



International Valuation Newsletter

9th Edition
July 2019

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Dear reader

The trade conflict between China and the US is just one of many ongoing disputes around the world. However, the G20 summit at the end of June may have produced a first step to end the huge tariff increases and their negative impacts on economic developments. The significant oil price increase in the immediate aftermath indicates the potential effects of any escalation. In Europe, elections to the European Parliament in Q2 revealed large gains for far-right parties, while the selection of a new UK prime minister is still pending.

Combined, the ongoing political uncertainties, a weak US dollar, and a possible easing of the Federal Reserve and the ECB's monetary policies have driven investors to a traditionally safe-haven investment – gold. Its price hit a six-year high at the end of June, having gained more than 9.2% in Q2 2019 while the S&P 500 and EUROSTOXX 600 gained 3.8% and 1.5% respectively.

As the results of these developments continue to be observed and digested, this edition of KPMG's International Valuation Newsletter shares an update on recent capital market data that are relevant to any valuation analysis in these turbulent times:

- Major stock market performances: US indices outperformed by SMI
- EURO STOXX 600 sector multiples: Mainly flat while IT dominates Q2 2019
- Current risk-free rates for major currencies: Interest rates continue to decline
- Recent country risk premiums and inflation forecasts for the BRIC countries: Stable, high growth rates expected over the coming years for India and Brazil

In addition, we shed some light on valuation considerations resulting from the new IFRS 16 leasing standard.

We wish you a pleasant summer and look forward to discussing with you any questions you might have regarding valuation trends and practices.

Yours faithfully



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IFRS 16

how will the new leasing standard affect your company valuation?



The introduction of IFRS 16 'Leases' significantly changes the view of the balance sheet in many consolidated financial statements. As of January 1, 2019, it requires that the present value of future lease and rental payments is recognized as a liability, and the right to use the leased or rented assets is capitalized as an asset on the balance sheet. This is a change from how operating leases were treated in the past. Instead of leasing expenses being part of the operating result, depreciation expense on the right of use – as well as interest expense from the liability – is now recognized in the income statement. The question is: does this impact the value of your company and the valuations you carry out? Let's address some key questions:

Does it provide any new information?

A valuation appraiser may instinctively reply «no». But the answer must not be given in haste. The decisive factor is what new information is provided by applying the new standard.

If applying IFRS 16 enables capital market participants to gain significant new insights into a company's obligations and liabilities, it can be assumed that the share price would fall if they identify new (additional) liabilities. Corresponding effects may also be expected from a fundamentally derived enterprise value. By contrast, if no material new information becomes known, no material change to the share price and enterprise value is to be expected.

With regard to disclosures in the notes to the financial statements – including information on future lease payments in individual maturity bands – we assume that in most cases the application of IFRS 16 will not result in any material new information. And therefore no significant impact on share prices and company values. This is supported by initial empirical data based on quarterly and annual reports of companies that already apply IFRS 16 (so-called 'early adopters') and the fact that rating companies already took the scope and effects of operating leases into account in their past rating assessments.

How are cash flows affected?

We now move on to examine the individual effects of IFRS 16 on the valuation calculation. As net debt increases as a result of additional interest-bearing leasing liabilities being carried as liabilities, an unchanged enterprise value (equity value) means that the total enterprise value (entity value or enterprise value) increases by the same amount as the net debt under gross discounted cash flow (DCF) methods.

The (total) value of the company is determined by the cash flows and capital costs of the object. At the cash flow level, applying IFRS 16 does not change the sum of a company's cash inflows and outflows, as cash flows

are independent of accounting standards. However, how relevant cash flows are derived for this measurement is influenced by the application of IFRS 16 due to their shift from the operating sphere to the financial sphere. IFRS 16 changes the cash flows of the gross DCF methods such as free cash flow and total cash flow, which are intended to reflect the company's operating sphere. Leasing and rental expenses no longer apply, causing these cash flows to increase. And when a lease agreement is extended, accounting for the right of use has the same valuation effect as an investment that reduces the mentioned cash flows. In the simplified calculation of a perpetual annuity, in which the leasing cycle is



annuity condensed, free cash flow and total cash flow increase by the interest portion of the leasing and rental expenses. The remaining part of the previous leasing and rental expenses is compensated by the computational investments. The cash flow of the net DCF method, the flow to equity, remains unchanged as it comprises both operating and financial spheres.

