Valuation Newsletter

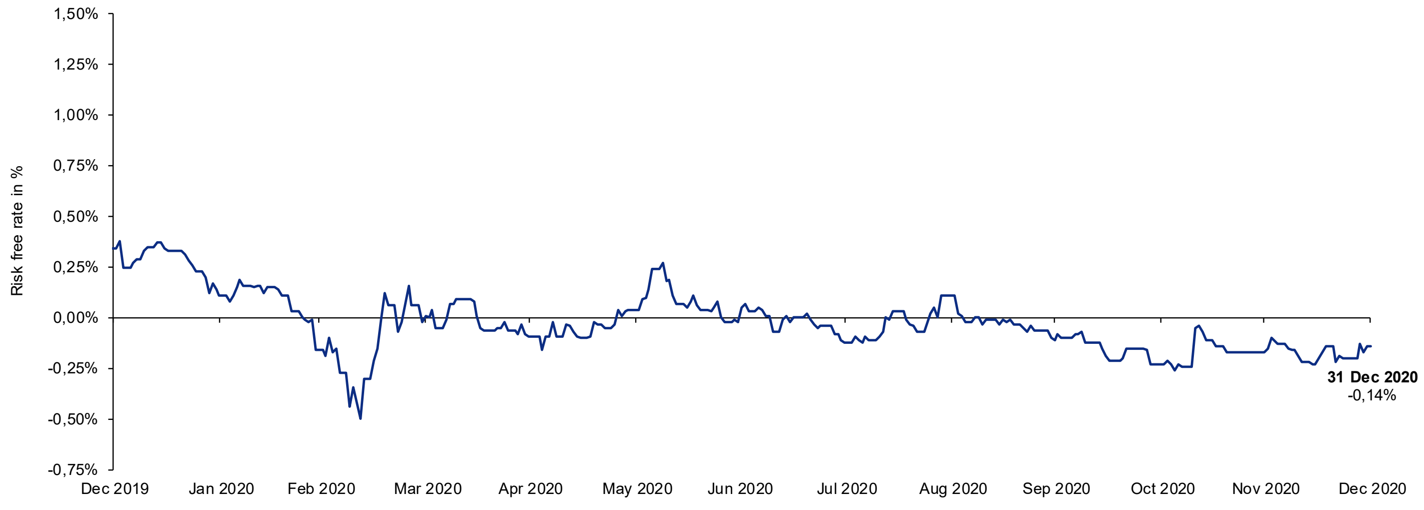
Special Edition on Cost of Capital
as of 31 December 2020

Risk-free rate for Austria
The risk-free rate can generally be broken down into two key components that seek to compensate the investor: the first for expected inflation and the second for deferred consumption. The risk-free rate is considered to be free of risks except for risks embedded in the underlying currency and risks related to investments in the particular country (including general political, legal, regulatory and tax risks, as well as the risk of a moratorium). As no investment is truly risk-free, the risk-free rate is typically approximated by reference to the yield on long-term debt instruments issued by presumably financially healthy governments.

As a risk-free rate we recommend to use the spot-rate of zerobonds, denominated in Euro with a maturity of 30 years applying the Svensson-yield curve and data from Deutsche Bundesbank, as of the valuation date. This approach is also in line with the Austrian Professional Guidelines for the Valuation of Businesses (KFS/BW 1) and respective recommendations.
The graph below summarizes the development of the above-mentioned risk-free rate (zerobonds) over the last twelve months as of 31 December 2020.

As of 31 December 2020, the risk-free rate (30-year spot-rate of German zerobonds) was -0.14 percent.

Risk-free rate (30y spot rate)
last twelve months as of 31 December 2020



Source: Deutsche Bundesbank; Analysis: KPMG

In the light of this historically low risk-free rate, we recommend to also align the long-term growth rate (eg applied in the terminal value) accordingly. Along the lines of economic and finance theory, the sustainable (real) growth rate cannot significantly exceed the long term (real) interest rate, ie the risk-free rate, in the long run.

