

Still A One Way Bet?

Updated WACC assumptions

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10 year government bond rates have moved up +0.7% since our last WACC update in August 2020, its most significant move since 2H16. Our interpolated 10 year spot rate (used for our WACC assumptions) is now c.2.3%, its highest since 1H19. Does this mark the beginning of the end of the ultra low interest rate environment, or is it just another kink in the curve in the multi decade trend towards ever lower interest rates? Market multiples appear to be indicating the latter, remaining at an all time high at around 30x 12m forward earnings. We update our WACC assumptions to reflect 100bps higher interpolated 10yr interest rates (Rf) partly offset by a 50bps reduction in the Market Risk Premium (TAMRP). Our new estimates for Rf and TAMRP are 2.3% and 5.5% respectively.

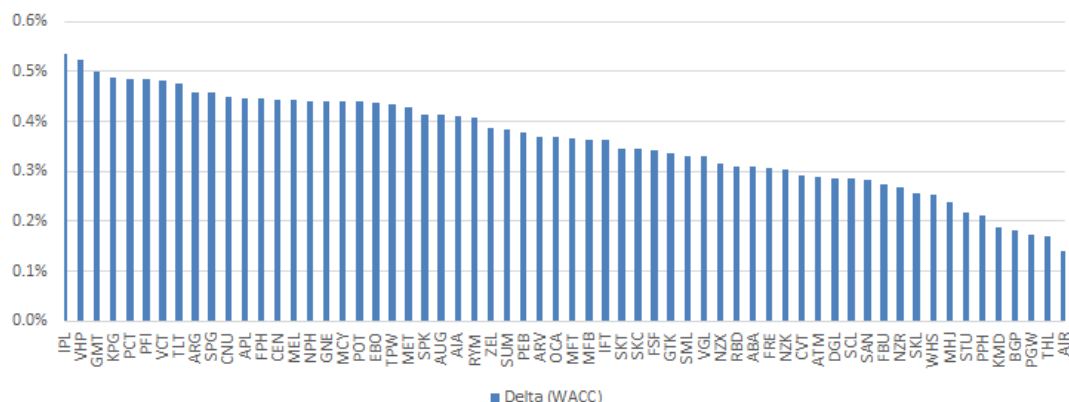
Interpreting Interpolated Interest rates

Short rates have remained ultra low at 0.25% and two year government bonds have barely moved. However, the curve has steepened materially; currently the 10 year is around 1.3%-1.4%. We apply the interpolated 10 year to our WACC calculations to take into account the longer duration of the equity market in relation to the "traditional" risk free rate of 10 years. It is an attempt to use information across the yield curve to derive a proxy for the average rate over the next 20 years. Incidentally, both our estimated interpolated 10yr and the reasonably liquid 20 year traded bond both point to c. 2.3%, an increase of 100bp since our last WACC review in August 2020.

Interest rates go down, PEs go up. Interest rates go up, PEs stay up.

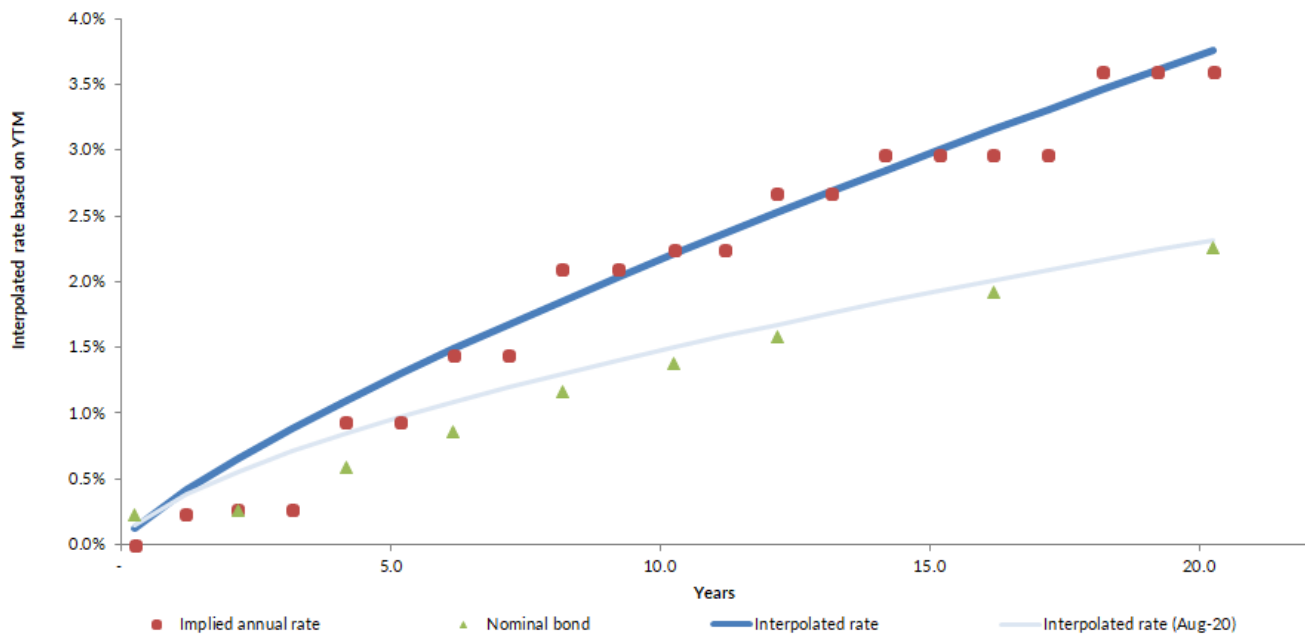
The last two times 10 year bond rates were around 1.3%-1.4% the market weighted PE was 20-25x. Today we estimate it is at c.30x. This could be driven by a reduced TAMRP, increased growth expectations, an expectation that interest rates will return to previous lows, or, most likely in our view, a combination of the three. We discussed our approach to Market Risk Premium in detail in our report *"The Cost of Capital Conundrum – When TINA Came to Our Shores"* (7 August 2020). Using our "ugly compromise" approach laid out in that report, we estimate that market implied TAMRP has been relatively stable, around 6% over the last decade. That approach now indicates a spot TAMRP of around 5%, fully offsetting the increase in interest rates, as would be expected with stable multiples. We approach changes in TAMRP with a high degree of conservatism. Contrary to interest rates, it is not directly observable and should be relatively stable over time. Additionally, an observed unusually low/high TAMRP could be an indication of shorter term dislocations in the market. We reduce our TAMRP for WACC calculation purposes by -50bp, to 5.5%, in-line with the change in the 12 month moving average TAMRP. Our WACC increases by an average of 0.4% which we will incorporate through the upcoming earnings season.

