DUFF & PHELPS

International Valuation Standards Council
1 King Street
LONDON EC2V 8AU
United Kingdom

April 30, 2014

Reference: IVSC Exposure Draft – Development Property

Dear Technical Director:

Duff & Phelps appreciates the opportunity to provide comments on the above referenced Exposure Draft.

Our valuation advice, particularly with regards to financial reporting, is sought by hundreds of global clients annually as we work with them in developing pragmatic solutions for applying fair value techniques.

We would be pleased to further discuss our comments with the IVSC. Please direct any questions to me via the contact information set forth below.

Sincerely,

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International Valuation Standards Council

Comments on Exposure Draft: Development Property

April 30, 2014

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General Observations

General Impressions

We would like to thank the Standards Board (the “Board”) for their efforts to provide guidance on the valuation of development property via this Exposure Draft (“ED”), as part of streamlining the guidance for the valuation of real property and real property interests.

Application of the Residual Method

The primary concern we have with the ED is the discussion of the application of the Residual Method, covered in paragraphs 24-28. While we realize that much of this material draws on the soon-to-be-retired IVS 233, we do not believe that the nature and depth of the discussion would serve practice sufficiently.

The current discussion of the Residual Method and inputs does not give a clear recognition as to when value is created by reference to meeting certain milestones in the development project. As milestones are being achieved, the project becomes de-risked and value accretes, and this underlies the valuation of the project at any distinct point in time.

When the milestones are expected to be achieved would be a function of the specific project: some projects are more risky in their permit phase, some in their construction phase, whereas others - in their lease-up phase. These breakpoints can drive particular assumptions, for example, different discount rates. Recognizing such milestones in the valuation model not only introduces more transparency in the valuation process, but mitigates the risk of front-loading value by making unrealistic assumptions, e.g., the timing of reaching a stabilized occupancy level and the associated risk.

Further, we believe the Board could provide more depth and detail in the discussion of certain inputs in the Residual Method and their interrelationship.

Illustrative Examples Needed

In addition to our prior recommendation, we strongly encourage the Board to include examples illustrating the application of the Residual Method. For instance, two or three examples of the valuation of a development property using a Residual Method at different points in the project/showing different complexities in the value creation process would be very useful.

Level on which the Guidance is Written

We recommend writing the ED in a straightforward, simple language so that the principles, methods and inputs are understandable to not only real estate valuation professionals but to users in general. Since the ED did not explicitly state it is geared solely to real estate valuation professionals, we understand that the audience is intended to be broader.

Summary

Overall, we believe that the guidance for valuing development property is not ready to be published in its current form. While the guidance reproduces large sections of IVS 233, we believe there is room for improvement with the goal of reducing diversity in practice and improving the quality of valuation measurements.

We urge the Board to revisit the discussion of the process and inputs used in the application of the Residual Method and address it within a framework of value creation and reduction of risk. The risk of not providing clear guidance is misunderstanding and/or diversity in practice.

We would also encourage the Board to re-expose the guidance once it has been further developed and has incorporated illustrative examples.

Questions

It is proposed that the specific requirements for valuations of investment property under construction for financial reporting under IFRS be referenced in the guidance on IFRS requirements in IVS 300 Valuations for Financial Reporting, rather than being in a separate standard. The Board considers it more logical to include all the requirements in the IVSs for valuations used in financial reporting and guidance on the requirements under IFRS in the same standard. If this is done the current IVS 233 would be withdrawn.

Question 1:

Do you agree with the Board's proposal to move all material in the standards specific to financial reporting to IVS 300?

Response: We agree. There is no need to create guidance for a subset of an asset class which follows a specific financial reporting model (i.e. investment property).

* * *

This Exposure Draft is of a proposed Technical Information Paper (TIP) that will retain the guidance in the current IVS 233 Investment Property under Construction if the latter is withdrawn. The guidance in this proposed TIP is designed to be more broadly applicable to all development property rather than to the specific case of valuations of investment property under construction under IAS 40. The Board considers that similar valuation considerations and methods are applicable to all types of real property under construction, not just investment property.

Question 2:

Do you agree with the Board's view that the valuation techniques described in the commentary to the current IVS 233 are applicable to all types of development property, not just investment property as defined in IFRS?

Response: We generally agree that the techniques described in the current IVS 233 are applicable to all types of development property, and we think that the ED does a better job of discussing the appropriate techniques and their pros and cons.

However, we have concerns about the discussion of the Residual Method in the ED. Please see our General Observations in this letter and our responses to Questions 6, 7 and 8.

* * *

The intended purpose of the proposed new TIP will be to provide guidance to support the application of the principles in IVS 230 Real Property Interests to development property. Paragraphs 1-4 set out the scope of the proposed guidance.

