It is worth taking note

KPMG Valuation Practices Survey 2018
Contents

Introduction 4

About the survey 5

The survey results 6

General market environment 6
Impairment 8
Risk free rate and market risk premium 10
Cost of equity 14
Assessment of franking credit 16
Gamma factor 17
Environmental, social and governance factors 18
Control premium 19
Introduction

Welcome to KPMG’s Valuation Practices Survey 2018

In this report, KPMG presents the key findings of its 2018 Valuation Practices Survey. The 2018 survey provides a short-form summary update of opinions on the current market environment and key valuation assumptions.

We believe the results provide insight into current perceptions of value. 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, as always, invaluable.

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

Sean Collins
Partner in Charge, Valuation Services
Deals, Tax & Legal
About the survey

Why this survey matters

Valuation plays a significant role within many areas of finance.

Understanding what an asset is worth, and what drives that value, is essential when management and stakeholders need to make informed, and effective, business and investment decisions. This requires decision makers to trust the valuer’s opinion.

Valuation, however, is not objective. Value is always influenced by a variety of factors: the preconceptions and bias of the asset’s owner, the valuer’s understanding of the market, the methodology that is being used, and the complexity of the underlying business. These influences impact the assumptions being made by valuers.

Decision makers must be confident that the assumptions applied are appropriate, and that they are not overly optimistic or needlessly pessimistic. This is why it is essential to know, and understand, the basis of the assumptions made by a valuer.

We believe the information gathered by this survey highlights the key assumptions being made by those who are currently issuing valuation opinions — and provides a strong reference point in understanding the basis of those assumptions.

Who was surveyed

We captured the views of 56 valuation professionals from a variety of organisations across Australia, including Australia’s Big 4 accounting firms, leading corporates, investment banks, investment funds, prominent boutique valuation firms, second-tier accounting firms and smaller practitioners.

Where relevant, we have additionally segregated respondents between those who consider themselves “valuation practitioners” (21 in total) and “other professionals” (35 in total).

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

- Corporate (41%)
- Valuation practitioner (38%)
- Fund Manager (5%)
- PE Investor (4%)
- Infrastructure Investor (4%)
- Investment Banker (2%)
- Other (6%)

The survey was circulated to various practitioners, and responses were received, in the third quarter of 2018.
The survey results

General market environment

2018 has seen challenges emerge in the global economy. Brexit, trade wars and increasing risk free rates may temper expectations that the Australian economy will sustain its steady rate of growth.

We asked respondents for their opinion as to current level of value for certain key asset classes in Australia:

**Real Estate**: was considered to be overvalued despite signs of a cooling Australian property market due to property control policies implemented in 2017. Will this slide continue into 2019?

**Infrastructure**: was seen as ‘about right’ despite a significant level of new investment flowing into the sector during the past decade chasing a limited supply of quality assets. A $75 billion 10-year national infrastructure plan announced by the Federal Government in May 2018 will continue to stimulate the sector.

**Listed equities**: the perception is that listed equities are slightly ‘overvalued’. A recent pull back in listed equities as a result of global growth concerns and geopolitical risk has tempered recent equity market growth, but will this be a blip or the start of a sustained adjustment?

**Bonds**: uncertainty in the bond market continues to be fuelled by the underlying interest rate environment as quantitative easing is slowly unwound.

**Agriculture**: a sector that is quickly rising in prominence with an increase in foreign investment driving transaction activity. This has resulted in prices being driven up, but respondents view the sector as fairly valued.

**Resources**: An improvement in commodity prices continued in 2018, positively impacting valuations in the resources sector, which has resulted in respondents considering the sector to be ‘about right’.

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

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Undervalued</th>
<th>About right</th>
<th>Overvalued</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Real Estate</strong></td>
<td><img src="image.png" alt="Real Estate" /></td>
<td><img src="image.png" alt="Real Estate" /></td>
<td><img src="image.png" alt="Real Estate" /></td>
</tr>
<tr>
<td><strong>Infrastructure</strong></td>
<td><img src="image.png" alt="Infrastructure" /></td>
<td><img src="image.png" alt="Infrastructure" /></td>
<td><img src="image.png" alt="Infrastructure" /></td>
</tr>
<tr>
<td><strong>Listed Equities</strong></td>
<td><img src="image.png" alt="Listed Equities" /></td>
<td><img src="image.png" alt="Listed Equities" /></td>
<td><img src="image.png" alt="Listed Equities" /></td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
<td><img src="image.png" alt="Bonds" /></td>
<td><img src="image.png" alt="Bonds" /></td>
<td><img src="image.png" alt="Bonds" /></td>
</tr>
<tr>
<td><strong>Agricultural</strong></td>
<td><img src="image.png" alt="Agricultural" /></td>
<td><img src="image.png" alt="Agricultural" /></td>
<td><img src="image.png" alt="Agricultural" /></td>
</tr>
<tr>
<td><strong>Resources</strong></td>
<td><img src="image.png" alt="Resources" /></td>
<td><img src="image.png" alt="Resources" /></td>
<td><img src="image.png" alt="Resources" /></td>
</tr>
</tbody>
</table>
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How do you expect the S&P/ASX200 index to move in FY19?

