Valuation in a Trade-War World: A Practical Overview of Tariff Risk

Recent increases in US import tariffs and retaliatory actions taken by affected countries in response have had important commercial and economic effects and created significant economic uncertainties that have had knock-on effects on companies and asset valuations. These have been accompanied by policy reversals and conflicting signals which have complicated economic forecasting and corporate planning.

The effects of tariffs have been widespread but are of particular concern to certain countries and industries. For example, early tariff actions focused on North American trade between the US, Canada and Mexico. Subsequent very large new tariffs on trade between the US and China, in particular, have had direct effects on physical trade flows and even shipping levels. Particular industries have seen outsized effects, especially where extensive supply chains had developed, most notably in technology, but also in sectors such as footwear. However, even countries and companies with less direct linkages are affected, with an increased risk of a recession or stagnation as well as inflation.

Currently, trade deals are being negotiated and in certain cases measures are on hold as the situation evolves dynamically. This has limited the economic effects to-date and raised questions about the ultimate outcomes.

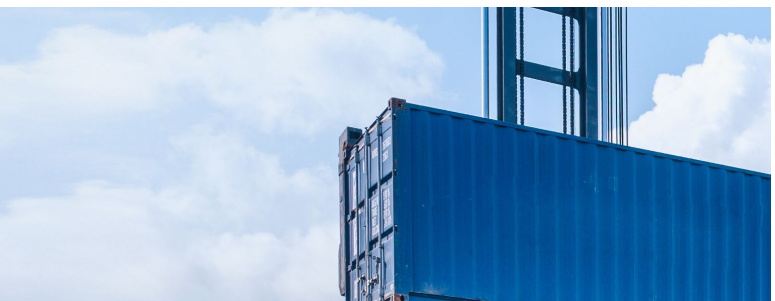
In looking to understand the potential effects of tariffs on a company and its valuation, the complexity is increased because of uncertainty about how long these arrangements will remain in place. For example, some indications were that the objective of the policy is to shift manufacturing back to the US. This would require the expectation that tariffs would remain in place for the long term so that companies increased investment in US manufacturing.

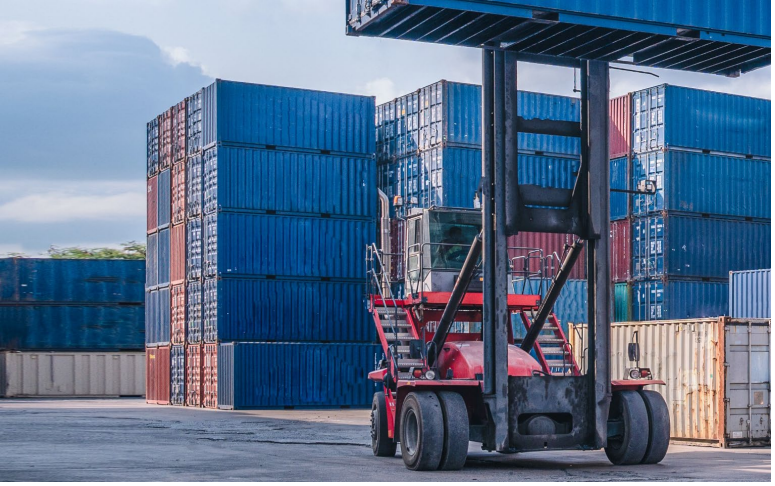
However, other signals suggest that the current arrangements are an opening negotiating position, implying these will change in the relatively short term, in which case, companies may decide to not change their investment plans (but may change short-term import decisions). This increases the complexity for companies managing in this environment and valuers performing valuations.

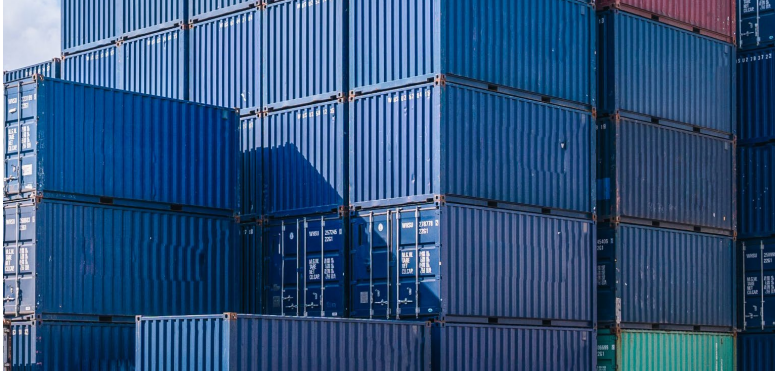
This article addresses some of the key uncertainties that companies are currently weighing, which could directly or indirectly affect valuations.

Effects of Tariffs on Companies and Valuation

01 **Revenue.** The effects on revenue start with how entities react to these new costs. Tariffs increase the cost of imported goods. Companies affected need to consider how such costs will be borne, e.g., to what extent exporters will reduce the prices they charge to maintain the post-tariff prices to customers versus importers passing on the full effects of tariffs to their customers. The level of some tariffs suggests that much or all of the tariff increases may be pushed onto customers,







(cont.) but any price decrease will directly affect companies' revenues. Higher prices relative to domestic producers changes the relative competitiveness of each party and may increase the short-term profitability of local producers who typically increase their prices in response, though many companies may have similar supply chains which may mitigate this effect. Moreover, any short-term benefits to domestic producers are likely to be offset by increased uncertainty and worse economic conditions given that such higher prices are likely to reduce overall customer demand and product volumes, negatively affecting revenue for all market participants.

