



What's it worth?

Determining value in the continuing low interest rate environment

KPMG Valuation Practices Survey 2019







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Introduction

Welcome to KPMG's Valuation Practices Survey 2019

In this report, KPMG presents the key findings of its 2019 Valuation Practices Survey. The 2019 survey is a short-form update of opinions on the current market environment and key valuation assumptions as valuers perceived them on 30 June 2019, at the end of the 2019 financial year. Comparisons are made to our prior survey, which referenced 30 June 2018.

The results provide insights into the current approach to determining value in the continuing low interest rate environment, as well as emerging valuations issues such as the impact of AASB16 Leases and the treatment of Environmental, Social and Governance considerations. We hope the survey will help build consistency in valuation practices and enhance trust in the accuracy and independence of the valuation community.

Many thanks to those who completed the survey. Your input is invaluable.

Please feel free to discuss the results of the survey with us.

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About the survey

Survey structure

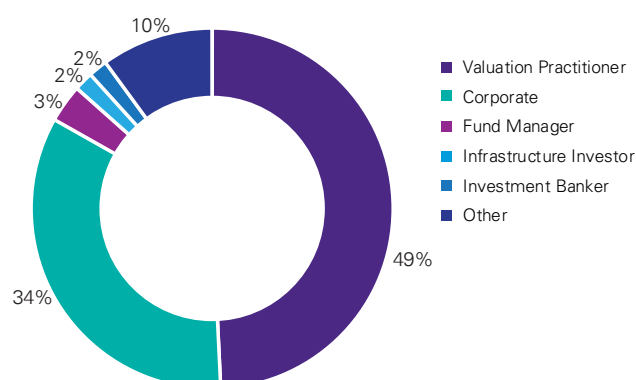
An online survey was conducted by KPMG Acuity with a sample of valuation and other business professionals. The survey provides a summary of their opinions on the current market environment and key valuation assumptions.

The 2019 survey was open between the 17th to the 30th of October 2019, with a total of n=59 respondents completing the survey. This is a slight increase on the number completing the survey in 2018 (n=56).

Where applicable, 2019 survey results are compared to 2018 survey outcomes.

Respondent Profile

The role of respondents who completed the survey is specified below:



Key survey findings

- There has been a decline in positive sentiment year on year. Valuation professionals expect the S&P/ASX200 to decline rather than increase in FY20. Only 22% say the index will increase in FY20, down from predictions of 39% for FY19 in the previous year's survey.
- Australian government bond yields are an important indicator and the market is predicting a decline in bond yields. 49% of the respondents (a significant increase from 7% in 2018) believe the yield on 10-year Australian government bonds will decrease in FY20.
- In line with this, two thirds (68%) have changed the risk free rate they adopted for Australia in the last 12 months – a significant jump relative to FY18 (32%). However, the majority have not changed their market risk premium (80%).
- Uncertainty has increased since FY18 on current levels of value for key asset classes. Listed equities and real estate are now perceived as the most 'overvalued' asset class. Real estate continues to be perceived as being 'overvalued' by close to half, but is down significantly on the previous year (47%, down from 89%).
- Unchanged from observations in FY19, retail, construction and the finance/insurance/real estate sectors are the top three sectors identified at risk of facing impairment challenges in FY20. To note, the manufacturing and mining sectors are expected to face an increased risk relative to FY19.
- The standard rate of inflation applied in valuations at FY19 for the coming years is expected to grow incrementally, specifically from 2020 to 2024, but remains below 2.5% on average.
- Australia has the highest 'market' cost of equity of the selected developed economies at 8.8%, with the US and Europe the lowest at 6.5%.

The survey results

The General Market Environment

Asset Valuation



Uncertainty over the current levels of value for key asset classes has increased since the prior survey.