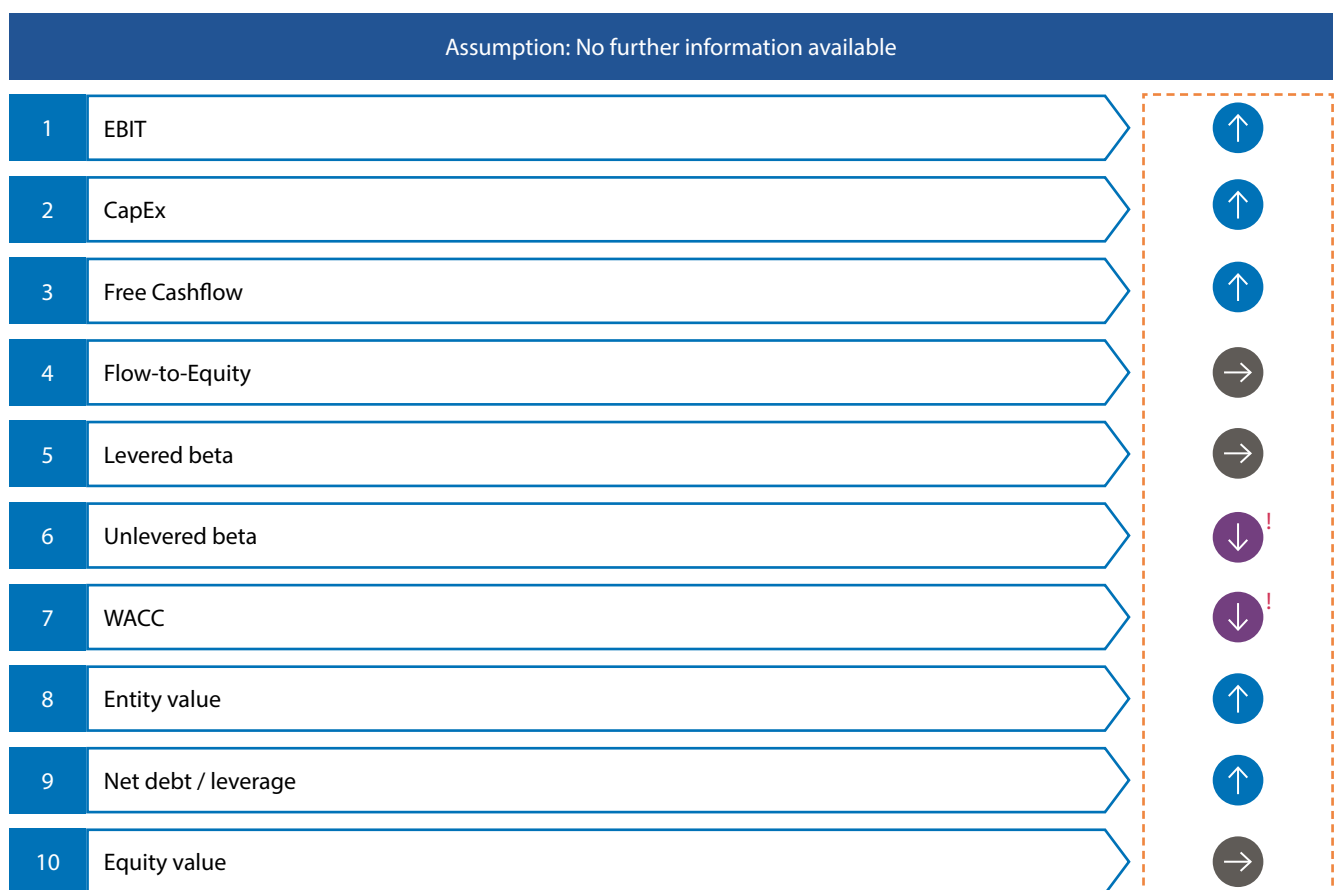
How is cost of capital impacted?