Question 3:

Do you agree with the scope as described? If not, please explain any additional matters that you believe should be added to the scope or matters currently included that you believe should be excluded.

Response: We agree with the scope of the ED as described.

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Paragraph 7 provides a non-exhaustive list of matters that typically need to be considered when undertaking a valuation of development property.

Question 4:

Please indicate if there are any items on this list with which you disagree or any additional matters you believe should be included.

Response: We think that the list is adequate.

* * *

Paragraph 15 suggests that all three valuation approaches identified in the IVS Framework can be applied to development property.

Question 5:

Do you agree? If not, please explain why.

Response: We agree that all three approaches can be considered and would be applied based on the facts and circumstances. However, we think that the income approach is the most relevant and commonly applied, while the market approach is least suitable for development property.

We also believe that the cost build up method is subject to the same principle of value-creation/profit accretion upon the achievement of defined milestones as the residual method. We recommend strengthening the discussion around the cost approach in that light.

* * *

Paragraph 20 introduces the "Residual method". Paragraphs 21 and 22 explain the sensitivity of the residual value due to small changes in the inputs.

Question 6:

Do you consider the caution provided here is sufficiently detailed or do you consider further guidance is required?

Response: We believe that the issue here extends beyond the sensitivity of the inputs. The discussion of the Residual Method can be made more robust and supplemented with examples. As currently presented, the Residual Method might be prone to misapplication and diversity of practice.

If the discussion is more focused on the stages of the development project - which could require different assumptions rather than "blended" inputs – one might find that some of the sources of sensitivity are in fact in part addressed through a higher quality valuation measurement. Also please see our comments in the General Observations section of this letter.

* * *

Paragraph 24 lists typical inputs into a cash flow forecast for a development property. This list is almost identical to that appearing in the current IVS 233.

Question 7:

Do you consider that there are any typical inputs that are not referenced but should be included or items included that would not typically be used? If yes, please identify the input and the reasons for inclusion or exclusion.

Response: We believe that the bigger issue with the discussion of the Residual Method extends beyond the inputs and into the framework for their application. Please see our comments in the General Observations section of this letter.

Further, we believe that the Board could provide more depth and detail in the discussion of certain inputs and their relationship to other inputs and the overall valuation. These include, but are not limited to:

- Assumptions about the completed property. The ED currently states: "The value of the completed project may be based on current values on the *special assumption* that on the *valuation date* it had already been completed in accordance with the current specification or the projected value of the property upon completion, ie the expected value of the property on the date when it is anticipated to be complete. …" We believe that the way this language is drafted could imply that the expected value of the property is considered as of the valuation date, which would not be appropriate.

- Buyers' profit and risk – while the ED discusses an allowance for profit and risk, it is implied that it is a line item in the projections. If so, care should be taken that such profit is not double counted in the discount rate.

  In our experience, profit is typically captured in the discount rate. Either way, a clarification should be made in the guidance to avoid double counting.

- The discussion of inputs should also address whether the valuation is to be performed on a pre- or post-tax basis and how that reconciles with the selection of a discount rate.

* * *

Paragraph 25 indicates common sources or methods for determining the appropriate discount rate. More detailed guidance is provided in TIP

Question 8:

Do you consider that there are any other methods for determining the interest rate that should be included? If so, please explain these.

Response: We believe that in addition to the rates implied from transactions or using a weighted average cost of capital (WACC), the ED should make mention of a survey of market participants as an additional method. Also, the ED should discuss whether the valuations are performed on a pre- or post-tax basis and the relationship to the discount rate.

* * *

Paragraph 34 includes a list of recommended matters that should be included in a valuation report for development property where relevant and appropriate.

Question 9:

Do you agree with this list? If not, please identify any additional matters you would like to see included or matters that are included that you think should be excluded, with supporting reasons.

Response: We agree with the recommendations on the list.

* * *

Paragraph 36 suggests that it may be advisable to include a sensitivity analysis if the valuation is very sensitive to changes in key inputs. This is in order to illustrate the risk of the value changing if, say, market conditions or construction costs were to change during the period required for completion.

Question 10:

Do you agree that this type of disclosure is helpful and should be encouraged wherever appropriate?

Response: We believe that the purpose of the valuation should be the sole determining factor in including disclosures of various kinds. Thus, the purpose of the valuation or the specific instruction of the party commissioning the valuation would determine if a sensitivity analysis is appropriate.

Further, a more disaggregated approach in modeling the valuation of the development property, whereby one distinguishes between the major development phases and associated risks, and as a result applies more refined assumptions, may be more informative about the drivers of value and sources of uncertainty in the first place. Please see our comments in the General Observations section of this letter.