2019 was a continuation of the challenges that emerged in the global economy during 2018 – Brexit is unresolved, the US/China trade dispute is ongoing and a brief increase in risk free rates proved to be temporary as yields have once again dropped. We asked respondents for their opinion as to current level of value for certain key asset classes in Australia:

Real Estate: remains overvalued but less so than in FY18 as the signs of a cooling Australian property market became more widespread.

Infrastructure: remains 'about right' with significant levels of new investment continuing to flow into the sector. A limited supply of quality investment opportunities in Australia continues to push investors to look offshore for opportunities.

Listed equities: listed equities continue to be perceived as slightly 'overvalued'. However, expectations for equity value may be adjusted as the low risk free return environment is increasingly seen as sustainable over the longer term.

Bonds: bond market volatility is likely to continue for as long as global macro issues remain unresolved, with current perceptions bond markets are 'about right'.

Agriculture: despite continued investment into the agricultural sector, assets in the sector are still perceived to be slightly 'undervalued'.

Resources: stable prices in a number of key commodities is driving a positive perception of value with values in the sector considered to be 'about right'.

What is your opinion as to the current levels of value for the following asset classes?

0 = Undervalued 1 = About right 2 = Overvalued



Real Estate



Infrastructure



Listed Equities



Bonds



Agricultural



Resources

Movement in FY20

The S&P/ASX200 is more likely to decline than increase in FY20.

Sentiment has reversed from a year ago, with a smaller proportion of respondents (22%) expecting the index to increase – a large dip relative to the prior survey (39%) – **with over a third of respondents expecting a decline over FY20** (36% v 23% in the prior survey).

During FY18 and FY19, the S&P/ASX200 index moved +8.3% and +6.8% respectively. How do you expect the index to move in FY20?

36%

said decrease

22%

said increase



Australian government bond yields are expected to decline in FY20.

The number of respondents **expecting the yield on 10-year Australian government bonds to decrease in FY20 has significantly increased** (49%, up from 7% in 2018). Only **16% are predicting an increase** in the yield, while the remainder (36%) expect it to remain steady.

During FY19, the yield on 10-year Australian government bonds started at 2.74% and declined to finish at 1.38%. How do you think bond yields will move in FY20?

36%

said steady

2020

49%

said decrease



Impairment of Asset Values & Valuations

Incidence of Impairment

The incidence of impairment of asset values was steady in FY19.



Close to half (46%) of all respondents surveyed indicated that the **incidence of impairment in FY19 was steady**, although this is notably lower than in the prior survey (63%). **About a third (34%)** of respondents believe the incidence of impairment increased in FY19, up from 25% in FY18.

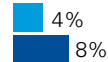
Looking forward to FY20, expectations of impairment remain relatively unchanged compared to last year.



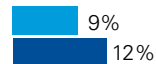
Close to half (47%) expect the incidence of impairment to remain steady while a similar proportion (44%) expect impairment to increase in FY20. Only 3% predict a lower incidence of impairment than that experienced in FY19.

Would you say that the incidence of impairment of asset value and valuations increased, decreased or remained steady in FY19?

Don't know/unsure



Decreased



Remained steady



Increased



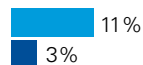
FY18 FY19

Do you expect the incidence of impairment to increase, decrease or remain steady in FY20?

Don't know/unsure



Decrease



Remained steady

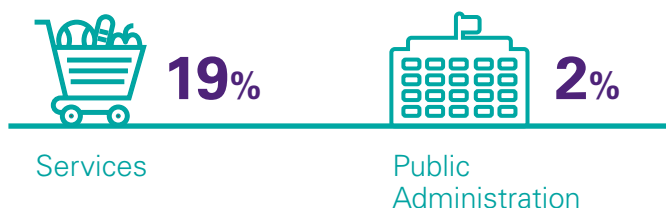


Increase



FY19 FY20

Which of the following sectors do you expect to face impairment challenges in FY20?



Unchanged from observations in the prior survey, retail, construction and the finance/insurance/real estate sectors are the top three sectors identified as being at risk of facing impairment challenges in the year ahead.