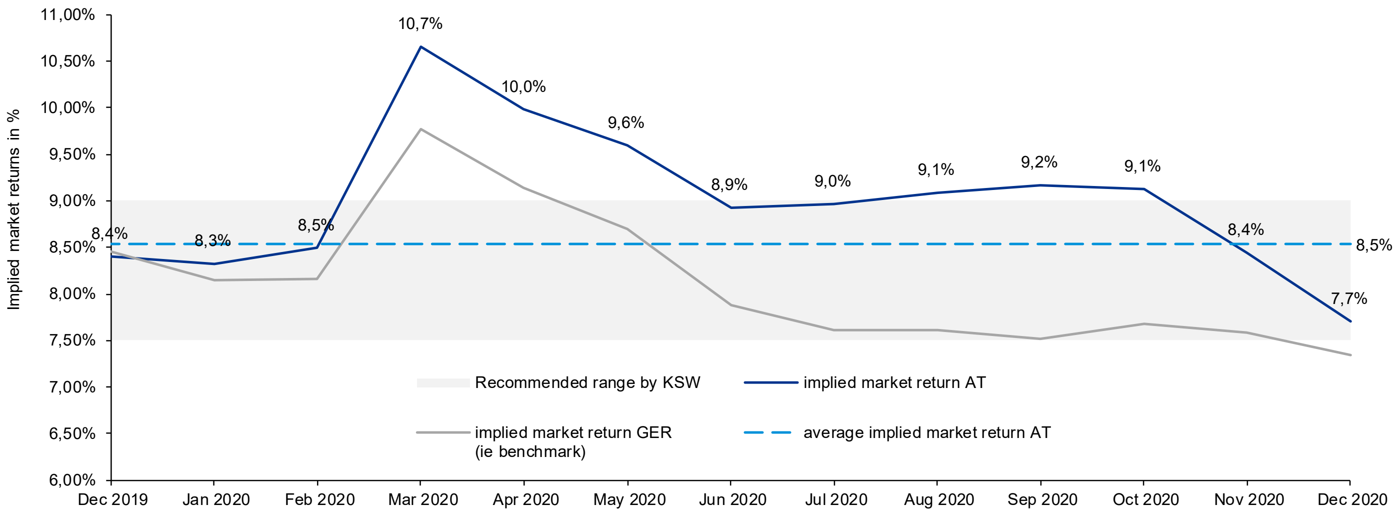
Equity risk premium for Austria

The equity risk premium represents a compensation for the higher risk of investing in a company compared to a (theoretically) risk free security, eg government bonds. According to finance theory – ie CAPM - the equity risk premium refers to the excess return of the equity market, ie the difference between the expected return on the market portfolio, which represents the portfolio of a typified fully diversified investor, and the return of a risk free investment.

According to the new recommendation of the Expert Group on Business Valuation of the Austrian Chamber of Tax Advisors and Auditors, the market risk premium should be based on (implied) market returns. The Expert Group recommends a range for the expected market return between 7.5 percent and 9.0 percent. Furthermore, the market risk premium should be consistent with the current level of the market return and the current level of the risk-free rate.
Along these lines, we build a comprehensive model and have been calculating and analyzing implied market returns for major capital markets over the past years.

The graph below summarizes the development of the implied market return for Austria (ATX Prime) over the last twelve months as of 31 December 2020.

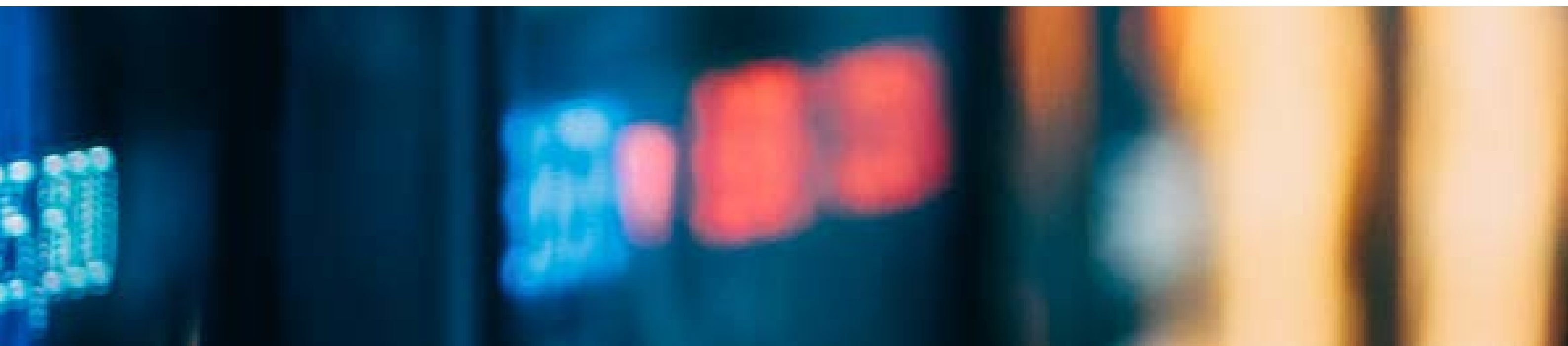
Implied market returns (ATX Prime)
last twelve monts as of 31 December 2020



Source: S&P Capital IQ; Analysis: KPMG
Note: long-term average refers to the period 01/2017 to 12/2020
Note: For details on the methods and assumptions of our model please refer to our Valuation Newsletter 2018 Q1

As of 31 December 2020, the implied market return for Austria amounts to approx. 7.7%. However, considering the bullish rally not only on the Austrian but also on other international stock markets over the last 8 weeks, the current observable implied return might overestimate the actual implied return to a certain degree, since it can be assumed, that not all of the underlying estimates on future earnings and dividends might already be adjusted and in line with updated expectations of investors. Furthermore, despite all the optimism about the new COVID-19 vaccines, there are still significant uncertainties and risks regarding the future development of the financial and economic environment.

Against this background, we recommend using a market risk premium of 8.25 percent for the Austrian capital market as of 31 December 2020.



The table below summarizes our recommendations for the risk-free rate, the corresponding market risk premium and the implied market return for the last twelve months for Austria. Here, parameters represent our recommendation for valuations within the Austrian market.

Recommended risk-free rate and market risk premium				
Date	Implied market return	Risk-free rate	Implied MRP	Recommended MRP
Dec 31, 2019	8,40%	0,34%	8,06%	8,00%
Mar 31, 2020	10,66%	0,01%	10,65%	8,50%-9,00%
Jun 30, 2020	8,93%	-0,02%	8,95%	8,50%-8,75%
Sep 30, 2020	9,17%	-0,11%	9,28%	8,50%
Dec 31, 2020	**7,71%**	**-0,14%**	**7,85%**	**8,25%**

If you are interested in further reading, we recommend the following papers:

- Aschauer/Isack/Purtscher: Zum Basiszins für die Unternehmensbewertung. RWZ (2020), 5
- Aschauer/Purtscher/Witte: Renditeforderungen in Krisenzeiten - Eine empirische Untersuchung der letzten Krisenereignisse. RWZ (2020), 6
- Aschauer/Purtscher/Witte: Renditeforderungen in Krisenzeiten - Ein Update empirischer Untersuchungen zum aktuellen Krisenereignis. RWZ (forthcoming)

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