<table>
<thead>
<tr>
<th>34%</th>
<th>39%</th>
</tr>
</thead>
<tbody>
<tr>
<td>said steady</td>
<td>said increase</td>
</tr>
</tbody>
</table>

While 39% of respondents expect the **ASX200 index to increase** in FY19, the impact of out-of-cycle interest rate raises and geopolitical tensions may impact equity market expectations.

The US Federal Reserve has continued to increase benchmark rates in 2018 causing a re-evaluation of growth and inflationary expectations. **Will these rates rise continue in FY19?**

How do you think bond yields will move in FY19?

<table>
<thead>
<tr>
<th>29%</th>
<th>62%</th>
</tr>
</thead>
<tbody>
<tr>
<td>said steady</td>
<td>said increase</td>
</tr>
</tbody>
</table>

While 62% of respondents were expecting an **increase in the yield**, 55% of respondents thought the increase would be **less than 1%**.
Impairment

The broad consensus is that the incidence of impairment of asset values has remained steady in FY18. This indicates a general improvement in conditions compared to our 2017 survey.

In the next 12 months there is, on balance, an increase in the expectation of impairment, with the key ‘at risk’ sectors noted on the following page.

Would you say that the incidence of impairment of asset values increased, decreased or remained steady in FY18?

- Don’t know/unsure: 4%
- Decreased: 9%
- Remained steady: 51%
- Increased: 25%

Compared to the 2017 valuation survey, there has been an increase in the expectation of impairment for the coming year.

Do you expect the incidence of impairment to increase, decrease or remain steady in FY19?

- Don’t know/unsure: 4%
- Decrease: 7%
- Remained steady: 41%
- Increase: 26%
The sector viewed to be most at risk in the next 12 months is finance, insurance and real estate, a direct result of the impact of the Hayne Royal Commission on the financial services industry and the slowdown in housing activity.

This compares to our 2017 survey where the construction sector was at the most risk.

The Australian retail sector is continuing to experience a difficult trading environment, shaped by disruptive forces changing spending patterns of Australian consumers and other disruptive behavior which has put pressure on traditional retail businesses.

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction</td>
<td>57%</td>
</tr>
<tr>
<td>Retail Trade</td>
<td>68%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>43%</td>
</tr>
<tr>
<td>Mining</td>
<td>7%</td>
</tr>
<tr>
<td>Finance, Insurance, Real Estate</td>
<td>70%</td>
</tr>
<tr>
<td>Agriculture, Forestry, Fishing</td>
<td>18%</td>
</tr>
<tr>
<td>Services</td>
<td>13%</td>
</tr>
<tr>
<td>Public Administration</td>
<td>4%</td>
</tr>
<tr>
<td>Transportation &amp; Public Utilities</td>
<td>14%</td>
</tr>
<tr>
<td>Wholesale Trade</td>
<td>11%</td>
</tr>
</tbody>
</table>
Risk free rate and market risk premium

Valuers continue to take different approaches in setting the risk-free rate, as reflected in the relatively wide range of risk-free rates being adopted.

The range of risk free rates applied as at 30 June 2018 by respondents is **1.25% and 7.0%**, reflecting the split between valuers using a spot rate and those using an adjusted rate. A risk free rate of between 2.5% and less than 3.0% was most common (21% of respondents).

In terms of valuation practitioners, most respondents tended to adopt a risk free rate between 2.5% and less than 3.0% (38%) or between 4.0% and less than 4.5% (29%).

In terms of other professionals, the responses provided indicate a range of different approaches. Most respondents tended to adopt a risk free rate less than 2.0% (23%) or between 3.5% and less 4.0% (20%).

What was the risk free rate you adopted for valuations you completed for a perpetual life Australian asset at 30 June 2018?

Risk free rate for perpetual life assets – valuation practitioners

Risk free rate for perpetual life assets – other professionals

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Six in ten (61%) respondents indicated that they have not changed the risk free rate they adopted for Australia in the last 12 months.

The majority of respondents (54%) adopted a market risk premium between 6.0% and less than 6.5% for valuations completed for a perpetual life Australian asset at 30 June 2018. This compares to the 2017 valuation survey, where 73% of respondents adopted a similar market risk premium.