More than half of respondents expect impairment challenges for the finance, insurance, real estate sectors (51%, although notably down from 70% in the prior survey).

The mining sector (32%) has seen a significant increase in the risk of impairment relative to last year (7%).

Determination of a Cost of Equity

Risk Free Rate

At 30 June 2019 the average risk free rate adopted for valuations of perpetual life Australian assets was 2.4% on average – down from 3.0% at 30 June 2018.



Most respondents **(66%)** tended to adopt a risk free rate of below 3.0%.

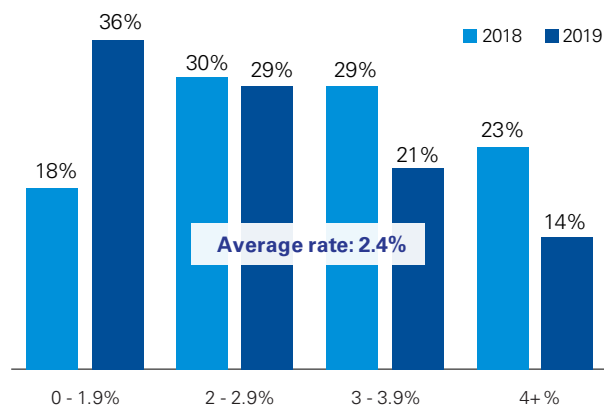
Most changed the risk free rate for Australia in the last 12 months.



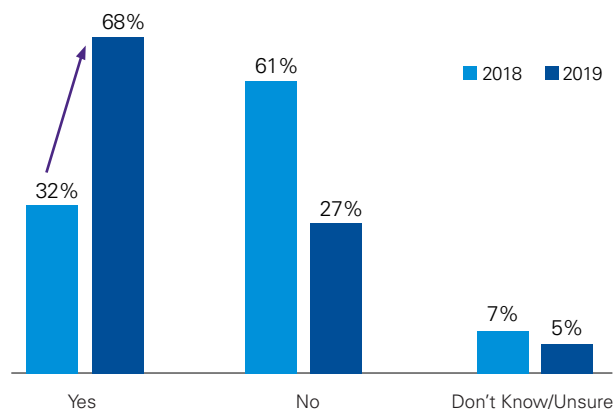
Two thirds (68%) of all respondents indicated that they changed the risk free rate they adopted for Australia during FY19. This is a significant jump relative to the result recorded in the prior survey (32%).

Those who changed the rate (68%), adjusted it down by 0.6% on average.

What was the risk free rate you adopted for valuations you completed for a perpetual life Australian asset at 30 June 2019?



Have you changed the risk free rate you adopted for Australia in the last 12 months?



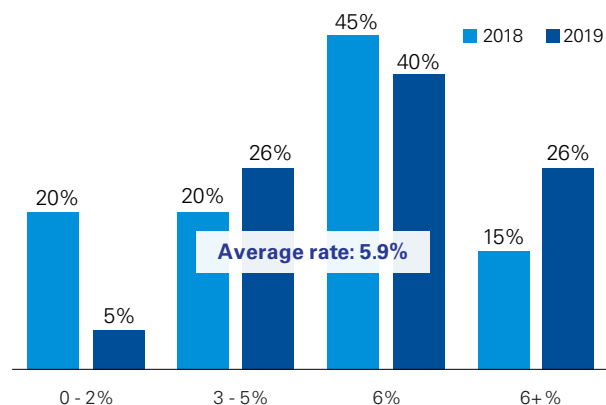
Market Risk Premium

In line with a declining risk free rate the market risk premium has increased.



Most respondents adopted a market risk premium of 6% or more for valuations completed for a perpetual life Australian asset at 30 June 2019. The average market risk premium was 5.9%, up from an average of 5.5% in 2018, with more than a quarter of respondents adopting a market risk premium of more than 6%.

What was the Market Risk Premium you adopted for valuations completed for a perpetual life Australian asset at 30 June 2019?



