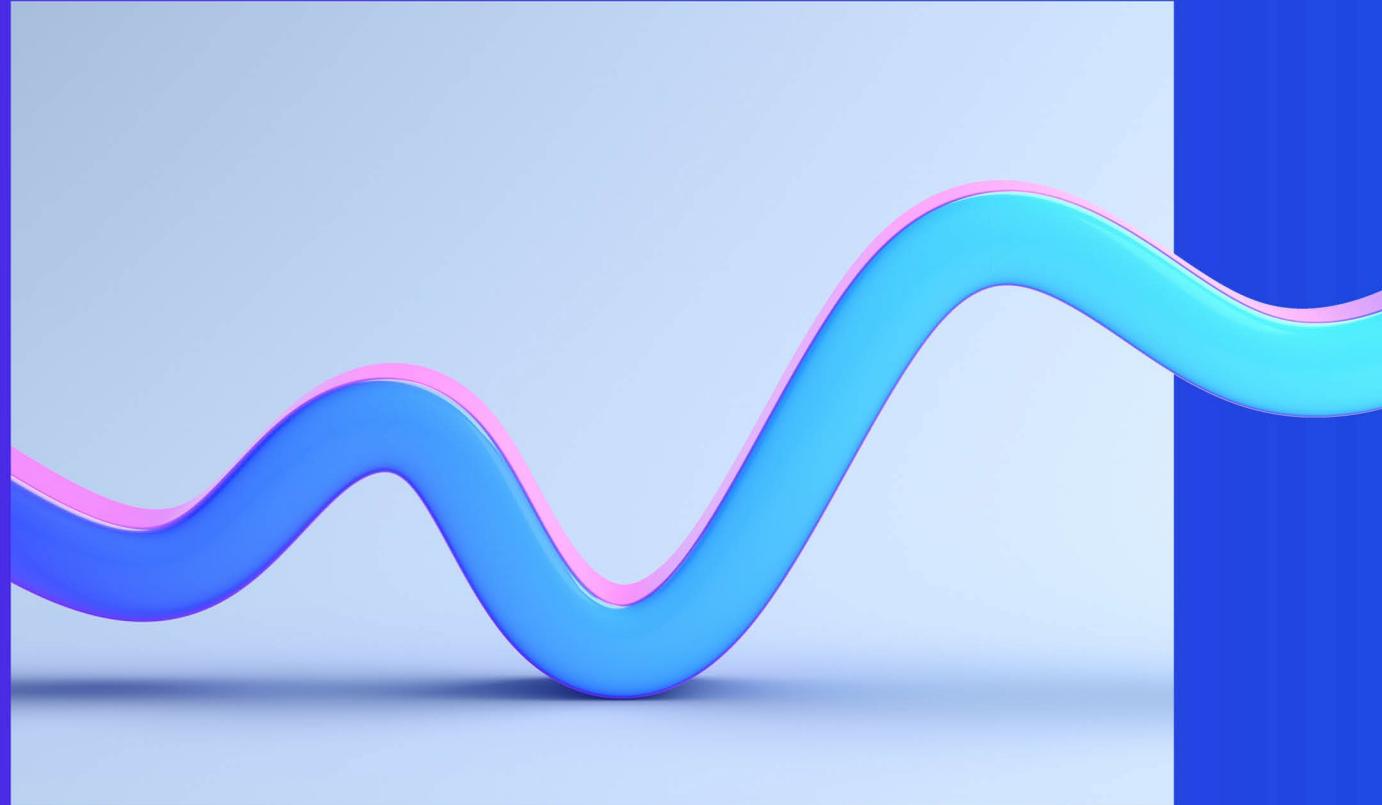# Equity Market Risk Premium

Research Summary on the Icelandic market

October 2025

-

KPMG Advisory

We recommend a MRP of 5.75% as per 30 June 2025

KPMG Iceland recommends the use of market risk premium (MRP) of 5.75% as per 30 June 2025 for cost of equity assumptions in ISK

Disclaimer

Information contained in this document is of general nature and is not intended to cover circumstances of any individual or entity. Although we endeavour to provide accurate and timely information, there is no guarantee that such information will be accurate at the date it is received or that it will be accurate in the future. No one should take decisions based on such information without first seeking appropriate advice which would take into consideration the circumstances of the individual or entity concerned.

KPMG contacts:

Magnús G. Erlendsson
Partner
KPMG Advisory
+354 545 6000
merlendsson@kpmg.is

Agnes Ísleifsdóttir
Senior Manager
KPMG Advisory
+354 545 6187
aisleifsdottir@kpmg.is

Kristján Jóhannesson
Manager
KPMG Advisory
+354 545 6126
kjohannesson@kpmg.is

Introduction - Valuation and discount rate

Introduction

To estimate if a certain investment decision is a good or bad one, a discount rate to find the net present value from future cash flows is an important parameter based on the discounted cash flow methodology.

