Kroll Recommends Using a Spot 20-Year UK Government Bond Yield When Higher than the Normalized UK Risk-Free Rate

Executive Summary

Kroll regularly reviews fluctuations in global economic and financial market conditions that may warrant changes to our equity risk premium (ERP) and accompanying risk-free rate recommendations. The risk-free rate and ERP are key inputs used to calculate the cost of equity capital in the context of the Capital Asset Pricing Model (CAPM) and other models used to develop discount rates.

On September 1, 2022, Kroll increased the UK normalized risk-free rate from 3.0% to 3.5%. At that time, we cautioned that continued inflationary pressures, which were exacerbated by the Russia-Ukraine war, could cause further rises in long-term inflation expectations, which would lead us to revisit our normalized risk-free rate assumptions.

Since then, a new UK government has taken office. On September 23, 2022, the new government unveiled a mini-budget that proposes the biggest debt-financed tax cuts in 50 years, along with some other measures to assist with high energy prices. This announcement roiled financial markets and pushed UK long-term government bond yields to levels last seen in October 2008, at the height of the Global Financial Crisis. The British pound (GBP) reached a record low against the U.S. dollar. To stabilize the government debt market, the Bank of England (BoE) launched on September 28th a temporary bond-buying program, halting its quantitative tightening plans to start shrinking the size of its balance sheet. While the BoE plans to purchase long-dated UK government bonds (Gilts) through October 14, 2022, the success of these interventions is not guaranteed.

Based on these recent events, **we recommend using the spot 20-year UK government bond yield as the proxy for the risk-free rate, if the prevailing yield as of the valuation date is higher than our normalized UK risk-free rate of 3.5%. This guidance is effective when developing GBP-denominated discount rates as of September 30, 2022 and thereafter, until further guidance is issued.**

The adoption of this hybrid methodology, which has also been implemented for U.S. risk-free rates, is designed to give analysts the flexibility to adjust to potential rapid changes in yields that may outpace the rate at which changes indicated by our risk-free rate normalization models.

The BoE indicated that purpose of these purchases is to restore orderly market conditions in the long-term bond market and reduce risks from contagion to credit conditions for UK households and businesses (i.e., the overall UK economy). During this period of heightened uncertainty, we may observe even higher levels of volatility in spot yields before they stabilize. Hence, if UK government bonds yields continue to fluctuate considerably, valuation professionals may consider using a moving average of spot yields to mitigate the impact of this volatility (e.g., weekly or monthly average).

Please contact the costofcapital.support@kroll.com with any questions.

Kroll Cost of Capital Inputs

Data as of September 30, 2022

	U.S. (in USD)	Eurozone*** (in EUR)	U.K. (in GBP)	Canada (in CAD)
Normalized Risk-Free Rate	Higher of 3.5% or Spot*	2.0%	Higher of 3.5% or Spot**	3.5%
Kroll Recommended Equity Risk Premium	5.5%	5.5% to 6.0%	n/a	n/a

* We recommend using the spot 20-year U.S. Treasury yield as the proxy for the risk-free rate, if the prevailing yield as of the valuation date is higher than our recommended U.S. normalized risk-free rate of 3.5%. This guidance is effective when developing USD-denominated discount rates as of June 16, 2022 and thereafter.

** We recommend using the spot 20-year U.K. Gilt yield as the proxy for the risk-free rate, if the prevailing yield as of the valuation date is higher than our recommended U.K. normalized risk-free rate of 3.5%. This guidance is effective when developing GBP-denominated discount rates as of September 30, 2022 and thereafter.

** German normalized risk-free rate and Eurozone equity risk premium (ERP) for use in EUR-denominated discount rates from a German investor perspective. Additional country risk adjustments may be warranted when estimating discount rates for other countries in the Eurozone.