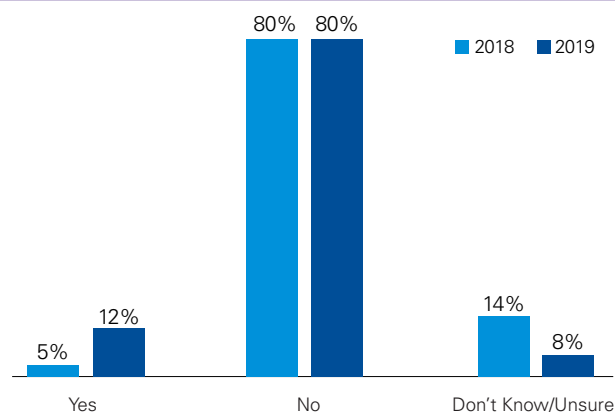
Changing the Market Risk Premium

The majority of respondents have not changed their market risk premium adopted for Australia in the last 12 months.



In line with the previous year's results, **eight in ten (80%)** respondents **have not changed their market risk premium.**

Have you changed the Market Risk Premium you have adopted for Australia in the last 12 months?



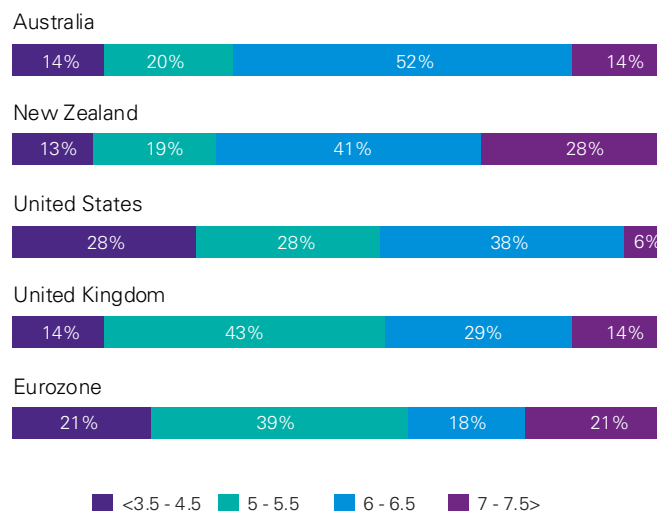
Market Risk Premium adopted for various countries

The market risk premium adopted for the Eurozone continues to be the lowest across the common developed economies, having the least number of respondents using a market risk premium of above 6%.



The market risk premium **is lowest in the US, UK and Europe.**

What Market Risk Premium do you adopt when valuing assets in the following countries? Don't know responses excluded



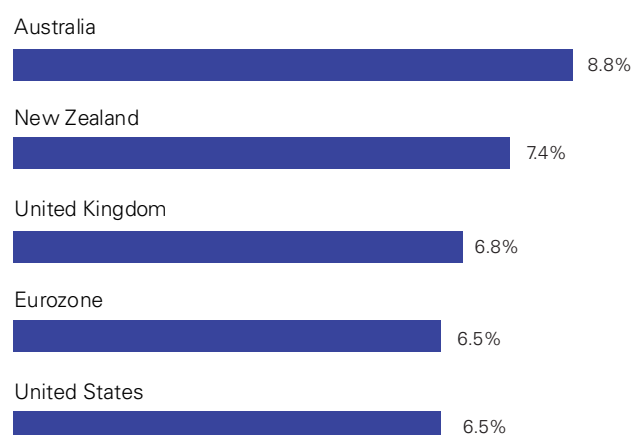
Equity and Equity Rates

With a geared beta of 1 assumed, Australia had the highest cost of equity at 30 June 2019.

