JAPANESE ASSOCIATION OF REAL ESTATE APPRAISAL
SVAX TT Bldg., 3-11-15, Toranomon, Minato-ku, Tokyo 105-0001 JAPAN
Telephone: +81- 3-3434-2301, Facsimile: +81-3-3436-6450
E-mail: ishiyama@fudousan-kanteishi.or.jp

International Valuation Professional Board
41 Moorgate,
London EC2R 6PP
United Kingdom

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Subject: **Exposure Draft**
Proposed Technical Information Paper 1 01/2011
The Discounted Cash Flow (DCF) Method-Real Property and Business Valuations

Japanese Association of Real Estate Appraisal (JAREA) is pleased to respond to your request for comments on the exposure draft of Technical Information Paper 1 –The Discounted Cash Flow (DCF) Method published in January, 2011.

Sincerely,

前川 桂子
MAEKAWA, Keiko
Chairperson of International Relations Committee
Japanese Association of Real Estate Appraisal (JAREA)

Q1 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?

A International Relations Committee of Japanese Association of Real Estate Appraisal (hereafter, IRC/JAREA) considers that the DCF method is useful as a method to arrive at market value, when; 1) income projection and assumption are made from typical market participants' view and also 2) discount rate and terminal cap rate are derived from market participants' view. Such application will enforce the persuasiveness of value indicated by the DCF method as market value.

Market value is a value indicated by valuers who performed and considered as a market. Therefore, IRC/JAREA also agrees that the DCF method should not be judged on the basis of whether or not the explicit cash flow assumptions are ultimately realized.

However, such consideration applies when valuers "adopt realizable cash flow assumption form the market participants' point of view" and not allow the valuers to adopt obviously unrealizable assumptions even those are the market participants' view.

Q2 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?

A The underlying concepts and calculating formula of valuation approaches and method are identical between real property valuations and business valuations, although we have to be aware of the difference between those two valuations, such as identifying income and expense items, reference and decision criteria for cap rate.

Q3 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?

A IRC/JAREA agrees to consider the risk associated with the cash flow when determine the discount rate. Although, decision criteria for risk might be different from market value to investment value.

IRC/JAREA also supports the items to be considered for investment decision making, listed in the Exposure Draft(ED).

Q4 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?

A IRC/JAREA considers that the constant growth model is applicable only for going concern businesses or perpetual assets such as land or extreme long-life real property assets. However, even for going concern business, there are businesses that are not appropriate to apply constant growth. Therefore, valuers should assume its cash flow according to the business contents. Accordingly, IRC/JAREA finds that the expression in ED "a constant growth model is the most commonly used method" is not appropriate.

When assuming cash flow in forecast period and for the year following the last year of the forecast period, decrease of income and its recovery might happen. It is possible to contain such fluctuation risk in terminal cap rate.

In Japan, it is common to apply direct capitalization method at the end of the cash flow period to calculate the terminal value. The Japanese Real Estate Appraisal Standards employs this method, too. It is considered that there is a theoretical consistency to calculate the terminal value from the assumed income, because the DCF method is the one to estimate the income value. If accuracy enhancement is admitted when multiple methods are applied, then multiple methods should be undertaken. However, if liabilities of those methods were identical, then more persuasive method should be applied.

If the method of calculating the terminal value varies in national standards of each country, the IVPB should not mention about the calculating method on TIP and let the matter follow the local rule.

Q5 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?

A IRC/JAREA agrees that if a discount rate were consistent with the financial assumptions of the cash flow, eg inclusive or exclusive of anticipated inflation, inclusive or exclusive of tax, the valuation result will be identical.

However, in market under hyper-inflation, calculation of inflation inclusive cash flow and its discount rate might be possible theoretically, but it might be impossible and/or extremely unreliable practically. Therefore, it is necessary to note that cash flow assumption must be made according to the local economic background.

Q6 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?

A IRC/JAREA considers that the explanation about DCF method on TIP should be limited to basic and common matters admitted worldwide. Details, such as determination or listing of income and expense items, should be left for local rules. In this context, this ED remains such basic and common matters.