According to the net present value rule investors accept investments that have positive net present value. The discount rate includes both the time value of money and the risk associated with the investment; thus, it is equal to cost of capital. If a project is equity financed, then the cost of capital equals the cost of equity.

All else equal, a higher discount rate will lead to a lower asset value and vice versa.
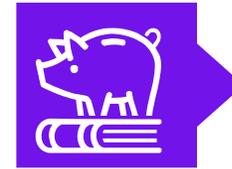
A general DCF model can be expressed by the following formula:

$$\text{Present value} = \frac{CF_1}{(1+k)^1} + \frac{CF_2}{(1+k)^2} + \frac{CF_3}{(1+k)^3} + ... = \sum_{t=1}^{\infty} \frac{CF_t}{(1+k)^t}$$

Present value = value of the analysed asset (e.g. a company)

CF_t = cash flow that the asset will generate in period t

k = asset – specific discount rate

Cost of equity as the discount rate

The most used methodology to derive discount rate is the "build-up methodology" based on the Capital Asset Pricing Model (CAPM).

The formula for the CAPM can be expressed as:

$$k = rf + \beta \times MRP + \alpha$$

k = required rate of return on equity

rf = risk free rate

β = a company's systematic risk

MRP = market risk premium

α = asset – specific risk factors

Introduction - Cost of equity parameters

rf
Risk-free rate

- In theory the risk-free rate is the rate of return on an investment that does not have a default risk or counter party risk.
- The nominal risk-free rate should incorporate to general components:
  - Time value of money
  - Inflation
- No investments are truly risk-free, but in practice the yield on long term government bonds are used as the risk-free rate in the build up methodology.

β
Beta

- The beta measures the volatility between a stock and the relevant benchmark market.
- According to portfolio theory, risk free assets have a beta of 0 and the market portfolio has a beta of 1. Stocks that have a beta lower than 1 are characterized as conservative stocks with lower market risk than the market. Stocks with higher beta than 1 are described as aggressive and have a higher market risk than the market portfolio.

α
Alpha

- Alpha is an asset-specific adjustment factor that represents the unsystematic risk that is not represented in the beta.
- The alpha is usually estimated based on these factors:
  - Size premium
  - Liquidity premium
  - Volatility of returns
  - Leverage
  - Other-company specific risk factors

MRP
Market risk premium

- The market risk premium is the expected return investor would get for investing in the stock market above the risk-free asset.
- The formula for MRP according to CAPM model is:
  - **MRP = Rm – rf**
  - Rm = The expected market returns
  - Rf = risk-free rate
- MRP is a forward-looking concept.

Different approaches to estimate Market Risk Premium (MRP)

Implied MRP

The implied MRP is the expected return on the market above the risk-free rate, derived from current market prices and future earnings expectations.

The discounted cash flow model-based premium is sensitive to the input assumptions so all inputs must be carefully considered:

- Cash to investor, both the dividend yield and the buyback yield.

- The basis of expected growth rate.

Historical analysis

Actual returns of the stock market over a long period are compared to the risk-free rate for the same time period.

This methodology assumes that the expected MRP can be derived by studying historical data.

When using a historical MRP a key assumption is made. The past is going to mirror the future because the MRP is a forward-looking concept.

The historical MRP is sensitive to the period under review and extreme market conditions.

Survey and other approaches

The expected MRP captures investors' expectations on the return they will get on their equity investments over the risk-free rate.

