

EXPOSURE DRAFT OF PROPOSED INTERNATIONAL VALUATION GUIDANCE NOTE – VALUATION OF SPECIALISED TRADING PROPERTY

Comments to be received by 31 October 2004

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Exposure Draft of Proposed International Valuation Guidance Note

Specialised Trading Property

This Guidance Note should be read in the context of the background material contained in General Valuation Concepts and Principles and implementation procedures required under International Valuation Standards 1,2 and 3

1.0 Introduction

- 1.1 Specialised Trading Properties (STPs) are individual properties, such as hotels, gas or petrol stations, and restaurants that usually change hands in the marketplace as operating entities. These entities include not only the usual elements of land and buildings, but also fixtures and fittings (furniture, fixtures and equipment) and a business component made up of intangible assets and goodwill.
- 1.2 Known as Specialised Trading Properties or Properties with Trading Potential in Commonwealth countries, STPs are often referred to as Going Concerns in the U.S.A. However, their valuation differs. In the U.S.A. the valuation premise adopted is that of a going concern, whereas an STP valuation excludes the personal circumstances of the owner. Although in both cases the value estimated is Market Value, the methodologies for valuing STPs and Going Concerns deal with different sets of assets.
- 1.3 This Guidance Note provides direction on valuation approaches for STPs as operating entities as well as the componentisation of STP entity value into its main constituents. Component values are usually required for depreciation and tax purposes. This Guidance Note should also be read in conjunction with the Guidance Notes cited in para. 2.1 below.
- 1.4 The concepts involved in the valuation of an entire business must be distinguished from those involved in the valuation of *Specialised Trading Property*.

2.0 Scope

2.1 This Guidance Note focuses on STP valuation. For further insight into the application of valuation principles, the following IVS Guidance Notes should be consulted:

- 2.1.1 GN 1, Real Property Valuation,
- 2.1.2 GN 3, Valuation of Plant and Equipment,
- 2.1.3 GN 4, Valuation of Intangible Assets,
- 2.1.4 GN 5, Valuation of Personal Property,
- 2.1.5 GN 6, Business Valuation,
- 2.1.6 GN 10, Discounted Cash Flow Analysis.

3.0 Definitions

3.1 *Capitalisation.* At a given date the conversion into the equivalent capital value of net income or a series of net receipts, actual or estimated, over a period.

3.2 *Discounted Cash Flow.* A financial modeling technique based on explicit assumptions regarding the prospective income and outgoings of a business or property. The most widely used applications of DCF analysis are the Internal Rate of Return (IRR) and Net Present Value (NPV).

3.3 *Goodwill:*

3.3.1 *That intangible asset* that arises as a result of name, reputation, customer patronage, location, products or similar factors, which generate economic benefits.

3.3.2 *Goodwill.* Goodwill that is property-specific and inherent within the property. This is an intangible but sustains the Market Value of the asset based on the probability that customers will continue to return to the same premises.

3.4 *Reasonably Efficient Operator, or Average Competent Management.* A market based concept whereby a potential purchaser, and thus the Valuer, assess the maintainable level of trade and future profitability that can be achieved by a competent operator of such a business, acting in an

efficient manner. The concept involves the trading potential rather than the actual level of trade under the existing ownership.

3.5 *Specialised Trading Property.* Property with trading potential, such as hotels; gas, or petrol, stations; restaurants; or the like, the *Market Value* of which may include assets other than land and buildings alone. These properties are commonly sold in the market as a going concern, or with regard to their trading potential that may make separate identification of the value of the land, building, personal property, intangible assets, and business itself difficult.

4.0 Relationship to Accounting Standards

4.1 Under the provisions of International Financial Reporting Standards (IFRSs), the Fair Value components of STPs may need to be separately determined under the requirements of IAS 16 Property, Plant and Equipment and IAS 38 Intangible Assets, the latter including elements of purchased goodwill, licenses, etc.

4.2 In preparing financial statements, it may be necessary to apportion the value of STPs among asset components to enable the allocation for depreciation, tax purposes, and/or to satisfy accounting requirements.

