



Kroll Cost of Capital Recommendations and Potential Upcoming Changes – February 8, 2024 Update

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. We also update country risk data on a quarterly basis for 175+ countries using various models.

The Kroll Recommended U.S. ERP is being reaffirmed at 5.5% when developing USD-denominated discount rates, but it could be lowered in the near future. The Kroll Recommended Eurozone ERP is being reaffirmed in the range of 5.5% to 6.0%, but we believe that a 5.5% ERP (i.e., towards the lower end of the range) is more appropriate when developing EUR-denominated discount rates as of February 5, 2024, and thereafter, until further guidance is issued.

Cost of Capital Recommendations

United States

The **Kroll Recommended U.S. ERP remains at 5.5%**. This is matched with the higher of a U.S. normalized risk-free rate of 3.5% or the spot 20-year U.S. Treasury yield as of the valuation date.

Recently, as interest rate uncertainty began to subside and a scenario of soft landing became more plausible, investor confidence has risen. Interest rates have likely peaked, and investors are pricing significant policy rate cuts in 2024. The Federal Reserve (Fed) may ultimately be more conservative about the timing and speed of cuts than investors are anticipating. Nevertheless, in its December 2023 meeting the Fed projected a median reduction in its policy rate of 80 basis points, which boosted investor optimism.

Recently, the S&P 500 and the Dow Jones Industrial Average indices have both reached new record highs, which had not occurred in two years. While markets may still experience high volatility until interest rates settle, continued strength in consumer spending and the job market, coupled with an expected improvement in earnings growth, may lead equity markets in the U.S. to test new highs. This “risk-on” attitude means the equity risk premium is likely to come down, barring a major geopolitical event (e.g. escalation of Middle East conflict) or other unforeseen materially negative events.

Eurozone (From a German Investor Perspective)

The Kroll Recommended Eurozone ERP remains in the range of 5.5% to 6.0%, to be used in conjunction with the higher of a German normalized risk-free rate of 3.0% or the spot 15-year German government bond yield as of the valuation date.

However, recent inflation readings in the Eurozone have declined at a much faster pace than initially anticipated by economists and the European Central Bank (ECB). In light of these developments, rate cuts are also being contemplated by the ECB in 2024. Long-term inflation expectations have also declined significantly, in both Germany and the overall Eurozone. As a result, it is possible that the Kroll normalized risk-free rate for Germany will be lowered in the near future. In addition, although the Eurozone economy has not been as resilient as in the U.S., real GDP growth in 2023 likely ended in a much better place than originally projected at the beginning of the year. The job market continues to be relatively strong, and economic recovery is expected to continue, albeit at a slow pace in some of the countries within the region (e.g. Germany, Italy, etc.). Benchmark stock indices in some of the countries in the Eurozone have touched new records, like the CAC-40 in France and the DAX in Germany. The STOXX Europe 600 index has been approaching, but not yet reaching, the record high last observed in early 2022.

While the Kroll Recommended Eurozone ERP remains in the range of 5.5% to 6.0%, based on current economic and financial market conditions, we believe that a **5.5% ERP (i.e., towards the lower end of the range) is more appropriate when developing EUR-denominated discount rates as of February 5, 2024, and thereafter, until further guidance is issued.**

Incremental country risk adjustments for other Eurozone countries with a sovereign debt rating below AAA may be appropriate. Please note that this information does not supersede Germany's IDW (Institut der Wirtschaftsprüfer) guidance for projects that will be reviewed by German auditors or regulators.

We will continue to closely monitor the situation and publish new guidance when appropriate.

Please contact our support team with any questions: costofcapital.support@kroll.com