction negotiations.

A Company's Cost of Capital

When applying an income approach method, a company's value is estimated based on three variables: (1) the company's future economic benefits (i.e., expected cash flow), (2) the growth potential of the company, and (3) the risk involved in receiving the expected income (i.e., the discount rate). These variables are applicable in two common income approach methods: the discounted cash flow method and the single-period capitalization method.

THE COST OF DEBT (PRETAX) IS BASED ON THE COMPANY'S MARGINAL BORROWING RATE, ASSUMING THE COMPANY BORROWS AT MARKET RATES.

The discount rate is commonly known as the cost of capital, which represents the required rate of return that attracts an investor to invest in a particular asset and reflects the level of risk associated with receiving the future economic benefits (or income) of that investment.

When valuing the net cash flow to equity (i.e., cash flow available to equity investors) of a company, the appropriate discount rate should be the cost of equity ("COE"). When valuing net cash flow to invested capital (i.e., cash flow available to debt and equity investors), the appropriate discount rate should be the weighted average cost of capital ("WACC"), which reflects the overall cost of financing the company.

Table 1
20-Year U.S. Government Bond Yields
Risk-Free Rates

12/31/2005	4.61%	
12/31/2006	4.91%	
12/31/2007	4.50%	
12/31/2008	3.05%	← Great Recession
12/31/2009	4.58%	
12/31/2010	4.13%	
12/31/2011	2.57%	
12/31/2012	2.54%	
12/31/2013	3.72%	
12/31/2014	2.47%	
12/31/2015	2.67%	
12/31/2016	2.79%	
12/31/2017	2.58%	
12/31/2018	2.87%	
12/31/2019	2.25%	
12/31/2020	1.45%	← COVID-19 pandemic
12/31/2021	1.94%	
12/31/2022	4.14%	← Inflation surges
12/31/2023	4.20%	
12/31/2024	4.86%	
12/31/2025	4.79%	

Source: The Federal Reserve Statistical Release.

The most common methods used to develop the COE rate include these components: (1) the RFR of return, (2) the general equity risk premium ("ERP"), and (3) a size risk premium and company-specific risk premium.

If discounting net cash flow to invested capital, the estimated COE then is used to develop the WACC. The WACC is a blended combination of (1) the COE and (2) the required rate of return on the company's debt, based on an estimated capital structure comprised of debt and equity. The cost of debt (pretax) is based on the company's marginal borrowing rate, assuming the company borrows at market rates.

The Risk-Free Rate

A foundational component of commonly applied COE

models (e.g., the build-up model ["BUM"], the capital asset pricing model, etc.) is the RFR. The RFR is the rate of return on a risk-free investment as of the valuation date. It is the rate of return investors would expect from a safe asset over a specific time.

When developing the discount rate of a business, it is common practice to select the RFR considering the expected maturity of the cash flow of the business. Most valuation professionals select an RFR based on a long-term U.S. Treasury bond yield (e.g., 10-, 20-, or 30-year). The most commonly used source for the RFR is the 20-year U.S. Treasury bond because the Kroll, LLC data used to estimate the ERP (another COE component) is based on this 20-year Treasury bond benchmark.[1] In addition, it is often assumed that the life of an equity investment would closely match a 20-year Treasury bond.

Table 2
Company ABC
Higher Interest Rates' Effect on the COE and Business Value

	12/31/2021	12/31/2025
Risk-Free Rate of Return	1.94%	4.79%
General Equity Risk Premium	7.00%	7.00%
Industry Equity Risk Premium	1.00%	1.00%
Size/Company-Specific Equity Risk Premium	5.00%	5.00%
Estimated Cost of Equity (i.e., BUM)	**14.94%**	**17.79%**
Less: Estimated Long-Term Growth Rate	3.00%	3.00%
Direct Capitalization Rate	11.94%	14.79%
Expected Cash Flow to Equity	$ 1,000,000	$ 1,000,000
÷ Direct Capitalization Rate	11.94%	14.79%
Indicated Market Value of Equity (rounded)	**$8,380,000**	**$6,760,000**

NOTABLE EXPERTS DISAGREE WITH NORMALIZING THE RFR, PRIMARILY BECAUSE THE NORMALIZED RFR DOES NOT REPRESENT AN AVAILABLE INVESTMENT ALTERNATIVE AS OF THE VALUATION DATE.

Inflation affects the RFR, which then affects the COE. Therefore, the COE of a company might increase or decrease as inflation changes. Generally, as the RFR increases, the COE increases and thereby reduces the present value of a business's future cash flow.

In recent years, the RFR experienced significant volatility. Table 1, on the preceding page, highlights the fluctuations during 2005 through 2025 based on the 20-year Treasury bond.

As illustrated in Table 1, the 20-year U.S. Treasury bond yield decreased significantly after 2010 as the FOMC responded to the 2008 financial crisis (which led to a deep recession for the United States and globally and became known as the Great Recession) by keeping the federal funds rate at historic lows. During the COVID-19 pandemic, the FOMC reduced the federal funds rate further, and the 20-year U.S. Treasury bond yield decreased to under 2 percent.

