**Rolling WACC:** A Time-Varying WACC

economics



### 1. Discount rate and its use in quantum of damages

- The discount rate allows the calculation of the present value of past or future cash flows by accounting for the time value of money and risk. It reflects the opportunity cost of capital.
- In damages assessment, the discount rate is used to determine the present value of the benefits a party failed to receive due to a breach or harm, thereby providing equivalent compensation today.





# 2. Relevant discount rate in quantum of damages

- To determine which rate to use as the discount rate, it is important to understand the alternative use of the foregone cash flows.
- If the cash flows would have been reinvested or allocated to ongoing business operations, the WACC best reflects the company's opportunity cost.
- WACC represents the firm's financing rate, and as such, it indicates the minimum return the company's assets must generate in order to cover the cost of financing.





#### **3. The WACC rate**

• It is calculated by weighting the costs of debt and equity based on the company's capital structure:

$$WACC = \left(\frac{Equity}{Assets}\right) * Cost of equity + \left(\frac{Debt}{Assets}\right) * Cost of debt * (1-tax rate)$$

- Cost of equity: return required by shareholders on the capital they have contributed.
- Cost of debt: cost at which the company borrows funds from third parties.





- Rolling WACC: a WACC that varies over time, instead of applying a single constant rate for each period.
- It is used when the cost of capital is expected to change significantly over time due to market or firm-specific conditions.







Below are the most common contexts in which Rolling WACC is used:

1. Periods of high uncertainty or crisis (e.g., pandemics)

During periods of high volatility in interest rates, inflation, or country risk, the WACC can fluctuate significantly.

To avoid penalizing future estimates based on current economic conditions, it is reasonable to apply a higher discount rate in the short term (higher uncertainty) and a lower one in the long term (greater stability).





#### 2. Early-stage companies

Young companies typically face greater risk, which implies a higher WACC. As they become more established and stable, their cost of capital tends to decline, justifying the application of decreasing rates over time.

This can be implemented by analyzing the Interest Coverage Ratio<sup>1</sup> and the associated risk spread<sup>2</sup>.

1. Measures a company's ability to pay interest on its debt using EBIT. It shows how many times the firm can cover its interest obligations with operating income: Ratio = EBIT / Interest Expense

2. The additional premium investors require to compensate for the higher risk of default associated with a debt instrument, relative to a risk-free instrument.





#### 3. Expected changes in capital structure

If the company is projected to alter its mix of debt and equity (e.g., reducing leverage), this may affect the WACC and justify the use of differentiated rates.

#### 4. Investment projects with distinct risk phases

For example, in infrastructure or energy projects, there is often an initial construction phase with high risk, followed by a more stable operational phase.

