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Mr Chris Thorne
Chairman
International Valuation Professional Board
41 Moorgate
LONDON EC2R 6PP
UNITED KINGDOM

Technical Information Paper on the Discounted Cash Flow Method (DCF)

Dear Sir

Thank you for the opportunity to comment on the Technical Information Paper on the Discounted Cash Flow Methodology. This response is on behalf of the global Ernst & Young organisation which as well as providing accounting, audit and tax services, includes professionals who provide valuations of businesses, property, plant & equipment, financial instruments and intangible assets.

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Should you have any questions please contact me on +61 2 9248 4616.

Yours faithfully

John E Gibson
Partner - Valuation and Business Modelling

RESPONSE TO QUESTIONS

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, provided that the inputs are consistent with those that would be used by market participants. As with the application of other methods it is important that a cross check be done to another method or methods.

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

Yes the underlying DCF method applies equally to any asset including real property and businesses.

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 the discount rate should be determined based on the risk of the cash flows.

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

Yes the constant growth model is the most common terminal value calculation for assets with a continuing life.

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

The discount rate needs to be consistent with the basis of the cash flows (pre or post tax and real or nominal). It is recommended that after tax nominal cash flows be used as the simple method of converting an after tax nominal discount rate by grossing up for the tax rate and conversion to a real rate by use of the Fisher equation is unlikely to be sufficiently accurate for valuations.

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

Additional guidance would be useful and more detail is required if the Technical Information Paper is to identify best practice. It is noted that the CICBV has published a recent exposure draft that seeks to identify the type of investigations for different valuation scopes.

Comments of specific paragraphs

Paragraph 4
The issues dealt with in this paragraph would be better dealt with in paragraph 16 under the heading Business.

Paragraph 5
With respect to Free Cash Flow the wording could be improved by using cash in flows and outflows rather than income and expense and the term periodic rather than annual.

Paragraph 16
A number of the issue listed under Real Property Assets and Business are the same and may be better dealt with together.

Paragraph 16i
It is important to normalise the terminal cash flow estimate but depreciation and amortisation expenses are not relevant to cash flows. Care should also be taken with respect to any significant expenditures that might be subject to fluctuations such as repairs and maintenance.

Paragraph 17
This paragraph is inconsistent with paragraphs 16 h and i. Provided the appropriate capitalisation factor and discount period are used the cash flow estimate can be based on either the last period of the cash flow forecast or the following year. In either instance it is important to consider the factors listed in paragraph 16i.

Paragraphs 21 and 22
As noted in response to question 6 a simple conversion of discount rates is unlikely to be sufficiently accurate for valuation purposes.

Paragraph 25
While it is important to use another method or methods as a cross check to a discounted cash flow valuation and the difference should be analysed and discussed in the report it is unlikely that the numbers can be reconciled.

Other Matters
Consideration should be given to noting the limitations of a static analysis such as discounted cash flow and that consideration should be given to the use of scenarios, decision tree or real option analysis where there is likely to be a significant enhancement in value due to active management of the asset.