



# VAA update

## Round Table Lunches



Are you an investor in unlisted investments?

If the answer is yes, you will be interested to know that our upcoming Sydney and Melbourne Round Table Lunch series will be focussed on the role of 'alpha' or discount rate adjustments for non-systematic risk.

Frequently used as a catch-all for (often) unquantifiable risks, alpha is both the source of returns for most managers and the subject of extensive debate amongst investors and valuers.

Watch your inbox for an invitation to a Round Table Lunch soon or contact Kylmyn Cowburn-Cainer on 1800 912 226 or [k.cainer@vaassociates.com.au](mailto:k.cainer@vaassociates.com.au) for more details.

## CPA Australia's National Valuation of Equity and Other Securities Forum panel



In June Michael Churchill was invited by CPA Australia to be the key Victorian contact for the CPA Australia's National Valuation of Equity and Other Securities Forum panel. Philip Mann of Value Adviser Associates is already a member, representing South Australia.

The purpose of this national panel is to coordinate forums and webinars to direct and guide contemporary points of discussion for experts in valuation today. Recent topics of interest have been Calculation of Beta post GFC, Family Controlled Business Valuation and Carbon Investing; the impact on valuation.

This panel is perfectly aligned with Michael Churchill's skill set and Michael is very keen to be a part of this initiative from CPA Australia.



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## As seen in JASSA, Adjusting the MRP to reflect the GFC

Dr Steven Bishop, Michael Fitzsimmons and Prof Bob Officer prepared an article published in JASSA, the FINZIA journal of Applied Finance examining how to deal with the increase in stock market risk arising from the global financial crisis when estimating the cost of capital.

JASSA is a quarterly publication that provides subscribers current, relevant and up to date articles in the financial services industry. This publication offers peer reviewed technical analysis research in the financial services industry. In its 41st year of publication it is a great honour to see Dr Steve as well as his esteemed collaborators publish a peer reviewed relevant article pertinent to what is happening right now.

[To read the full article please click here.](#)

## ADJUSTING THE MARKET RISK PREMIUM TO REFLECT THE GLOBAL FINANCIAL CRISIS

*Because of the substantial increase in stock market risk arising from the global financial crisis, it is not appropriate to use a constant market risk premium (MRP) when estimating the cost of equity. This is particularly so when estimates of the weighted average cost of capital include the current high risk premiums on debt but this is not reflected in the equity MRP. We propose a method for adjusting the MRP to reflect unusual risk situations.*



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The global financial crisis (GFC) has had a significant impact on the capital market. The stock market return for 2008 was negative 40 per cent, the lowest in the 126-year recorded history of market returns. The most recent available data (as at early December 2010) show that market risk as defined by the variance of the market index, although declining from its peak, is still over 60 per cent above our estimate of the long-term average level of market risk.

There is an obvious link between the increase in market risk and the decrease in equity values. We argue that the market risk premium has risen to reflect this increased risk, and we suggest a method which reflects this increased risk in the cost of equity used for business valuations.

The increase in risk is very apparent in debt markets. Debt margins on BBB-rated corporate bonds are around 400 basis points (bps) above the 10-year Commonwealth Treasury bond rate compared with an average of around 120 bps prior to the GFC. While this is apparent in debt markets, estimating a weighted average cost of capital (WACC) also requires an estimate of the cost of equity capital. If we were to follow the common practice of using a 6 per cent market risk premium (MRP) in the Capital Asset Pricing Model (CAPM), which is used under more 'normal circumstances', then the outcome would be a substantial narrowing of the difference between the risk premium on equity relative to debt. However, we argue that this could be misleading since the risk premium on equity would be expected to rise, at least commensurately with the risk premium on debt.

As we have indicated above, the cost of equity can be estimated using the CAPM. The CAPM defines the cost of equity as a risk-free rate plus a premium for risk, where risk is a market risk premium multiplied by beta (a measure of the risk of an asset relative to market risk). Since beta is a relative measure of risk, the impact of the GFC on the overall market return is unlikely to be reflected in changes in beta (the market beta will still be one). The overall market adjustment must be reflected in the MRP.

The MRP is a forward-looking risk premium and will change over time to reflect the changing view of risk and attitudes to risk on the part of risk-averse investors who require a positive risk premium relative to a risk-free asset. We would expect the MRP to vary within an average range of, say, 6 per cent to 7 per cent.

The method we use to estimate the current forward view of the annual MRP is to assume a constant required premium per unit of risk, implying increasing risk would increase the risk premium (the expected, or required, MRP), and conversely for

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**Value Adviser Associates is a specialist, independent business and securities valuation practice with offices in Melbourne, Brisbane, Adelaide and operating in Tasmania.**

To contact a member of the Value Adviser Associates team please call **1800 912 226** or visit the website **www.vaassociates.com.au**

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