The required MRP is the incremental return investors demand over the risk-free rate
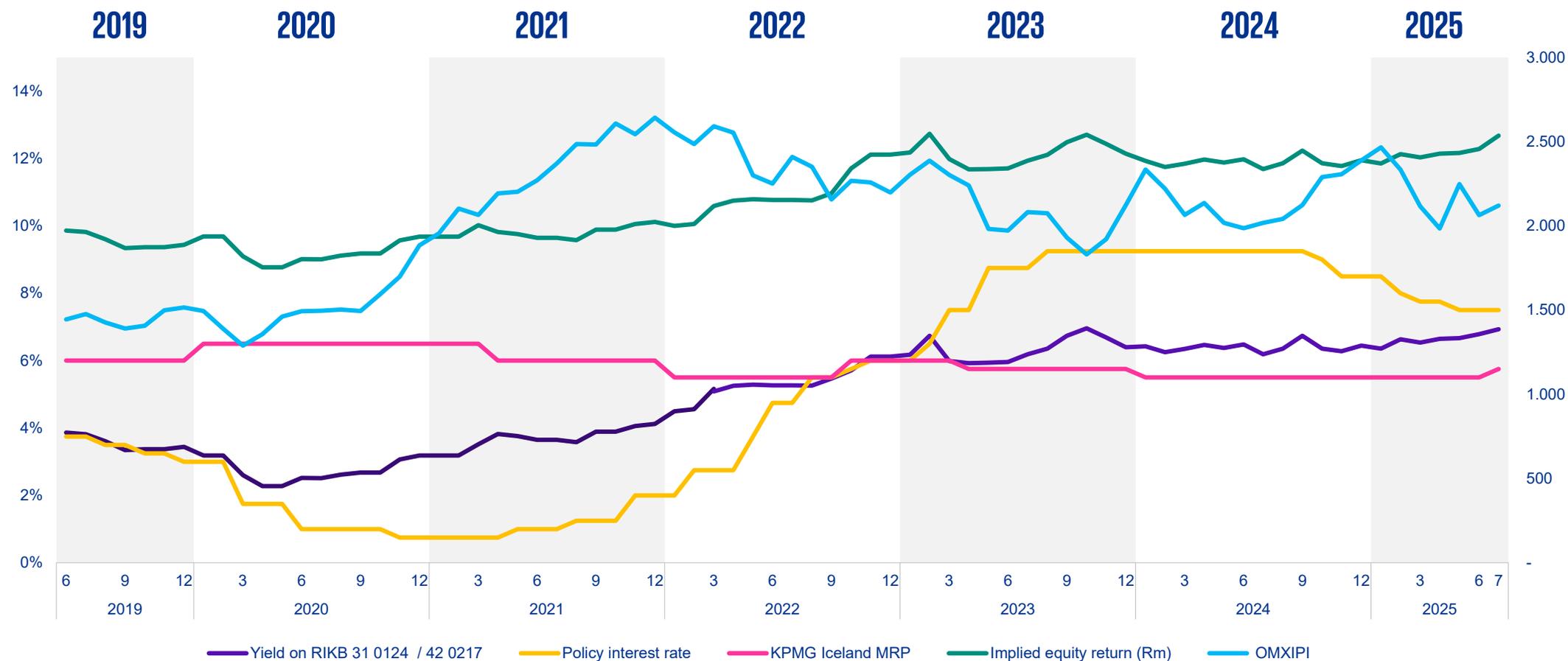
KPMG Iceland has conducted a survey on market participants and CFOs on their expected and required MRP, the number of responses has not been good enough for KPMG to publish.

KPMG Iceland approach

The focus is going to be on the **implied equity risk premium** derived by the discounted cash flow model as it incorporates recent market developments and expectations. However, KPMG will also consider other approaches when estimating the market risk premium.

Market developments from Q3 2019 until Q3 2025

Legend: Yield on RIKB 31 0124 / 42 0217 — Policy interest rate — KPMG Iceland MRP — Implied equity return (Rm) — OMXIPI

Before Q2 2022 RIKIB 31 0124 is presented as benchmark of the risk-free rate, from 31.3.2022 RIKB 42 0217 is used

Source: Lánamal.is, Central Bank of Iceland – Interest Rate Data Portal, Nasdaq OMX – OMXIPI index and KPMG analysis
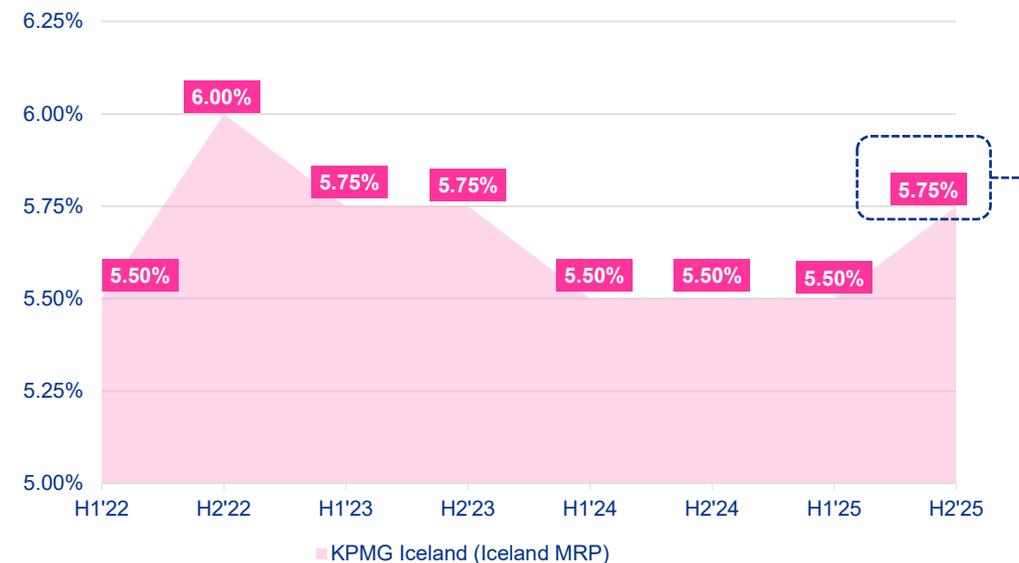
Recommended MRP 5.75%

Findings

Since the beginning of the year 2025, **the yield on RIKB 42 0217 has increased** from 6.45% to 6.79%. In the meantime, **policy interest rates have decreased** from 8.50% to 7.50%.