An assessment must first be made along the observable parameters, taking into account the described theory. The levered cost of equity does

not change. The basic interest rate and market risk premium are unaffected by the introduction of IFRS 16. The levered beta factor does not change if the share price remains unchanged when IFRS 16 is applied. And borrowing costs remain unchanged, as the application of IFRS 16 does not change the credit ratings. The weighted average cost of capital (WACC), on the other hand, declines because a block of capital – liabilities under leases – is added to the cost of capital, which is comparable to the cost of debt and is therefore lower than the previous WACC.

Looking at the effects on the other parameters of the cost of capital, the unlevered beta factors fall as a result of the unchanged levered beta factors and the higher debt-equity ratio. The decline in the unlevered beta factor is in line with the adjusted definition of operating cash flows, which are less volatile due to the absence of more fixed leasing and rental expenses.

The following diagram summarizes the effects we have just described.



Implementation in valuation practice

When implementing these concepts in practice, various factors must be considered. At the cash flow level, it must be ensured that integrated budgeting includes all elements of how IFRS 16 is applied.

In addition to eliminating leasing and rental expenses, and instead taking into account interest expenses and depreciation, the tax burden remains unchanged as IFRS 16 as a rule does not change the tax assessment base and the addition of the right of use and lease liability to the balance sheet.

Taking into account a necessary extension of the leasing business, which equals an investment in terms of valuation, must also be considered.



When deriving beta factors, it should be noted that these have in the past been derived usually from historical data collected from the capital market. While this is not critical for the levered beta factors on the basis of the theory explained, when adjusting the financing risk, the so-called "unlevering", it must be ensured that the indebtedness applied for this also takes into account the leasing liabilities from IFRS 16. Since these are usually not available for historical periods, an estimate of the amount of leasing liabilities must be made on the basis of available information. KPMG has a number of models to achieve this. The adjustment to the financing risk of the specific valuation object, the so-called "relevering", is also made on the basis of the debt including IFRS 16 liabilities. Without a corresponding estimate, the unlevered beta factor would be 'too high', and the enterprise value therefore 'too low', which could lead to incorrect decisions in the context of corporate transactions or to unjustified value adjustments in the context of impairment tests.

Over time, the problem will become less significant due to the successive availability of data for IFRS 16 obligations in consolidated financial statements.

The instinctive response that IFRS 16 does not change company values can therefore be justified conceptually and explained in practice.

In addition to the DCF methods, the multiple methods are also influenced by the application of IFRS 16. While this has no significant impact on equity multiples such as the P/E multiple, greater impacts may be observed on entity multiples (EV) such as EV/EBITDA or EV/EBIT. If the entity value increases according to our hypothesis by the lease liability under IFRS 16, and EBITDA increases by the lease and rental expenses, the effect on the EV/EBITDA multiple depends on the ratio of the lease liability to the lease and rental expenses. In most cases, this ratio is likely to be higher than the previous EV/EBITDA multiple, so that the EV/EBITDA multiple will increase once IFRS 16 is applied. This corresponds to the lower WACC mentioned, as multiples are ultimately only inverse values of the cost of capital.

A consistent approach is of the utmost importance when applying the multiple methods. Key performance indicators derived from companies that apply IFRS 16 should only be used in conjunction with multiples from companies that also apply IFRS 16 and vice versa.

Capital market data





In this section we provide a selection of key financial market data, covering:

- Comparison of major stock market performances for the 12 months ending 30 June 2019
- EURO STOXX 600 sector multiples
- Risk-free rates for major currencies
- Country risk premiums and inflation forecasts for the BRIC countries
- Gold price development

Major stock market performances: US indices outperformed by SMI

The MSCI World index maintained its momentum from Q1 2019 by performing well again in Q2 (+3.3%). Despite significant losses in the second half of 2018, the positive development in these first two quarters of 2019 resulted in the MSCI gaining 4.3% on an annual basis.

