Equity Risk Premium for the United Arab Emirates

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The KPMG Lower Gulf valuation team continually endeavors to carry out independent in-house research on valuation-related matters. This document contains a summary of our recent observations and possible inferences on one key valuation parameter, the Equity Risk Premium (ERP) in the United Arab Emirates (UAE), used in the derivation of cost of equity for regional businesses. Given the dynamic nature of this crucial metric, our aim is to derive the ERP on a quarterly basis and share the results with a larger audience.

**UAE economic outlook**

It appears that the UAE’s GDP growth has comparatively slowed in recent years, driven by falling oil prices, the general slow down in the global economy, and a challenging geo-political situation in the Middle East and in some large economies around the world. Despite these factors, the UAE’s GDP growth is expected to improve in the near future, driven by factors including continued economic diversification geared toward further reducing dependence on the petroleum sector, an increase in government spending, stronger fiscal position driven by the introduction of VAT and an increase in oil prices.

**General concept**

The ERP is the excess return of the stock market over the risk-free rate. It represents the additional return investors require from an equity investment to reflect the additional risk in the asset compared to a ‘risk-free’ asset. Despite the relatively straightforward nature of the ERP concept, its derivation is more complicated, as practitioners use various methods. Three key approaches to deriving ERP can be discerned:

- **Historical premiums**: this methodology assumes that expected ERP can be derived by studying historical equity returns. Although well established and theoretically sound, potential for its application in the UAE is limited due to the lack of a sufficiently long and detailed history for regional indices.

- **Implied premiums**: ERP is derived by assessing current prices, growth, and return expectations. This methodology is also well established and theoretically sound, and furthermore allows for incorporation of the most recent market developments. It is, however, sensitive to the inputs used.

- **Survey premiums**: surveys provide study participants’ current views.

**Historical ERP findings**

Historically, over the last few years, ERP appears to have ranged between ~4.5% - ~7.5% for developed markets. This is based on estimates and surveys of various practitioners and academics, including Damodaran, Fernandez, and global KPMG research. While data for the GCC region is more limited, the range over the last three years appears to have been ~5.5% - 9%, excluding outliers.

**Based on our analysis, we recommend an ERP of 7.0% for the UAE as of 30 September 2018.**
KPMG methodology
Our model is based on the implied premium methodology and calculates the potential returns of the market.

Key assumptions for the UAE
– KPMG’s ‘market’ has been selected from the equity stocks listed on Dubai Financial Market, Abu Dhabi Securities Exchange, Nasdaq Dubai, and the MSCI UAE Index.

The selected KPMG index consists of:

<table>
<thead>
<tr>
<th>Sector</th>
<th>Weight (%)</th>
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</thead>
<tbody>
<tr>
<td>Financial services</td>
<td>49%</td>
</tr>
<tr>
<td>Telecommunication</td>
<td>26%</td>
</tr>
<tr>
<td>Real estate</td>
<td>15%</td>
</tr>
<tr>
<td>Others</td>
<td>10%</td>
</tr>
</tbody>
</table>

The selected KPMG index has been weighted by market capitalization.

– Consensus estimates have been considered for estimating returns in the explicit period; long-term growth estimates have considered expected long-term growth, as well as inflation expectations for the UAE economy.

– The risk-free rate has been developed using 20-year US government bond yields, adjusted for inflation differential and country risk premium for the UAE.

Limitations of the methodology
The results of the exercise are dependent on the inputs used, including the selection of income or return proxies (e.g. dividends, buy-backs, cash flow) and the basis of expected growth rates (e.g. macroeconomic considerations, consensus forecast estimates). Further, as the UAE market deepens, it continues to face some limitations in terms of free float, traded volumes, and analyst coverage. We will continue to monitor these factors closely and refine our inputs.

Equity Risk Premium for the UAE
Based on our analysis, we recommend an ERP of 7.0% as of 30 September 2018. Given the increase in bond yields driven by Federal Reserve rate hikes, and subdued equity markets and economies, we believe this increase in ERP demanded by investors vis-à-vis the 31 March 2018 estimate of 6.6% is reasonable.

Our estimation is based on information available on 30 September 2018. Developments in the market after this date can have an impact on the perceived market risk, which is not reflected in the ERP estimate on 30 September 2018. As a general comment, we would point out that individual input parameters for a discount rate calculation should never be assessed in isolation.

Please note that this is a summary document only. Should you require more detailed information on the methodologies used to derive the ERP, please do not hesitate to contact us directly.