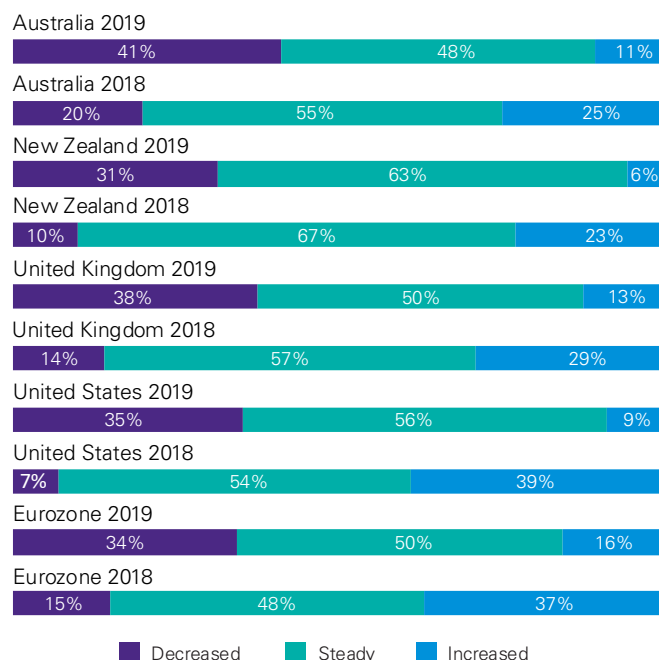


Assuming a geared beta of 1.0, the cost of equity was highest in Australia (8.8%). The next highest was in New Zealand (7.4%), followed by the UK (6.8%). Both the Eurozone and United States came in with the lowest cost of equity at 6.5%.

Assuming a geared beta of 1, what would your cost of equity have been at 30 June 2019 for:



Have these equity rates increased/decreased or remained the same since 30 June 2018:



Equity rates are largely perceived to have decreased in FY19.



Equity rates are most commonly perceived to be 'steady' across all the regions surveyed by approximately half of all respondents. However, relative to the prior survey, there has been a notable increase in those saying that equity rates have decreased globally, with as many as 41% of respondents indicating a decline in equity rates in Australia, 38% in the United Kingdom, 35% in the United States and 34% in the Eurozone.



Assessment of Franking Credits

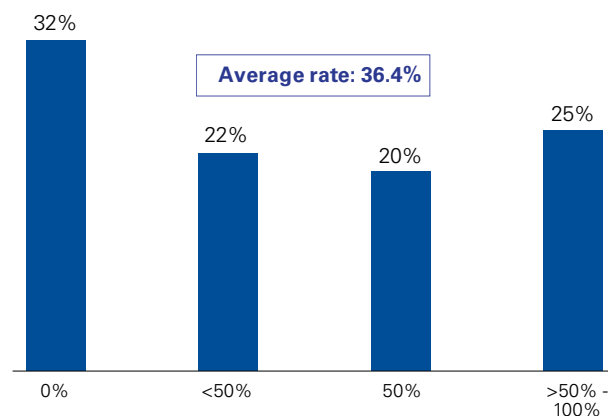
Benefits

Where imputation benefits are included the average utilisation factor assumed was 36.4%.



Respondents were relatively divided with a third (32%) assuming a utilisation factor of 0% when imputation benefits were included as an adjustment to cash flow, 22% adopted less than 50%, 20% adopted half, while the remainder (25%) adopted a factor of between 50% to 100%.

Where imputation benefits are included as an adjustment to the cash flows, what utilisation factor do you assume?



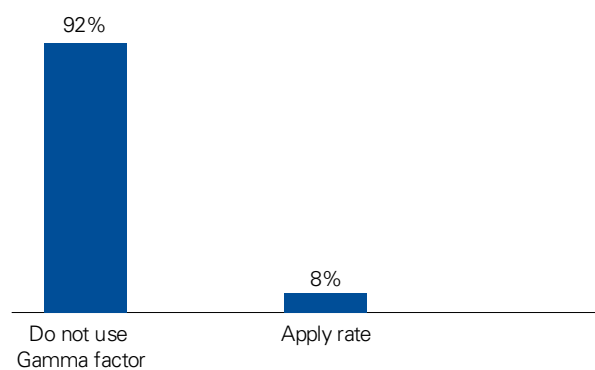
Gamma Factor

The majority do not apply a gamma factor.