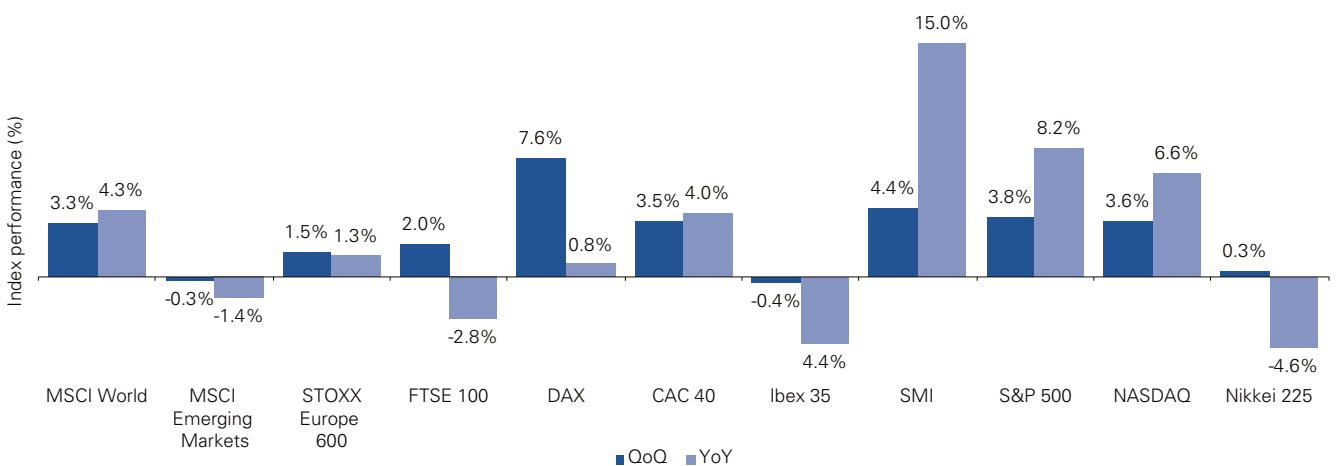
The DAX was the best-performing index in Q1 (+7.6%) though its performance over the past twelve months overall was comparably weak (+0.8%). The SMI continued to perform very well in Q2, at 4.4%. The Swiss index started its rally at the beginning of Q1 after hitting a two-year

low. Due to gains in both quarters of 2019, it outperformed the other major indices on a yearly basis (+15.0%).

In the second quarter of 2019, the major US indices S&P 500 (+3.8%) and NASDAQ (+3.6%) continued strong performances while the Nikkei 225 index (+0.3%) and the Ibx 35 index (minus 0.4%) lagged behind their other European and US counterparts. On an annual basis, both the Ibx 35 and the Nikkei 225 index posted the lowest performance, at -4.4% and -4.6% respectively.

The FTSE 100 index recovered, gaining 2.0% in Q2 despite its negative performance overall in the last 12 months.