Equity **markets experienced heightened uncertainty** during the first half of the year, reflected in increased volatility and a 13.6% decline in the OMXIPI index. This downturn was primarily driven by tariffs imposed on imports to the U.S.

KPMG estimates that the **implied market return (Rm) has risen during this period**, influenced not only by higher government bond yields but also by an increase in the market risk premium (MRP) for the Icelandic market. The MRP is now estimated at 5.75%, up by basis points from the previously recommended MRP, 5.50%, for H1 2025.

Please note that these **estimates are based on information available as of June 30, 2025**. Market developments after that date are not reflected in the estimated MRP.
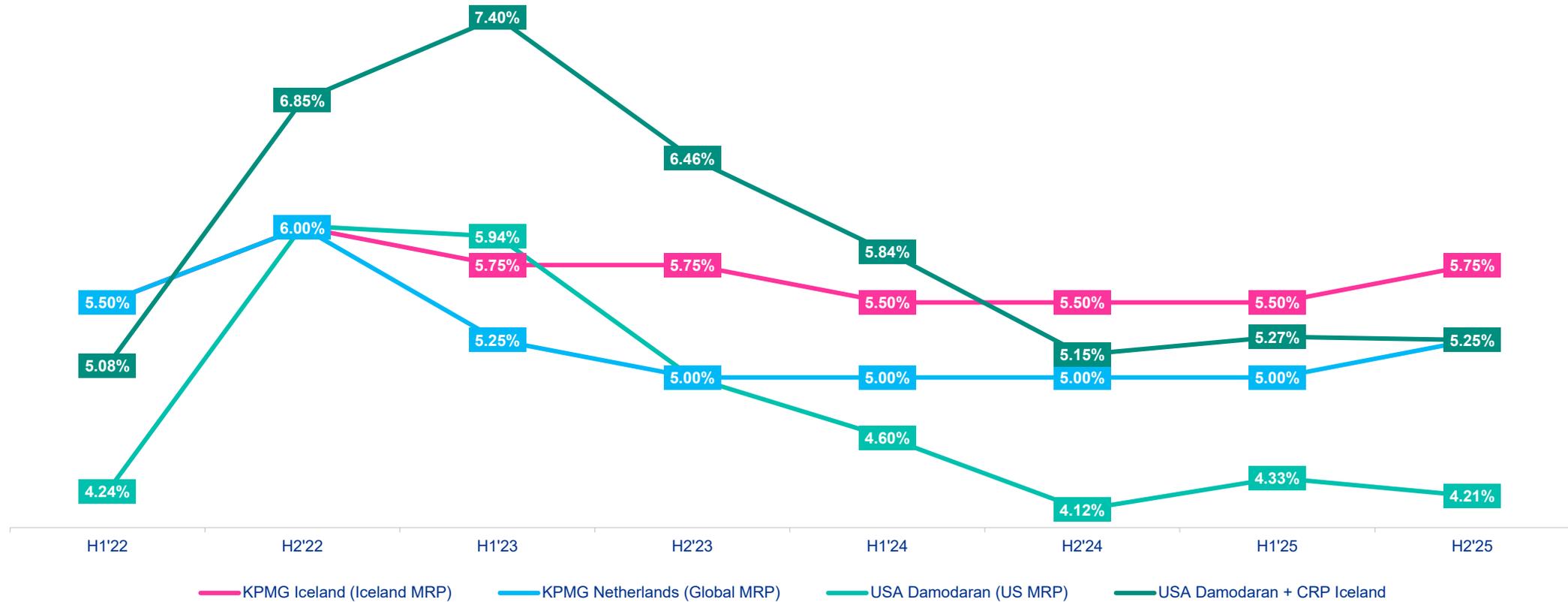
MRP development in Iceland

Legend: KPMG Iceland (Iceland MRP)

Data points:
- H1'22: 5.50%
- H2'22: 6.00%
- H1'23: 5.75%
- H2'23: 5.75%
- H1'24: 5.50%
- H2'24: 5.50%
- H1'25: 5.50%
- H2'25: 5.75%

KPMG estimates MRP at 5.75%
25 bps higher than in H1 2025

Source: KPMG analysis

Appendix

MRP development accross equity markets

Legend:
- KPMG Iceland (Iceland MRP)
- KPMG Netherlands (Global MRP)
- USA Damodaran (US MRP)
- USA Damodaran + CRP Iceland

Source: KPMG Netherlands – Equity Market Risk Premium, Aswath Damodaran – NYU Stern and KPMG analysis