During 2020, when borrowing rates decreased significantly, some valuation professionals advocated using a normalized RFR, such as an average of the RFR benchmark over one or more years. One rationale for this practice is that during high levels of intervention by the Federal Reserve, or during a flight to quality, using a lower RFR implies a lower cost of capital, which is the opposite of what one might expect during a time of economic distress. Therefore, some valuation professionals rely on a "smoothed" RFR, such as the Kroll, LLC normalized RFR, when 20-year U.S. Treasury bond yields are "abnormally" low.

However, normalizing the RFR is controversial among business appraisers. Many notable experts disagree with normalizing the RFR, primarily because the normalized RFR does not represent an available investment alternative as of the valuation date.

Above is an example of how higher interest rates increase the RFR and, thus, the estimation of a

company's COE using the BUM. Valuation professionals often use the BUM to value small and medium-size closely held companies. The basic formula for the BUM is as follows:

RFR + ERP + size/company-specific risk premium + industry equity risk premium

Table 2 illustrates how the estimated equity value of Company ABC at December 31, 2021 (when the RFR was 1.94 percent), compares with the estimated equity value at December 31, 2025 (when the RFR was 4.79 percent).

In this example, the COE is estimated using the BUM, and the only variable that changed is the RFR. Because of higher interest rates, Company ABC's estimated equity value, based on expected cash flow of $1.0 million, was $1.6 million lower at December 31, 2025. The estimated equity value of Company ABC decreased 19 percent between the two valuation dates because of the increase in the RFR.

Cost of Debt

As previously discussed, the WACC is a combination of (1) a company's COE and (2) a company's cost of debt, weighted by the percentage of debt and equity capital in the company's capital structure. The cost of debt represents the interest a company pays on its borrowed funds, adjusted for tax deductibility.

BECAUSE THE COST OF CAPITAL IS USED TO DISCOUNT THE EXPECTED NET CASH FLOW OF A BUSINESS AND REPRESENTS THE EXPECTED RATE OF RETURN OF AN INVESTMENT, THE COST OF CAPITAL IS A FORWARD-LOOKING CONCEPT.

To estimate a company's cost of debt, the valuation professional might first consider the company's actual borrowing rates. However, if the company has fixed-rate long-term debt, the effective borrowing rates being paid might differ from prevailing market rates—rates available to the company on new loans—particularly if interest rates have had significant volatility. For example, in 2020, many companies took advantage of historically low interest rates to lock in long-term fixed-rate loans. As of 2025, those rates were unavailable and, therefore, might not be relevant in developing a market-based WACC as of a 2025 valuation date.

Because the cost of capital is used to discount the expected net cash flow of a business and represents the expected rate of return of an investment, the cost of capital is a forward-looking concept.[2] So, the valuation professional may decide whether a company's actual historical borrowing rates (potentially below current market rates available for new loans) should be used as a proxy for the cost of debt in developing the WACC.

Table 3
Historical Interest Rates

	U.S. Prime Rate [a]	LIBOR/SOFR [b]
12/31/2005	7.25%	4.34%
12/31/2006	8.25%	5.34%
12/31/2007	7.25%	4.82%
12/31/2008	3.25%	0.14%
12/31/2009	3.25%	0.17%
12/31/2010	3.25%	0.25%
12/31/2011	3.25%	0.15%
12/31/2012	3.25%	0.17%
12/31/2013	3.25%	0.08%
12/31/2014	3.25%	0.09%
12/31/2015	3.50%	0.27%
12/31/2016	3.75%	0.69%
12/31/2017	4.50%	1.43%
12/31/2018	5.50%	3.00%
12/31/2019	4.75%	1.55%
12/31/2020	3.25%	0.07%
12/31/2021	3.25%	0.05%
12/31/2022	7.50%	4.30%
12/31/2023	8.50%	5.38%
12/31/2024	7.50%	4.49%
12/31/2025	6.75%	3.87%

LIBOR = London interbank offered rate
SOFR = Secured Overnight Financing Rate
[a] Sourced from Federal Reserve Economic Data.
[b] Sourced from S&P Capital IQ. Represents the LIBOR overnight rate for December 31, 2005, through December 31, 2017; and the SOFR for December 31, 2018, through December 31, 2025. Although the LIBOR and SOFR are not directly comparable—the LIBOR includes a credit risk premium—the SOFR replaced the LIBOR as a commercial loan benchmark. We list the rates together for illustrative purposes.

To estimate a market-based cost of debt for a privately held company, the valuation professional may (1) consider the borrowing rates of selected guideline publicly traded companies, if available; (2) analyze benchmark corporate bond rates considering the subject company's risk profile; or (3) ask management about the interest rates available to the company on new long-term loans. Most privately held companies do not have readily available debt ratings, but the valuation professional might be able to estimate a credit rating based on the company's recent borrowing history or by creating a synthetic credit rating for the subject company based on its risk profile.

