IVSC Exposure Draft TIP1

Comments by the Italian Valuation Committee

On the pulse of the property world

The Italian Valuation Committee

The need for standardization in the matter of valuation methods and criteria is perceived as urgent by all parties involved in the real estate industry and the introduction of a common set of rules is fundamental to improve transparency in the Italian market.
A number of initiatives have been launched with the purpose of defining, updating and maintaining codes of practice and guidelines, as a reference for the community. The Italian Valuation Committee, established in 2003, is one of such initiatives.

With the introduction of the Euro and the impressive growth of real estate markets across the globe, it has become necessary for the Italian institutional market to make an important step forward as far as transparency is concerned, and to keep up to date with the evolution of international standards is no longer optional.

Hence the motive for the establishment of the Italian Valuation Committee, which gathers the vast majority of the main companies, local and international, which professionally value institutional real estate. In the course of the years, with the scientific supervision of IPD, the Committee has broadened the scope of its activity to embrace wider subjects under the pressure and impulse of the evolving market. Indeed, the pace and direction of the activity of the group is dictated by the market itself, its problems and its development, to which the Committee reacts with realistic courses of action.

Furthermore, the outcomes of the activity of analysis, documentation and standardization of methods are regularly communicated to the public, by means of the Annual Italian Property Valuation Conference. The first edition dates back to 2004 (the Conference will be at its 8th edition 2011). New projects and recent updates to the work of the Committee are announced at the event and made available to the public shortly after, to the benefit of investors, valuers and other players who are interested in valuation issues.

One example of the importance of the role of the Committee and of the way in which the group operates, is the effort some of the members put in the preparation of the Italian edition of the RICS Red Book. In fact, the Committee is best positioned to transfer the model of best practice represented in the manual to the marketplace.

The Italian Valuation Committee is a results-driven reality of professionals whose members are directly involved in the valuation of institutional property portfolios, on behalf of private valuation firms or as representatives of professional bodies. All are actively committed to the activities of the group, and personally take part in the regular meetings of the Committee, with the clear intent of sharing and comparing experiences and best practices, to the advantage of each of the members, of the group, and of the market as a whole.

INTERNATIONAL VALUATION STANDARDS COUNCIL
Exposure draft
Technical Information
Paper 1
The Discounted Cash Flow (DCF) Method –
Real Property and Business Valuations

Questions for Respondents

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?

Yes, we agree that the DCF is an adequate method to determine the Market Value of a property

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?

Yes, we agree that the DCF applies equally to both real property and businesses valuations, but we wish to point out that there are substantial differences in the way you structure a DCF for the valuation of a property compared to that of a business.

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?

Yes, we agree that, in every instance, the discount rate is strictly related to the risk of the investment. We wish to point out (as stated in the Exposure Draft, para 11), that where the objective of the DCF model is to estimate the market value, the discount rate should reflect only the market participants' view of risk, while it does not have to consider criteria like the target rate of return, the opportunity cost or the WACC of a specific investor.

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?

Yes, we agree with the approach suggested by the Exposure Draft.

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?

Yes, we agree with this statement.

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?

Yes, we agree that the scope of the Technical Information Papers is to provide a common view of the main issues related to a specific subject (in this case, the DCF method), while it is not meant to be a valuation manual, nor a schoolbook.