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

<table>
<thead>
<tr>
<th></th>
<th>Yes</th>
<th>No</th>
<th>Don't Know/Unsure</th>
</tr>
</thead>
<tbody>
<tr>
<td>%</td>
<td>32</td>
<td>61</td>
<td>7</td>
</tr>
</tbody>
</table>

What was the market risk premium you adopted for valuations completed for a perpetual life Australian asset at 30 June 2018?

Market risk premium for perpetual life asset – valuation practitioners
The vast majority of respondents have not changed their market risk premium adopted for Australia in the last 12 months.

This general theme is consistent with the responses from valuation practitioners, however we note that the instances where a Market Risk Premium of less than 6.0% was more common in other professionals (46.0%) compared to valuation practitioners (14.0%).
What market risk premium do you adopt when valuing assets in the following countries?

<table>
<thead>
<tr>
<th>Country</th>
<th>Market Risk Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurozone</td>
<td>7.5%+</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>7.0%</td>
</tr>
<tr>
<td>United States</td>
<td>6.5%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>6.0 to &lt;6.5%</td>
</tr>
<tr>
<td>Australia</td>
<td>&lt;6.0%</td>
</tr>
</tbody>
</table>

The most common market risk premium adopted when valuing assets lies between 6.0% and 6.5% across the selected western economies. However Australia and New Zealand tend to have a higher perceived risk.
Assuming a geared beta of 1, what would your cost of equity have been at 30 June 2018 for:

<table>
<thead>
<tr>
<th>Country</th>
<th>Cost of Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Eurozone</td>
<td>15%+</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>12.5% to &lt;15.0%</td>
</tr>
<tr>
<td>United States</td>
<td>10.0% to &lt;12.5%</td>
</tr>
<tr>
<td>New Zealand</td>
<td>7.5% to &lt;10.0%</td>
</tr>
<tr>
<td>Australia</td>
<td>&lt;7.5%</td>
</tr>
</tbody>
</table>

Interestingly, the majority of other professionals (35 respondents of 56 in total) indicated their preference to adopt a cost of equity of less than 7.5%.

Cost of equity as at 30 June 2018

The cost of equity adopted tends to vary between countries. Accordingly, we asked respondents what would their adopted cost of equity be in a number of countries assuming a geared beta of 1.

Interestingly the cost of equity is generally the highest in Australia compared to other parts of the developed world. The majority of respondents would adopt a cost of equity less than 7.5% in the Eurozone, United Kingdom and United States.

Valuation practitioners tend to be more conservative in setting equity returns, with most likely to adopt a cost of equity between 7.5% and 10.0% in the Eurozone, United Kingdom, United States, and Australia. Although, there was a preference for a cost of equity in the range of 10.0% to 12.5% for New Zealand.

Interestingly, the majority of other professionals (35 respondents of 56 in total) indicated their preference to adopt a cost of equity of less than 7.5%.
Movements in cost of equity

In Australia, equity rates were mostly reported as being steady with one in two (50%) saying so. About one in five respondents (20%) also reported equity rates in Australia decreased more than any other country.

The general consensus was that the cost of equity in Australia has remained steady since 30 June 2017.
Assessment of franking credits

Where imputation benefits are included, the majority of respondents adopted either 0% (46%) or less than 50% (21%).

Interestingly, for valuation practitioners where the imputation benefits exceeded 0%, the majority of respondents would adopt between 80% and less than 90% as illustrated to the right.
Gamma factor
Where a gamma factor is included in the discount rate, the majority of respondents indicated a factor of 0% (57%).

Where the gamma factor exceeded 0%, the most common response indicated a gamma factor in the range of 1% and less than 10% (23%). This general theme is consistent between valuation practitioners and other professionals.

Where a Gamma factor is included in discount rate, what rate do you assume?
Environmental, social and governance factors

84% of respondents consider ESG factors when performing a valuation. Most (46%) use a qualitative assessment, with 29% using a quantitative approach in conjunction with qualitative assessment.

When accounting for ESG factors most respondents do so qualitatively or by using a mix of qualitative and quantitative methods.

33% reported their treatment of ESG factors changed in FY18, with 29% reported giving more attention to factors, with only 4% reporting less attention was given.

Interestingly, for valuation practitioners 86% of respondents indicated no change in their treatment of ESG factors in FY18. This compares to 46% of other professionals. The instances where more attention was given to ESG factors was more common with other professionals (40%) compared to valuation practitioners (10%).

How do you account for environmental, social and governance factors when performing valuations?

Has your treatment of environmental, social and governance factors changed in FY18?
Control premium

The application of a control premium can have a material impact on the value of an entity.

The majority of respondents indicated control premium range between 20% and less than 30% for the low end and 30% or greater for the high end.

This theme was consistent amongst valuation practitioners, however we note that other professionals are more likely to adopt a control premium range in the order of less than 5% for the low end and greater than 30% for the high end.

What range do you currently adopt as the standard control premium in the Australian market?

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