5.0 Guidance

5.1 This Guidance Note describes that category of property referred to as STPs and explains how STPs are valued in accordance with International Valuation Standard 1, Market Value Basis of Valuation.

5.2 When performing an STP valuation, the Valuer should refer to IVA 1, Valuation for Financial Reporting, and the six Guidance Notes cited in para. 2.1 above.

5.3 STPs are considered individual trading entities and typically are valued on the basis of their Earnings Before Interest, Taxes, Depreciation and Amortisation (EBITDA), usually on the basis of DCF methodology or by use of a capitalisation rate.

- 5.4 The valuation assumes that the business is run by a “Reasonably Efficient Operator”. Profit generated, over-and-above market expectations that may be attributed to the owner is not included. The owner’s particular tax position, depreciation policy, borrowing costs and capital invested in the business are not considered for the purpose of establishing a common basis to compare different properties under different owners.
- 5.5 Although the concepts and techniques are similar to those used in business valuation, to the extent that the valuation of an STP does not consider actual tax, depreciation, borrowing costs and capital invested the business, the valuation is based on inputs somewhat different from those of a business valuation.
- 5.6 The valuation conclusion usually needs to be broken down between the different components for the purposes of financial reporting, for ad valorem taxation or, when required, for property lending purposes. This process enables the Valuer to arrive at an indication of the value of the underlying real estate component. The components of STP entity value are:
- 5.6.1 working capital;
 - 5.6.2 land;
 - 5.6.3 buildings;
 - 5.6.4 fixtures and fittings (furniture, fixtures and equipment), including software; and
 - 5.6.5 intangible assets, including goodwill/business value.
- 5.7 An estimation of the individual values of the components can only represent an apportionment, unless direct market evidence is available for one or more of these components to isolate component value from the overall STP value. There is substantial literature on the subject of componentisation/allocation.
- 5.8 **Working Capital.** Most business Valuers would define working capital, in this circumstance, as current assets (cash, accounts receivable, inventory and prepaid expenses) less current liabilities (accounts payable and accrued expenses). The impact of financing liabilities, such as the current portion of long term debt, is not considered. Working capital assets are tangible assets whose value can normally be taken directly from the balance sheet of the STP. It is important to note

whether or not some of these assets are included in the market analysis that was used to estimate the Market Value of the whole. Depending on whether or not such assets were included, appropriate adjustments must be made. The allocation for working capital is part of the business valuation. See GN 6 for a full discussion.

- 5.9 **Land and Building.** These are tangible assets that are normally valued by reference to the market for comparable assets. In some cases, the income approach, usually discounted cash flow analysis, is also used to arrive at an estimate of Market Value. The allocation to land and buildings is what constitutes the real property. See GN 1 for a full discussion.
- 5.10 **Fixtures and Fittings (Furniture, Fixtures and Equipment).** These are tangible assets. They are normally valued with reference to the market for comparable items, suitably adjusted for age, condition, etc. The proper analysis includes adjustments for all forms of depreciation, i.e., physical deterioration, functional obsolescence and economic (external) obsolescence. The allocation process must clearly define what part of this group of assets might be included with the building, and what cannot be. The allocation for fixtures and fittings includes plant and machinery. See GN 3 and GN 5 for a full discussion.
- 5.11 **Intangible Assets.** These assets are often a combination of the Trademark, Name, Franchise, Workforce (more properly called “trained workforce”) and Goodwill. Most business Valuers define goodwill as the sum of all the non-identified intangible assets. It is important to note whether or not some of these assets are included in the market analysis that was used to estimate the Market Value of the whole. The techniques used to value these assets are typically versions of discounted cash flow and capitalization of cash flow. In some cases, the cost to recreate (duplicate) the intangible asset(s) can also be successfully used as a methodology. Key to the income approach is determination of the cash flow that should be allocated to each of these assets. The allocation for intangible assets is part of the business valuation. See GN 4 and GN 6 for a full discussion.
- 5.12 **Cash Flow Allocation.** In applying the income approach, it is necessary to allocate the overall cash flow/income stream to the STP entity so as to arrive at valid estimates of the value of the asset components involved. The following pointers indicate how the cash flow/income stream might be allocated to each asset component.

