Picasso, Escobar, Fernandez

24 April 2017

Market Risk Premium and Risk Free Rate

With the release of Pablo Fernandez's annual survey of Market Risk Premium (MRP) and Risk Free (Rf) rates, InterFinancial thought it apt to summarise the results in light of recent valuations and the weakness in particular areas of analyst research.

Fernandez's paper contains the statistics of a survey regarding the Rf and the MRP used in 2017. The survey received answers from academics, analysts and managers of companies from 68 countries, however for statistical relevance the paper only reported the results for countries with more than 25 answers (N = 41).

Interestingly, the average Rf used in 2017 was less than the 2015 result in 12 countries whilst 10 countries indicated an increase in 2017's Rf rate of more than 1%. Additionally, the change between 2015 and 2017 of the average MRP used was higher than 1% for 11 countries.

Within Europe and the UK, the Rf was considered to be higher than the yield of the 10-year Government bond. The results for Australia were an average MRP of 7.3% (reflecting an increase of 1.3% since 2015) and a Rf of 3.0% (compared to the current 10-year bond rate of 2.52% and the forecast 10-year bond rate of 3.2% for 2020).

Valuations specialist and Executive Chairman of InterFinancial, Paul Keehan, would prefer to use the forecast for 2020 10-year bonds of 3.2% for Rf. This would provide Australia with an average cost of equity of 10.5%.

InterFinancial
Corporate Finance Limited
ABN: 49 136 962 966
AFSL: 341675
Level 3, 145 Eagle Street
GPO Box 975
Brisbane Queensland 4001
T. (07) 3218 9100
E. admin@interfinancial.com.au
www.interfinancial.com.au

Uncovering Wall Street Analysis: Snapchat

Many investors rely on advisors or analyst research to provide the information required to value companies and participate in transactions. It is clear however that company valuations can be easily swayed by both analyst research and the adjustment of discount rates.

On 27 March 2017, nearly a month after the stock debuted, Morgan Stanley published its first research note on shares of the newly public social media company, Snap, which it had helped take public. Snap is the company behind Snapchat, an image messaging and multimedia mobile application created by three former Stanford students in 2011.

Morgan Stanley priced Snap at USD 28 / share, a 23% premium to the trading price of the prior week, with the recommendation to buy. However, 22 hours later Morgan Stanley released a revised note with lowered estimates for Snap's future earnings without revising the USD 28 / share target price or buy recommendation.

So how did the research note manage to revise Snap's expected adjusted EBITDA in 2025 from USD 6.57bn to USD 4.92bn in just 22 hours? Taken from Morgan Stanley's updated research report:

> *"We have also corrected our discounted cash flow calculation so that it is consistent and comparable across our US internet coverage. More specifically, we are lowering our SNAP equity risk premium from 5.59% (an estimated pre-IPO rate) to 4.29% (consistent with other companies in our group). This change lowers our WACC to 8% (from 10%). On an aggregate basis, our price target is unchanged at $US28/share."*

The negative adjustment to EBITDA was cancelled out by the positive correction of the Weighted Average Cost of Capital (WACC). When the WACC is raised, the equity value is lowered.

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Although they have made this adjustment across their coverage of other stocks within the US internet sector, Morgan Stanley is still out of sync with its peers on Wall Street which used WACC's significantly above the 9.7% and 8% figures used in the research note to value Snap.

- Credit Suisse – 11%
- Deutsche Bank – ~16%
- Jefferies – 12%
- RBC Capital Markets – 11%
- Atlantic Equities – 11%

To put this in perspective; Facebook, a USD 410bn company that generates USD 10.2bn in net income in 2016, has a higher WACC than Snap, a USD 26bn company that has yet to turn a profit. This situation highlights the weakness of relying on Wall Street analyst research and raises important questions about the value of these models.

An article by Matt Levine, a Bloomberg View columnist (previously a Goldman Sachs investment banker, M&A lawyer and clerk for the US Court of Appeals), made some interesting points regarding the real value of advisors and equity research. Levine states that many investors have little interest in the research, rather they valued the connections within the market and the advisor's ability to facilitate knowledge sharing and corporate access for their clients.

InterFinancial are true believers in connecting with industry participants, from stockbrokers to CEOs, in order to discover the value driving factors within each company and ensure that we are able to achieve more for all our clients.

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If you would like to discuss value shifting factors within your business, how to develop a M&A strategy, or to successfully integrate and realise the benefits of a M&A strategy, please contact the team at InterFinancial.

Contact Details

Name	Position	Phone	Email
Paul Keehan	Chairman	(07) 3218 9100	pkeehan@interfinancial.com.au
Sharon Doyle	Managing Director	(07) 3218 9122	sdoyle@interfinancial.com.au
Chris Mundey	Partner	(07) 3218 9100	cmundey@interfinancial.com.au
David Hassum	Director	(07) 3218 9108	dhassum@interfinancial.com.au
Ted Marchant	Director	(07) 3218 9100	tmarchant@interfinancial.com.au
Andrew Wheeler	Director	(07) 3218 9107	awheeler@interfinancial.com.au
Mark Steinhardt	Director	(07) 3218 9105	msteinhardt@interfinancial.com.au
Hyun-ju Johnson	Director	(07) 3218 9109	hjohnson@interfinancial.com.au
John Crossland	Director	(07) 3218 9100	jcrossland@interfinancial.com.au
Kalan Douglas	Director	(07) 3218 9100	kdouglas@interfinancial.com.au
Simon Campbell	Associate Director	(07) 3218 9106	scampbell@interfinancial.com.au
Craig Turner	Associate Director	(07) 3218 9112	cturner@interfinancial.com.au
Jake Moyle	Associate	(07) 3218 9113	jmoyle@interfinancial.com.au

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InterFinancial
Corporate Finance Limited
ABN: 49 136 962 966
AFSL: 341675
Level 3, 145 Eagle Street
GPO Box 975
Brisbane Queensland 4001
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www.interfinancial.com.au

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