Almost all (92%) respondents indicated that they did not use a gamma factor in discount rates.

Where a Gamma factor is included in discount rate, what rate do you assume?



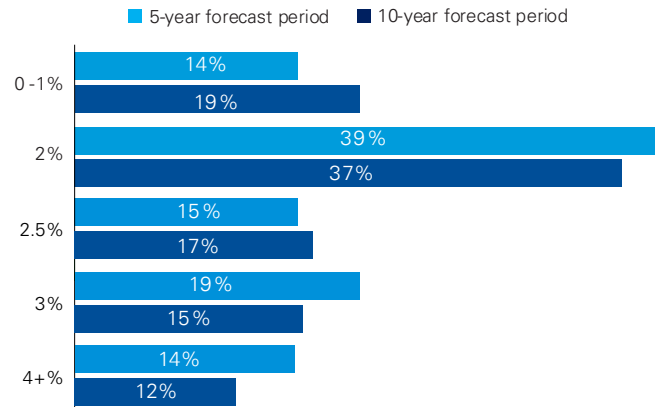
Perpetuity Growth Factor

The standard growth rates used for the perpetuity growth factor are similar for five and 10 year forecast periods.



An average growth rate of 2.9% is used for the perpetuity growth factor after a five year forecast period and 2.8% for a 10 year forecast period.

What standard growth rate do you use for the perpetuity growth factor after a 5 and 10 year forecast period?



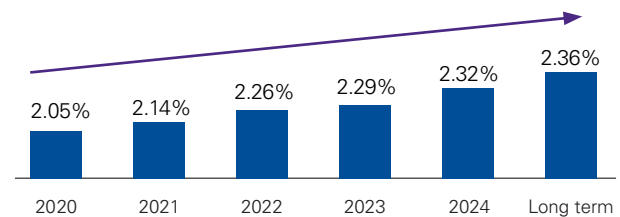
Standard Rate of Inflation

The standard rate of inflation applied in valuations at 30 June 2019 shows an increasing profile for the coming years.



Respondents are forecasting inflation to grow incrementally from 2020 to 2024, but staying below 2.5% in the longer term.

What standard rate of inflation did you apply in valuations at 30 June 2019 for:



Cost of Debt

Subject company borrowing rates and risk free rates are the most common approaches used to set the cost of debt.

And the average base cost of debt adopted at 30 June 2019 was 4.9%.

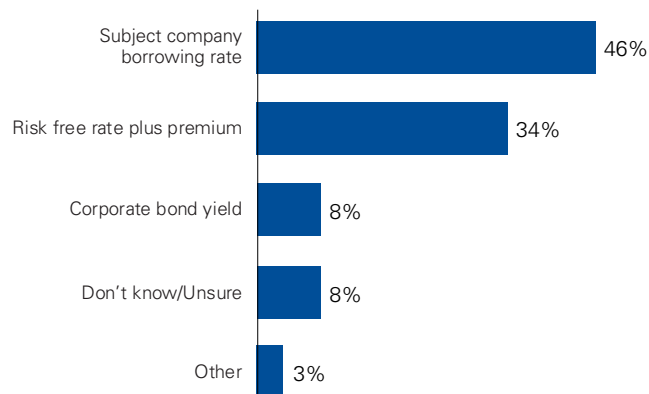
AASB 16 – Leases

Adjustments to accommodate AASB 16

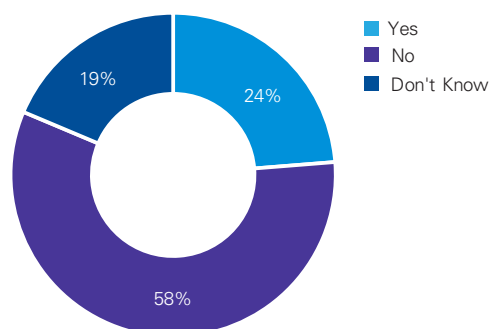
Most respondents (58%) have not made adjustments to their valuation process or assumptions to accommodate the introduction of AASB 16.