Performance of leading indices
30 June 2018 – 30 June 2019



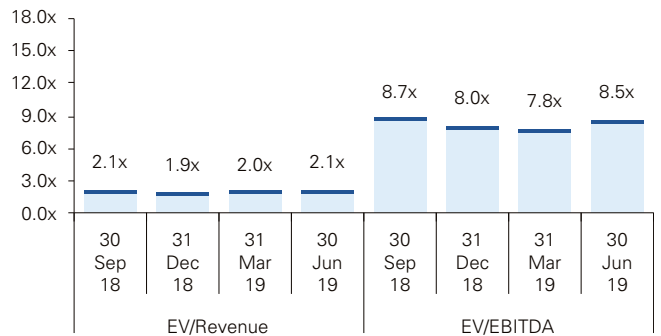
Source: Capital IQ, KPMG analysis

EURO STOXX 600 sector multiples: Mainly flat while IT dominates Q2 2019

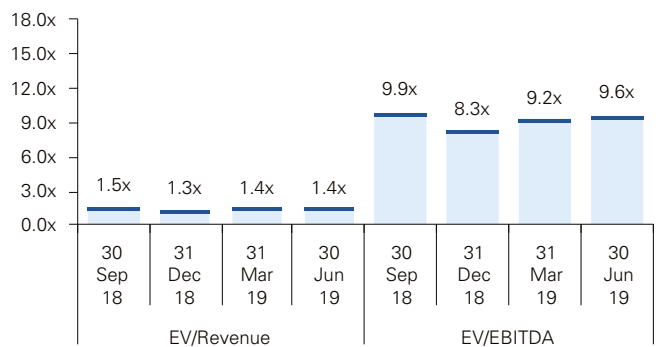
The enterprise value (EV) multiple states the market value of the business in relation to an appropriate base metric. Commonly used EV multiples are revenue and EBITDA. The numerator (EV) and denominator (revenue, EBITDA) represent all investor claims on the business.

The Euro STOXX 600 sector overview of trading multiples showed various valuation trends. Based on EV/EBITDA, most sectors in Q2 2019 experienced an increased multiple level (e.g. energy, industrials or materials) while several EV/revenue multiples remained flat (e.g. consumer discretionary, energy or industrials). Following a sharp fall in the last quarter of 2018, the EV/EBITDA multiple of the information technology sector rose at its highest levels for two quarters in a row in 2019, hitting a one-year high by June 2019.

