KPMG IFRG Limited
8 Salisbury Square
London EC4Y 8BB
United Kingdom

Tel +44 (0)20 7694 8871
Fax +44 (0)20 7694 8429
mary.tokar@kpmgifrg.com

International Valuation Standards Board
41 Moorgate
London
EC2R 6PP
United Kingdom

Our ref IVSC_Comment Letter_TIP 1_DCF_3 May 2011.docx
Contact Mary Tokar

3 May 2011

Dear Sirs

Exposure Draft
Technical Information Paper 1
The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations

We appreciate the opportunity to comment on the Exposure Draft *The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations* (the "ED") issued by the International Valuation Professional Board ("IVPB" or the "Board"). The following response expresses the views of the international network of KPMG member firms. We have set out responses to the questions raised in the ED in Appendix 1 as well as other comments related to specific elements of the ED in Appendix 2. We offer general comments on the ED below.

Objectives of Technical Information Papers ("TIPs")

We support the International Valuation Standards Council's (the "IVSC") efforts to provide standards and guidance to improve the quality and reliability of valuations. The IVSC has set out ambitious objectives for International Valuation Standards ("IVS") and other material it or its subsidiary boards propose to issue. It has positioned IVS to be at the centre of efforts to achieve high quality valuations, supporting the public interest in financial reporting and capital markets, bank lending, etc.

We support the specific objectives of the IVPB's TIPs "in identifying best practice" and "to promote consistency of practice". However, we do not believe that the ED, as a standalone document, will achieve these objectives.

Level of proposed guidance

The guidance in the ED is at a high level and does not deal comprehensively with application issues encountered in practice. Although we are supporters of principles based valuation standards, the principles in the ED are articulated at such a high level that they are unlikely to be influential in practice. We believe that the incremental contribution of the material in the ED to valuation practice would be very limited.

We understand that valuations involve the exercise of professional judgement and that high quality application guidance should not prevent a valuation professional from applying appropriate judgement. However, we believe that useful guidance should result in valuers approaching similar circumstances with a common framework and a consistent approach to technical issues to improve the quality and consistency of valuations, which we do not believe will be achieved by the proposed TIP.

We have previously made similar comments in relation to the draft IVS and had expressed a hope that more comprehensive guidance would be issued as part of the TIPs or other IVSC material. We are disappointed that the ED does not do this.

We also suggest that the IVSC reconsider the level of authority it proposes to apply to application guidance. While we believe that high quality guidance can achieve quasi-authority through professional recognition of the quality of such material, an ability to state that a valuation was prepared in accordance with IVS despite not complying with high quality application guidance is troubling and would not achieve the objective of improving the reliability of valuation reports.

Issues not addressed in the TIP

We believe that there are a number of issues related to DCF not addressed in the TIP that should be comprehensively considered, e.g.,

- the incorporation of risk when single estimate cash flows or expected cash flows are used (these are referred to as the discount rate adjustment technique and the expected present value technique, respectively, in IFRS 13, *Fair Value Measurement*),
- the treatment of cash flows generated in foreign currencies,
- the development of discount rates including empirical problems with commonly employed methods such as the Capital Asset Pricing Model ("CAPM"), alpha factors, etc.
- the treatment of entity specific and market participant factors, which will depend on the basis of value, e.g., market value or investment value,
- whether DCF represents a controlling or non-controlling level of value,

- the adjustment to nominal cash flows to exclude inflation when industry inflation differs to economy-wide inflation,
- the incorporation of a risk adjustment when calculating the present value of a liability,
- the treatment of debt outstanding at the end of the explicit forecast period in an equity cash flow, etc.

Illustrative examples would be useful in demonstrating how particular issues may be addressed. As TIPs are not mandatory, a concern that such illustrations would restrict the use of other positions is misplaced.

Use of DCF to Value Real Estate and Businesses

We believe that there are differences in how DCF is applied to value real property and businesses that need to be separately discussed if the two uses are to be addressed in a single paper. One implication of the current structure of the ED is that a business valuation practitioner might conclude that a DCF for a business is sufficiently similar to one prepared for a real property valuation that he was competent to do both. If real estate and business valuation DCFs are addressed in a single paper, the valuation of income producing properties that constitute a business should be addressed, e.g., a hotel.