Table 4
Company ABC
Higher Interest Rates' Effect on the WACC and Business Value

	12/31/2021	12/31/2025
Before-Tax Cost of Debt	3.25%	6.75%
Tax Adjustment	21.00%	21.00%
After-Tax Cost of Debt Capital	2.57%	5.33%
Weighted Average Cost of Capital Calculation:		
Cost of Equity Capital	14.94%	17.79%
Multiplied by: Equity/Invested Capital	70.00%	70.00%
Equals: Weighted Cost of Equity Capital	10.46%	12.45%
Cost of Debt Capital	2.57%	5.33%
Multiplied by: Debt/Invested Capital	30.00%	30.00%
Equals: Weighted Cost of Debt Capital	0.77%	1.60%
Weighted Average Cost of Capital (rounded)	**11.0%**	**14.0%**
Less: Expected Long-Term Growth Rate	3.0%	3.0%
Direct Capitalization Rate	8.0%	11.0%
Expected Cash Flow to Invested Capital	$ 1,000,000	$ 1,000,000
÷ Direct Capitalization Rate	8.0%	11.0%
Indicated Market Value of Invested Capital (rounded)	**$ 12,500,000**	**$ 9,100,000**

Like the RFR, the cost of long-term debt from 2011 through 2021 remained well below the historical cost of debt because of the Federal Reserve's monetary policy. This trend reversed in 2022 as inflationary pressures prompted aggressive rate hikes.

Several common benchmarks can provide indications of the market borrowing rates available to a company. As previously discussed, the U.S. prime rate reflects the interest rate posted by a majority of the top 25 insured, U.S.-chartered commercial banks and is a base rate sometimes used by banks to price short-term business loans. The Secured Overnight Financing Rate ("SOFR"), which replaced the London interbank offered rate ("LIBOR"), reflects the cost of borrowing overnight and is commonly relied on as a benchmark for corporate lending rates. For example, many lenders offer companies lending rates based on the SOFR plus a margin to account for credit risk premium (e.g., 250 basis points above the 30-day SOFR).

As presented in Table 3, on the preceding page, yields on the U.S. prime rate, the SOFR, and the LIBOR (overnight), reached historic lows at year-end 2020 and 2021 during the COVID-19 pandemic but increased significantly from year-end 2022 through 2024 because of the Federal Reserve's anti-inflationary measures. As of December 31, 2025, the yields were closer to pre-2008 financial crisis levels.

Continuing with the example of Company ABC, with an estimated COE of 14.9 percent and 17.8 percent at December 31, 2021, and December 31, 2025, respectively, we now estimate the company's WACC. In this example, the cost of debt is the other variable (with the RFR) that changed between the two valuation dates.

SEVERAL COMMON BENCHMARKS CAN PROVIDE INDICATIONS OF THE MARKET BORROWING RATES AVAILABLE TO A COMPANY.

According to *WSJ Buy Side*, as of January 2026, the current average business loan rates offered by banks started at 6.3 percent annually but might be higher or lower based on the loan type, the lender, and the borrowing company's ability to meet certain criteria and personal credit requirements.[3] In this example, we estimated

Company ABC's cost of debt based on the prime rate at each valuation date.

Table 4, on the preceding page, presents the estimated WACC and resulting market value of invested capital ("MVIC") of Company ABC as of December 31, 2021, and December 31, 2025. Because of the increase in interest rates and, therefore, the RFR and the company's cost of borrowing, the estimated WACC of Company ABC increased from 11 percent at December 31, 2021, to 14 percent at December 31, 2025.

These trends align with global market surveys of the cost of capital for various companies. For example, KPMG's 2025 survey of medium- to large-size companies reported an increase in overall WACC from 6.6 percent in 2020/2021 to 8.5 percent in 2024/2025.[4]

Because of higher interest rates affecting Company ABC's COE and WACC on the later valuation date, the estimated MVIC decreased by $3.4 million, or 27 percent, between December 31, 2021, and December 31, 2025, based on the same expected cash flow of $1.0 million. The decrease shows the significant effect rising interest rates and higher costs of borrowing can have on business valuations, even when cash flow remains constant.

Conclusion

While the example of Company ABC is simplistic, with only the RFR and the cost of debt changing, it illustrates how higher interest rates can significantly reduce indications of a company's business value. Higher interest rates result in a higher discount rate for Company ABC and, therefore, a lower indication of the company's value.

Professionals who rely on business valuations (e.g., attorneys) must understand how changes to the major variables (e.g., the discount rate) can affect a company's value. This knowledge equips them to help clients understand the valuation process and make informed decisions, such as selecting the most opportune time for estate planning or acquiring or selling a business.

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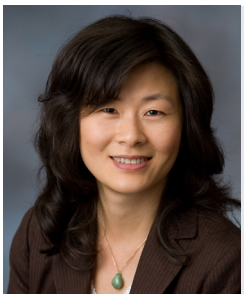

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