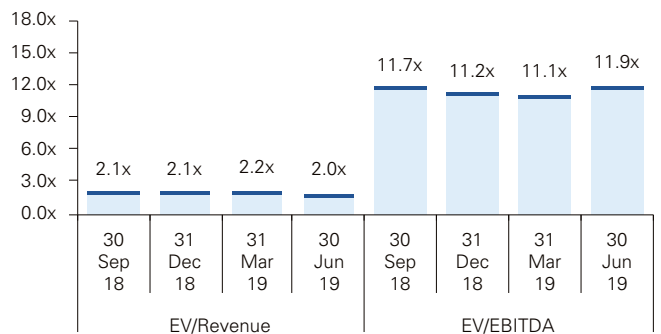
Communication Services Median



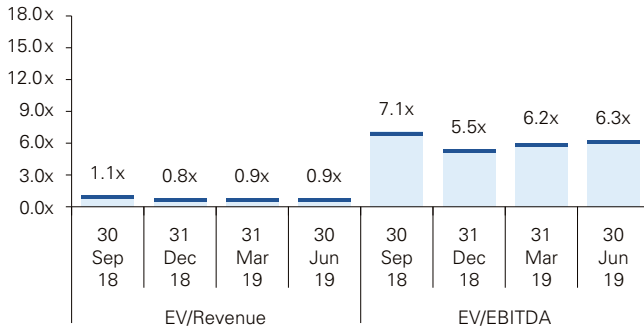
Consumer Discretionary Median



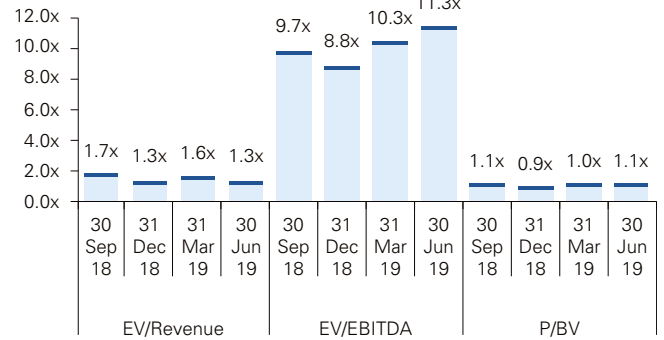
Consumer Staples Median



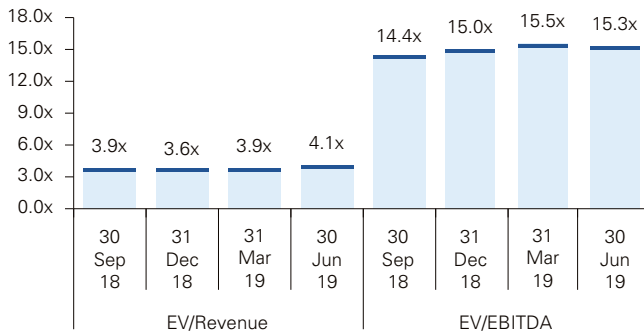
Energy (Oil and Gas) Median



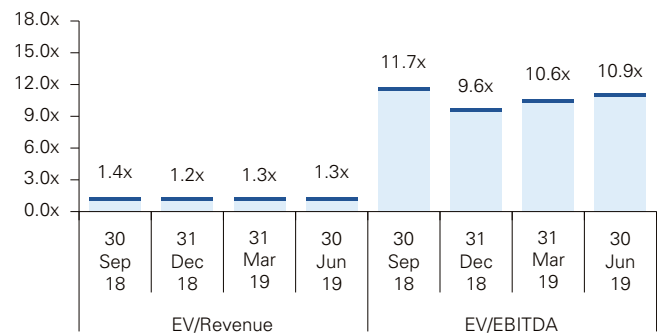
Financials Median¹



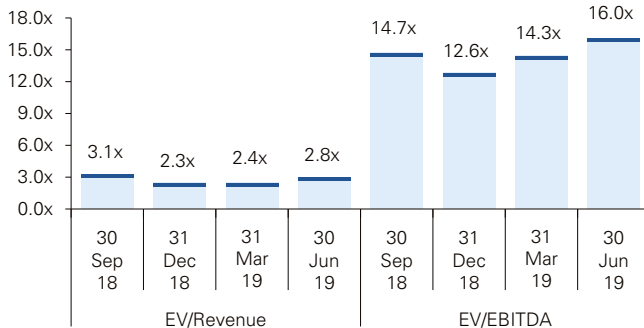
Health Care Median



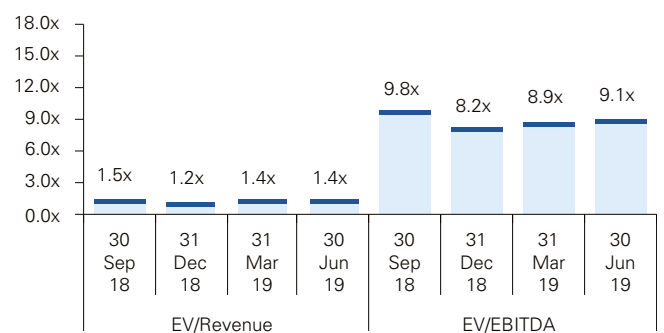
Industrials Median



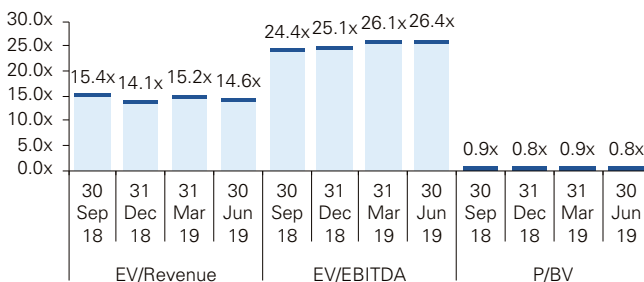
Information Technology Median



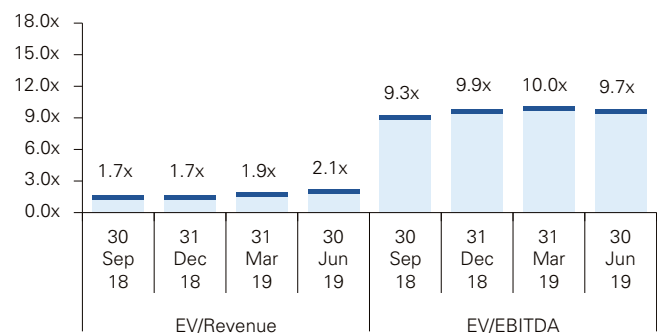
Materials Median



Real Estate Median



Utilities Median



Source: Capital IQ, KPMG analysis

Note: ¹ Financial services companies differ from many other companies in how they operate. Debt acts more like 'raw material' than operational capital for financial services companies. A common valuation metric used by analysts evaluating such firms is the price to book (P/B) ratio.

Risk-free rates: Interest rates continue to decline

The risk-free rate (or base 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 base 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. The historical risk-free rates for Germany, the Eurozone, the US, the UK and Switzerland are below.

