SOME HIGH LEVEL OBSERVATIONS ON THE MARKET COST OF EQUITY

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RBA urges boards to cut hurdle rates

- From RBA Governor Philip Lowe in October 2019:

“Some firms have been slow to adjust to the new reality of low interest rates ….. Hurdle rates of return are too sticky.”

“At low interest rates, many investments that didn’t make sense at higher interest rates should now make sense.”

Source: Australian Financial Review, *‘RBA urges boards to cut hurdle rates’*, 29 October 2019

Some CEO responses

*"We haven't lowered our hurdle rates at this time. Although interest rates are an input to our cost of capital, **equity risk premiums have, in our view, gone up, balancing out any benefits from low interest rates**." (Tabcorp)*

*"Over time we have reduced our hurdle rates based on the theoretical cost of raising debt, **but hurdle rates have not come down as much as some may think, because risk has increased**." (EnergyAustralia)*

Source: Australian Financial Review, *'CEOs on how to get business investing',* 11 December 2019

Some more CEO responses

"We have agreed with our board to ***moderately reduce*** *hurdle rates to prudently reflect the* ***dual impact of lower interest rates and high macro economic risks.*** *" (Stockland)*

"We revised our pre-tax normalised return on equity target to the RBA cash rate plus 14 per cent, ***removing the variable impact of interest rates.*** *" (Challenger)*

<u>Source:</u> Australian Financial Review, *'CEOs on how to get business investing',* 11 December 2019

KPMG 2019 valuation practices survey

- A survey of 59 valuation practitioners, investors and corporates as at 30 June 2019

"Australia has the ***highest market cost of equity*** *of the selected developed economies at* ***8.8%****, with the US and Europe the lowest at 6.5%."*

- Based on the 1.4% 10-year CGS yield at 30 June 2019, the 2018 RoRI would have produced a market cost of equity of just ***7.5%***.

Source: KPMG (2020), *Valuation Practices Survey 2019: What's it worth? Determining value in the continuing low interest rate environment, p. 5*

Leadenhall MRP estimates

Independent Australian corporate advisory firm

Date	MRP	10yr CGS (20-day averages)	Market cost of equity
30 June 2013	6.50	3.55	10.05
30 June 2014	6.00	3.75	9.75
30 June 2015	6.50	3.00	9.50
30 June 2016	---	---	---
30 June 2017	6.50	2.40	8.90
30 June 2018	6.25	2.70	8.95
30 June 2019	7.00	1.40	8.40
31 March 2020	**7.75**	**0.90**	**8.65**
30 June 2020	7.50	0.95	8.45
Change	***+1.00***	***(2.60)***	***(1.60)***

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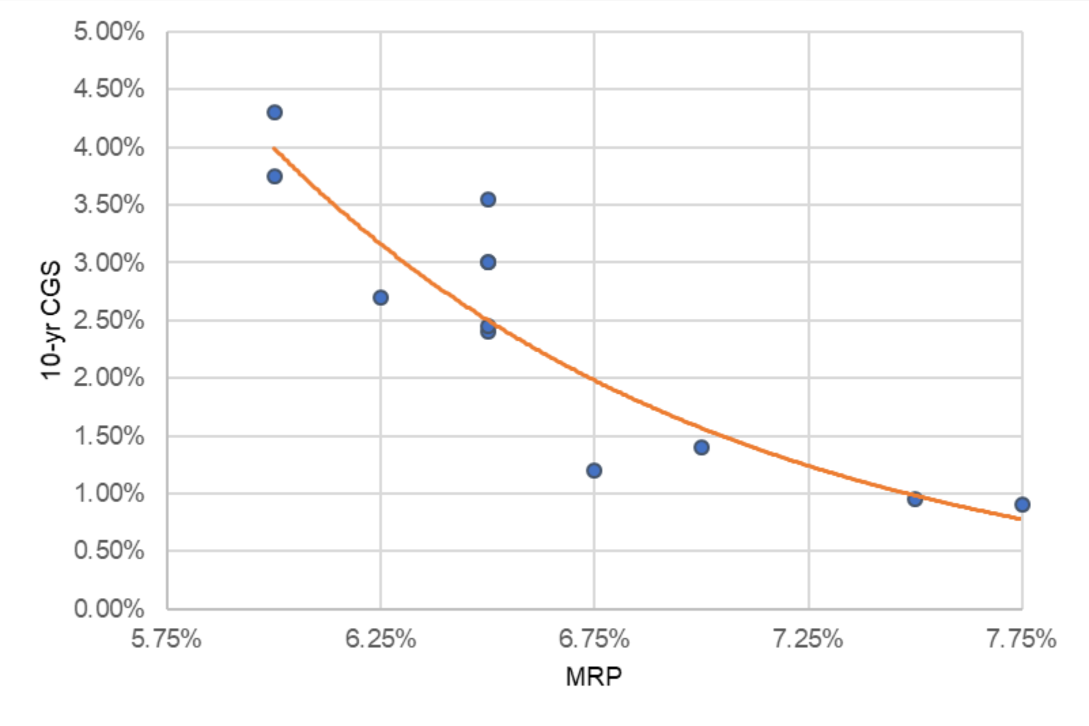
Leadenhall MRP estimates

June 2013 – June 2020



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Implications for the 2022 RoRI

- The 2018 RoRI assumes a perfectly positive point-for-point relationship between the 10-year CGS yield and the market cost of equity
  - A highly unusual relationship between a risk-free and risky asset
- Real-world hurdle rates and discount rates used by investors and practitioners are more consistent with *meaningful weight* being given to a relatively stable market cost of equity
- The 2022 RoRI must produce the best return on equity estimate across a wide range of future (uncertain) capital market environments
  - On an ex-ante basis, combining multiple MRP estimation approaches is more likely to achieve this outcome