Increased import prices and inflation creates negative effects for economies more broadly and recession fears have increased in many countries.

02 **Cost increases.** Many companies have international supply chains which utilize intermediate or final products manufactured in other countries. Bearing these increased costs will reduce companies' profitability.

03 **Exchange rate changes.** Foreign exchange rate changes are likely due to shifts in demand and these may offset some of the effects of the tariffs. Tariffs reduce demand for imports, which reduces demand for the exporters' currency. This leads to a relative strengthening of the local currency which makes imports less expensive, partially offsetting the increase in the price of imports caused by the higher tariffs.

04 **Company valuations.** The direct effects of tariffs on a company's performance and the indirect effects from the perception of increased risk will tend to reduce valuation.

05 **Investment plans.** Companies with significant investment plans have to consider the effects of tariffs on the expected profitability of such capital expenditures. Those companies may delay such plans to better understand the long-term tariff outcome. Delays like these, adopted cumulatively across many companies, may reduce economic growth and contribute to recession risks.

06 **Accounting effects.** The tariffs are expected to have wide-ranging effects on a company's accounting, including potentially asset and investment impairments, higher expected credit losses (ECLs), going concern risks, recovery of deferred tax assets, etc., with related disclosure requirements.

07 **Increased focus on risks from leverage.** Increased macroeconomic risks put greater focus on higher leveraged companies. In addition to higher refinancing risk, the compounding of business and financial risks levers the effects of the current uncertainties.

08 **Corporate transactions.** The tariffs are likely to lead to delays or the abandonment of M&A transactions or even new or renewed financing arrangements. Existing M&A and financing processes are seeing increased time spent on due diligence as counterparties seek comfort on the effects of tariffs.

On the other hand, this might be a catalyst for deals to gain access to certain markets and establish a direct footprint to avoid tariffs, e.g., to secure a US manufacturing footprint.

Effects on Valuation

01 **Greater efforts required to understand clients' plans.** Having a comprehensive understanding of a company's commercial plans is a critical factor in any valuation but especially important in such an evolving situation. This may affect the level of consulting a valuation requires.

For example, in more normal situations, the valuer may be satisfied relying on the insights and perspectives of financial and accounting executives. However, wider consultation may be required in the current circumstances.

02 **Discounted Cash Flow (DCF) techniques.** Most DCF valuations use a single cash flow scenario. It may be useful for entities to consider the expected cash flow (ECF) method which probability weights a range of cash flow scenarios.

This would allow different potential tariff effects to be considered and creates a structured approach to incorporating such factors. However, historically concerns about estimating the range of scenarios to be considered and their probability have limited the application of the ECF method.

03 **Discount rate.** In some jurisdictions, concerns about forecast risks in cash flow projections have been reflected in adjustments to the discount rate. The subjectivity of these adjustments has restricted the use of such premiums in other jurisdictions. In any event, risks should be considered in either cash flows or the discount rate but should not be double counted.

04 **Market approaches.** It is especially important to consider market prices and movements at times of increased uncertainty. For example, traditional techniques that estimate individual valuation inputs such as the equity risk premium (ERP) or beta inputs into cost of capital calculations may reflect stale data.

For example, increased spreads in higher risk bonds suggest increased investor risk aversion that may not be captured in ERPs generated from historic data. This may create an increased focus on reasonableness tests of the results of DCF techniques such as implied earnings multiples, even where a market approach is not the primary valuation technique.

05 **Terminal value.** If short-term cash flows are reduced, terminal value calculations are likely to be a greater proportion of the overall value. Given the uncertainty with amounts to be realized further in the future, increased scrutiny of such values will be important.

Generally, more consideration needs to be given to the assumptions embedded in the long-term "normalized" situation after the current uncertainties stabilize, as developments during the explicit projection period may or may not change some important business dynamics for the company being valued.

06 **Caveats.** Given the level of uncertainty, valuations may contain caveats similar to those used during Covid.

07 **Valuation range.** Given the uncertainty, the range of values of an asset or company may be wider than normal.

08 **Valuation date.** Valuations are prepared as of a specific date. This raises a question of what should be considered in the valuation based on what was known or knowable at that date. This requires consideration of the timeline of events before and after the valuation date.

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- **Financial modelling and scenario analysis fit for decision-making purposes:** We combine in-depth sector knowledge with advanced analytics, simulation tools and visualization techniques to model various tariff scenarios and assess the impact on cash flows, cost of capital and enterprise value.
- **Strategic support focused on value:** Whether you are financing growth, navigating restructuring, resolving disputes, or setting up value-based management systems, we help you unlock, protect, and maximize value across your organization.

Contact our experts

KPMG AG
Badenerstrasse 172
Postfach
CH-8036 Zurich

kpmg.ch/valuation

Johannes Post
Partner, Global Head of Valuation Services

+41 58 249 35 92
jpost@kpmg.com

Rolf Langenegger
Director, Valuation

+41 58 249 42 71
rlangenegger@kpmg.com

Simon Laval
Director, Valuation

+41 58 249 46 30
slaval@kpmg.com

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