In Q2 2019, the risk-free rates continued to fall – all for the second consecutive quarter, some for longer. On an annual basis, all risk-free rates reached new lows, with the Swiss risk-free rate almost hitting the 0.0% threshold. The US risk-free rate is the highest by a significant degree at around 2.7% though it fell by 0.25 percentage points in Q2.



Risk-free rates					
Date	Euro-countries EUR	Germany EUR	UK GBP	Switzerland CHF	USA USD
31/3/2015	0.69%	0.70%	2.39%	0.43%	2.66%
30/6/2015	1.79%	1.65%	2.80%	0.79%	3.31%
30/9/2015	1.51%	1.38%	2.58%	0.81%	3.06%
31/12/2015	1.70%	1.55%	2.77%	0.70%	3.17%
31/3/2016	1.03%	0.90%	2.39%	0.25%	2.81%
30/6/2016	0.46%	0.49%	1.85%	(0.03)%	2.50%
30/9/2016	0.53%	0.47%	1.61%	(0.06)%	2.48%
31/12/2016	0.97%	0.95%	2.03%	0.35%	3.06%
31/03/2017	1.25%	1.24%	1.88%	0.32%	3.27%
30/06/2017	1.39%	1.33%	2.02%	0.39%	3.04%
30/09/2017	1.40%	1.38%	2.05%	0.45%	3.04%
31/12/2017	1.34%	1.34%	1.89%	0.36%	2.89%
31/03/2018	1.25%	1.24%	1.79%	0.56%	3.08%
30/06/2018	1.09%	1.12%	1.83%	0.51%	3.00%
30/09/2018	1.13%	1.15%	1.87%	0.61%	3.10%
31/12/2018	0.90%	0.94%	1.91%	0.37%	3.17%
31/03/2019	0.67%	0.65%	1.65%	0.17%	2.96%
30/06/2019	0.35%	0.33%	1.56%	0.02%	2.71%

Source: KPMG analysis

Approach: Determination of a present value-equivalent uniform interest rate based on the yield curve of the particular central bank.

Note: The figures shown are rounded

Country risk premium: Geopolitical uncertainties do not impact on premiums

The country risk premium is a measure of risk faced by businesses when investing in sovereign states. It reflects a number of risks including economic, financial, political and institutional. The country risk premium is effectively the risk of low probability, high impact events that could lead to significant losses in investment values. These types of risk are at the forefront of many investors' thinking now more than ever due to a number of major economic and geopolitical events such as the Eurozone sovereign debt crisis and events in the Middle East and North Africa, all of which have led to previously stable countries becoming

much riskier. KPMG's Valuation practice has been analyzing and measuring country risk for 15 years and covers more than 150 sovereign states in a proprietary KPMG analyst model.

The country risk premiums for Brazil, Russia, India and China are set out below as of 30 June 2019 for an investment period of between 0.5 and 2.0 years. The country risk premium for China is substantially lower than that for Brazil, Russia or India. Both short-term and long-term country risk premiums remained stable compared to our March 2019 update. Thus, geopolitical uncertainties in recent months do not seem to have significantly impacted the premiums.

Country risk premium	0.5 year	1.0 year	2.0 years
Brazil	2.1%	2.3%	2.2%
Russia	2.0%	2.0%	1.9%
India	1.8%	1.8%	1.7%
China	0.5%	0.5%	0.6%

Source: KPMG CRP study as of 30 June 2019

Growth rates: Strong short-term growth expectations for Russia

Growth rates are a major component of the terminal value calculation for the discounted value method and are based on country-specific inflation forecasts. The growth rates for Brazil, Russia, India and China are based on the International Monetary Fund Economist Intelligence Unit inflation forecast for the years 2019 to 2023.

Overall, higher growth rates are expected for Brazil, Russia and India compared to China. For Brazil and India, growth rates are expected to remain stable at about 4.0%. By contrast, China's growth rate is expected to increase in the coming years. In the long run, China is expected to grow by around 3.0%. This is due mainly to expected economic growth, supported by a looser monetary policy and a supporting fiscal policy.

