Kroll is increasing the Canadian and UK normalized risk-free rates from 3.0% to 3.5% as of September 1, 2022

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 May 17, 2022, Kroll increased the Canada and UK normalized risk-free rates from 2.5% to 3.0%. 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. Indeed, based on newly updated long-term inflation expectations for Canada and the UK, **Kroll is increasing the Canadian and UK normalized risk-free rates from 3.0% to 3.5%, when developing respectively CAD- and GBP-denominated discount rates as of September 1, 2022 and thereafter, until further guidance is issued.**

We are closely monitoring changes to long-term inflation expectations for Germany and the eurozone. At this time, **we are reaffirming the Kroll normalized risk-free rate for Germany at 2.0% when developing EUR-denominated discount rates,** but this could also change in the near future.

Support for the Change in Guidance

Previously, the long-term average of government long-term bonds yields was an important input in developing our normalized risk-free rate conclusions for both Canada and the UK. We believe that giving some weight to long-term averages was especially appropriate when the Bank of Canada's (BoC) and Bank of England's (BoE) monetary policies were very accommodative, and inflation was close to the respective official targets (the BoE targets an inflation rate of 2.0%, while the BoC targets a 2.0% mid-point within an inflation-control range of 1.0% to 3.0%). However, given the rapid rise in inflation expectations and interest rates, we believe that long-term average yields of government bonds induce a downward bias, and therefore we are placing a lower weight on this method when arriving at our normalized risk-free rate conclusions.

For perspective, the annual consumer price inflation had averaged 1.8% in Canada and 2.0% in the UK over the 2011–2021 period on a rolling 12-month basis. By contrast, in recent months inflation has continued to surprise on the upside—reaching multidecade highs—with the recent Russia-Ukraine war exacerbating inflationary pressures, especially in energy prices. In addition, the long-term inflation expectations for Canada and the UK increased considerably in the last few months. The median long-term inflation expectations for Canada increased from 2.2% at the end of December 2021 to 2.7% at the end of August 2022, while for the UK the expectations surged from 2.3% to 3.5% over the same period.

This significant change in outlook precipitated an important shift in both the BoC's and BoE's monetary policies stance relative to December 2021. The two central banks adopted a more restrictive stance by: (i) raising their policy interest rate several times and signaling more hikes to come; and (ii) ending their quantitative easing (QE) programs.

These recent trends have led to a significant and very rapid rise in short and long-term interest rates in Canada and the UK with no signs of abating any time soon. For example, the Government of Canada Benchmark Long-Term Bond yield went from 1.7% on December 31, 2021 to 3.0% on August 30, 2022. Similarly, the 20-year British Government Securities yield went from 1.2% on December 31, 2021 to 2.9% on August 25, 2022. Long-term interest rates may finally be reverting to levels considered to be "normal," as attested by the rapid *acceleration* in the rise in yields over the last several months and the dramatic change in the BoE- and BoC-projected trajectory for policy interest rates.

For the underlying data support for the latest guidance for these countries, click here.

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

Kroll Cost of Capital Inputs
Data as of September 1, 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%	3.5%	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.

** 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.