5.12.1 **Tangible Assets.**

5.12.1.1 **Land.** The allocation of cash flow to land is what would be received in rents if the land were vacant and under lease.

5.12.1.2 **Land Improvements.** The allocation of cash flow to land improvements is what an investment analysis would estimate as the return expected from entering into a capital construction project.

5.12.1.3 **Building.** The allocation of cash flow to the building is what would be received in additional rents if the building were available for leasing.

5.12.1.4 **Fixtures and Fittings.** The allocation of cash flow to fixtures is what an investment analysis would estimate as the return expected from entering into a capital project.

5.12.1.5 **Machinery & Equipment.** Often included under the heading of Fixtures and Fittings, the allocation of cash flow to machinery and equipment is normally what would be received in rents if the machinery and equipment were to be leased.

5.12.1.6 **Working Capital.** Conceptually, the cash flow allocated to working capital is the weighted average of the return expected on each individual asset type (e.g., cash might be expected to earn about 2% to 3% in a money market fund) less the weighted average of the cost required to borrow the money that is loaned by suppliers in the form of accounts payable and accrued expenses.

5.12.2 **Intangible Assets.**

5.12.2.1 **Name.** The allocation of cash flow to a name is the excess of cash flow that would be earned by an operation, which was allowed to use the name, over the cash flow that would be earned by an operation, which was not allowed to use the name. It could also be the royalty that would be charged to use the name.

5.12.2.2 **Franchise.** The cash flow allocated to a franchise is calculated the same way as the cash flow allocated to a name.

5.12.2.3 **Workforce.** The cash flow allocated to the workforce is the excess of cash flow that would be earned by an operation, which was allowed to use the trained workforce, over the cash flow that would be earned by an operation, which was not allowed to use the workforce.

5.12.3 **Goodwill.** After all cash flow is allocated to individually identified assets, any remainder is normally allocated to goodwill. It should be noted that the sum of the cash flows to all the individual assets must not exceed the entire cash flow of the STP entity.

5.13 **STP Value Allocation.** In general the conceptual process involved in the allocation is fairly straightforward. The market cash flow allocated to each individual asset is discounted to present value at the appropriate market discount rate. Two of the asset categories are discussed in the section below.

5.13.1 **Working Capital.** In concept a discount rate is developed as the weighted average of the discount rates for each of the constituent assets or liabilities. That discount rate is applied to the cash flow allocated to the working capital to arrive at the Market Value of the working capital. In practice, the current assets and current liabilities that make up working capital are normally stated on the balance sheet of an STP at amounts that closely correspond to Market Value.

5.13.2 **Goodwill.** Since the allocation of cash flow to goodwill is the residual after the overall value of the STP has been allocated to all the other assets, the value of the goodwill will be the amount that is left after the values of all the other assets are subtracted from total STP value. To estimate the value of goodwill, the discount rate to be applied to the residual must be determined and the present value must be calculated. Typically, goodwill is a riskier asset than any of the other STP assets because if something starts to go badly for the STP, goodwill is the first to be affected, and its value will decline more rapidly than the value of any of the other asset components. While the tangible assets can normally be sold as used assets in a liquidation sale, intangible assets typically cannot. Moreover, goodwill can never be sold separately from the business that generates it. As a result, the discount rate applied to the value of the goodwill must be higher than any of the other discount rates, usually by several percentage points.

5.14 Methodology and Expertise

5.14.1 In practice, the income approach may not be the best methodology for estimating the Market Values of each of the assets discussed above. In some cases the market comparison approach may be a better alternative; in others the cost approach may be superior. Each of the individual assets, however, needs to be valued to arrive at an accurate allocation of the Market Value of the STP.

5.14.2 It may be advisable to have a business Valuer estimate the Market Value of the entire business enterprise, while the real property Valuer estimates the Market Value of the land and building. The Market Value of the machinery and equipment should be estimated by someone skilled in that type of asset valuation, and a Valuer with expertise in the valuation of intangible assets should estimate the Market Values of those assets.

6.0 Effective Date

6.1 This International Valuation Guidance Note became effective.....