Inflation forecast	2020	2021	2022	2023	2024
Brazil	4.1%	4.0%	4.0%	4.0%	4.0%
Russia	4.5%	4.2%	4.1%	4.0%	4.0%
India	4.2%	4.2%	4.2%	4.1%	4.0%
China	2.5%	2.8%	2.9%	3.0%	3.0%

Source: IMF database as of 30 June 2019

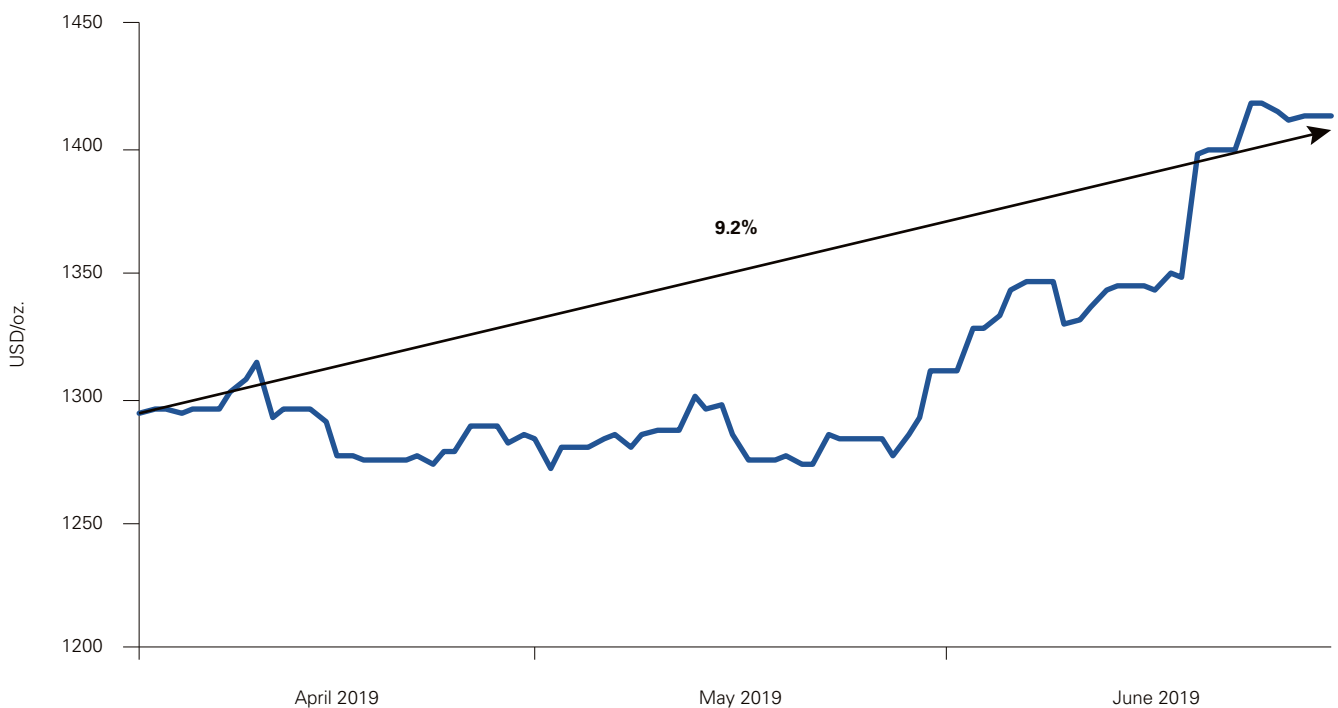


Gold price: A safe-haven investment in uncertain times

As noted in the introduction, the gold price per ounce increased by a significant 9.2% in Q2 2019, demonstrating its use as a safe haven investment. With political uncertainties in Europe and in particular due to the trade conflict between the US and China, the gold price increased

above USD 1400 per ounce at the end of June. At the G20 summit, China and the US announced the resumption of negotiations – as is to be expected, this had a negative effect on the gold price development in Q3 as observed on the first trading days following the summit.

Gold price development



Source: Capital IQ

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