

March 28, 2011

Mr. Jean-Florent Rérolle, Chairman
Professional Board
International Valuation Standards Council
41 Moorgate
London EC2R 6PP
United Kingdom

RE: Comments on the Exposure Draft of Technical Paper 1: *The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations*

Dear Mr. Rérolle,

On behalf of the Appraisal Institute, the Appraisal Standards Committee (“ASC”) submits these responses to the following questions posted in the Exposure Draft of Technical Paper 1: *The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations*.

- 1 This Exposure Draft states that the DCF method should not be judged on the basis of whether or not the explicit cash flow assumptions are ultimately realized but rather on the degree of market support for the assumptions at the time they were made.

Do you agree that the DCF method, if properly applied, can be used as a method to arrive at market value?

Response:

Yes, we agree with this statement.

- 2 The IVPB has concluded that although there may be distinct terms and types of analyses that apply respectively to real property valuations and business valuations, the underlying DCF method is identical in each case.

Do you agree that the underlying DCF method described in this paper applies equally to the valuation of real property and businesses? If not, please explain the differences that you believe exist?

Response:

We have a problem agreeing with this because although the broad "method" is the same, the application is different. And these differences have caused us to disagree with other things in the Exposure Draft, leading to a concern that the word "method" is being used differently.

- 3 This Exposure Draft states that the discount rate should be determined based on the risk associated with the cash flows (para 10), whether the DCF model is being used to determine a market value or investment value.

Do you agree, or do you consider that other matters should be taken into account in determining the appropriate discount rate?

Response:

Yes, we agree with this statement. In addition to risk, the time value of money needs to be considered.

- 4 A number of different methods are identified which can be applied to the calculation of the terminal value at the end of the cash flow period (growth, fading growth, net asset value, salvage value, etc). For long-life real property assets or going concern businesses the Board believes a constant growth model is the most commonly used method, coupled with a cross check for the reasonableness of the figure, eg by reference to the implied exit multiple.

Do you agree that the most commonly adopted terminal value calculation at the end of the explicit forecast period is the 'constant growth' model, cross-checked for sensibility to an implied capitalisation rate or exit multiple? If not please identify what other method you most commonly use?

Response:

Agreed, assuming that the rate is based on market data.

- 5 The Exposure Draft explains that cash flows can be developed on the basis of alternative financial assumptions, eg inclusive or exclusive of anticipated inflation, inclusive or exclusive of tax etc. Providing the discount rate used is consistent with the financial assumptions in the cash flows the valuation result should not be affected by the alternative used.

Do you agree that providing a discount rate is used that is consistent with the financial assumptions made in calculating the cash flows that the choice of using explicit or implicit financial assumptions in the cash flows should not affect the valuation result?

Response:

Yes, we agree.

- 6 This Exposure Draft is intended to identify best practice in the creation and application of discounted cash flow models. The Board has made the decision not to explain in detail the types of inputs that may be used in different situations or the investigations that may be appropriate. Neither are illustrative examples provided. The preliminary view of the Board is that detailed discussion of inputs or a limited range of examples is inappropriate because it could be misleading if it led readers to believe that these models were endorsed by IVSC or conversely, variations of these models in different situations were not appropriate. There are many industry specific sources for those who require training in the development and use of relevant DCF models.

Do you agree that more detailed discussion and examples of the valuation inputs into a discounted cash flow model are inappropriate? If not how much additional information do you think should be included in best practice guidance?

Response:

We agree that more detailed discussion is not needed. More detailed discussion may be provided in advisory or guidance material.

Additionally, we submit these comments on certain sections of the Exposure Draft of Technical Paper 1: *The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations*.

- 8 Cash flows for future periods are constructed using actual or projected income, (cash inflows) and actual or projected expenditure (cash outflows). The cash flows normally consist of a series of periodic receipts and expenses over a forecast period followed by a terminal value. The duration of the forecast period is normally for the period for which changes in the cash flows are known, eg because they derive from contractual rights or obligations, or are otherwise reasonably predictable. Once the forecast cash flows have stabilised a terminal value can be calculated. In cases where the asset is of indefinite life the terminal value will reflect the benefit of the cash flows from the end of the forecast period into perpetuity.

Comment:

We disagree with the statement, "The duration of the forecast period is normally for the period for which changes in the cash flows are known...." While this may be true for business valuation, it does not universally hold true for real property valuation. In real property valuation, the forecast period generally coincides with the typical investment holding period. This means often the real property valuer must project cash flows beyond when the quantities are known.

11 The discount rate will reflect the risk associated with the cash flows. Where the objective of the DCF model is to estimate market value, the discount rate should reflect market participants' view of risk, which may be determined from the discount rates, or return, implied by recent transactions involving similar assets. If there have been no recent transactions then it may be necessary to estimate an appropriate discount rate by considering the risk premium that would be required by an investor, ie the additional return required over that obtainable from a 'risk free' asset such as a AAA rated bond. Calculating the risk premium requires consideration of matters such as the certainty and security of the income, the strength of any counterparty and the prospects for future income growth.

Comment:

This sort of, but not really works for real property. The discount rate cannot be mathematically derived from the sale price and "calculating" the asset class risk as compared to risk-free investments is always interesting (though that is what we do).

e) An appropriate discount rate needs to be applied to the cash flow. If the frequency of the time points selected for the cash flow is, for example, quarterly, the discount rate must be the effective quarterly rate and not a nominal rate. Expenses may be placed at the accounting point in time rather than the point of time at which they are incurred. The best solution is to have a cash flow frequency that matches the timing of the most frequent aspect of the periodic cash flow.

Comment:

There is a serious problem with this provision. This allows for using the accounting accrual method for expenses rather than having expenses charged in the period they are incurred. This would create falsely high values, by allowing expenses to be deferred. This is NOT applicable to real property, which is valued on a cash accounting basis.

We trust that you will find our comments helpful. Please do not hesitate to contact me if you have any questions regarding these comments.

Sincerely,



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