One quarter (24%) say they have adjusted their process to accommodate AASB 16 (n=14). These adjustments included changes in the calculation of the cost of debt and gearing level.

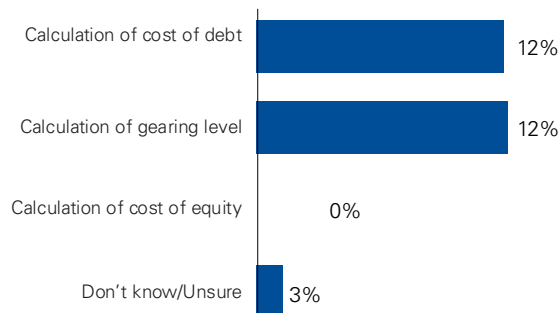
What approach do you adopt in setting the cost of debt?



Have you made adjustments to your valuation process or assumptions to accommodate the introduction of AASB 16?



What were these adjustments in relation to?



Assessment of Environmental, Social and Governance Factors

ESG Factors

Most respondents consider ESG factors when performing a valuation.



When accounting for ESG factors most respondents do so qualitatively (46%), while only 7% use a quantitative method when accounting for ESG factors.

Treatment of ESG Factors

Treatment of ESG factors is mostly unchanged in FY19.



A quarter reported their treatment of ESG factors changed in FY19 with 24% giving more attention to these factors (down from 29% in the prior survey). Over half (56%) did not change their treatment of ESG factors.

Control Premium

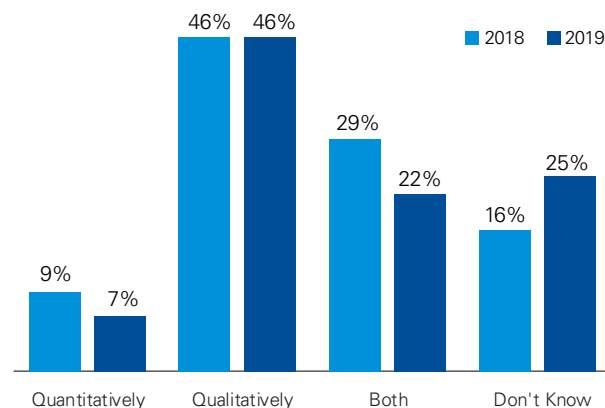
Range currently adopted as standard control premium.



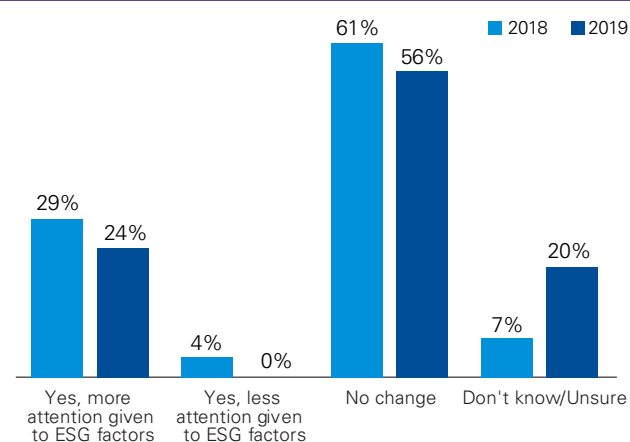
Overall, the average standard control premium adopted by respondents was 14% at the low end of the range and 27% at the high end of the range.

For Valuation Practitioners, the range increases to 17% to 34%.

How do you account for Environmental, Social and Governance factors when performing valuations?



Has your treatment of Environmental, Social and Governance factors changed in FY19?



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