Figure 1. Changed WACC assumptions



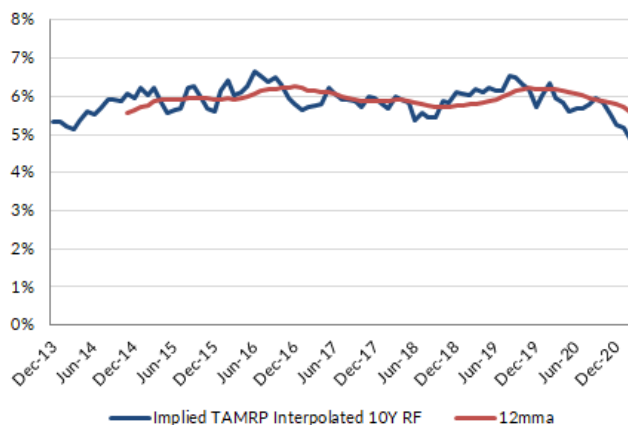
What a difference six months make...

Figure 2. Interpolated yield curve has steepened significantly in the past six months



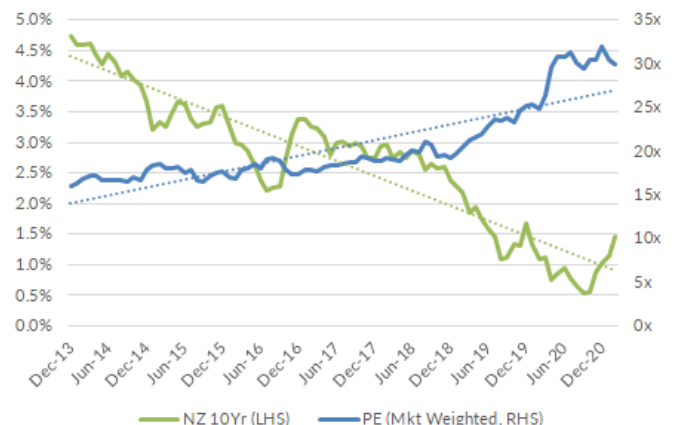
Source: Forsyth Barr analysis, Eikon

Figure 3. Implied TAMRP has begun to trend downwards



Source: Forsyth Barr analysis, Eikon

Figure 4. Inverse relationship of 10Y and Market PE



Source: Forsyth Barr analysis, Eikon

Improving outlook offsetting interest rate movements

All else equal, 40bps higher WACC should impact our price targets negatively by about 5–10%. However, all else is not equal. Interest rates are rising for a reason. Inflation and growth expectations globally in general and for New Zealand in particular have risen, and interest rates have responded. We believe that part of the reason for the maintained earnings multiples in spite of higher interest rates is higher nominal growth expectations. For companies with pricing power or with high operational gearing, we could potentially see meaningful earnings upgrades. However, for companies for which we see no positive impact from an improved domestic economy and which are negatively exposed to increased inflation, the increased cost of capital should suggest a lower price target.

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