Use of a DCF to Estimate Market Value

Paragraph 13 appears to establish criteria that could limit the use of the DCF method to estimate market value when there is limited available market support for the underlying assumptions. We believe that this could give rise to a significant issue for business valuations where there is generally more uncertainty in cash flow projections than in real property valuations for which some rental income may be contractually based. We believe that such an approach would be inconsistent with current practice.

We believe that IFRS 13 sets out a reasonable approach to the estimation of inputs in applying the DCF method to estimate market value:

> "An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, which shall be adjusted if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy). An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall not ignore information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement."

We strongly encourage the Board to adopt a position similar to that outlined by the International Accounting Standards Board ("IASB") in IFRS 13.

Please contact Patrick Coady at +1 613 212 2841, or Mary Tokar or Jim Calvert at +44 (0)20 7694 8871 if you wish to discuss any of the issues raised in this letter.

Yours faithfully

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Appendix 1

Technical Information Paper 1

The Discounted Cash Flow (DCF) Method – Real Property and Business Valuations

Question 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?

We agree that the DCF method can be used to estimate market value and believe that this view is well established across a range of interested parties including valuers, users of valuations, accountants, accounting standard setters, etc.

We believe that the introduction to the question and paragraph 13 of the ED may be interpreted as introducing a new criterion on when the DCF method may be used to estimate market value when there is limited available market support for the underlying assumptions. We believe that this could give rise to a significant issue for business valuations where there is generally significant uncertainty in cash flow projections compared to real property valuations for which certain rental income may be contractually based. We believe that such an approach would be inconsistent with current practice.

We believe that the IASB's proposed standard, IFRS 13 *Fair Value Measurement*, sets out a reasonable approach to the estimation of inputs in applying the DCF method to estimate market value, as follows:

> "An entity shall develop unobservable inputs using the best information available in the circumstances, which might include the entity's own data. In developing unobservable inputs, an entity may begin with its own data, which shall be adjusted if reasonably available information indicates that other market participants would use different data or there is something particular to the entity that is not available to other market participants (eg an entity-specific synergy). An entity need not undertake exhaustive efforts to obtain information about market participant assumptions. However, an entity shall not ignore information about market participant assumptions that is reasonably available. Unobservable inputs developed in the manner described above are considered market participant assumptions and meet the objective of a fair value measurement."

We strongly encourage the Board to adopt a position similar to the IASB's, as presented above.

Question 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?

We believe that there are differences in how DCF is applied to real property and businesses that need to be separately discussed if the two uses are to be addressed in a single paper. One implication of the current structure of the ED is that a business valuation practitioner might conclude that a DCF for a business is sufficiently similar to one prepared for a real property valuation that he was competent to do both. If real estate and business valuation DCFs are addressed in a single paper, the valuation of income producing properties that constitute a business should be addressed, e.g., a hotel.

Question 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?

We believe that the paragraph reference intended here is to paragraph 11 and have answered accordingly.

We believe that risk is a key factor in the estimation of a discount rate. However, we also believe that in addition to risk, a discount rate reflects the time value of money, based on the returns available on a risk-free investment.

We believe that it would be useful for the IVSC to address how risk should be incorporated into the selection of a supportable discount rate, since the methods applied are typically quite different for business valuations and real estate appraisals.

Question 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?

We believe that the constant growth model is a widely applied method to calculate the terminal value at the end of an explicit forecast period in a DCF. However, we also see market multiples used to calculate the terminal value, as well as the other methods that are referenced in this question depending upon the facts and circumstances.

It is important to note that it may be inappropriate to apply current market multiples to terminal value estimates. For example, if the rate of growth is expected to have slowed in the terminal period because the business has matured, multiples would normally be expected to fall.

Question 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?

We agree that valuers need to be consistent in the assumptions used in developing cash flow forecasts with the assumptions used to estimate the discount rate. For example, nominal cash flows should be used with a nominal discount rate, real cash flows should be used with a real discount rate, enterprise value cash flows should be used with a weighted average cost of capital and equity cash flows should be used with a cost of equity. However, we believe that a more comprehensive treatment of these issues would be useful.

Question 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?

We believe that a more comprehensive treatment of relevant issues is necessary to increase the influence of the TIP in improving the quality and consistency of valuations.

The introduction to TIP 1 is explicit that TIPs are not mandatory. Therefore, we believe that the concerns expressed in the introduction to this question are misplaced. Moreover, we suggest that the IVSC reconsider the level of authority it proposes to apply to application guidance. While we believe that high quality guidance can achieve quasi-authority through professional recognition of the quality of such material, an ability to state that a valuation was prepared in accordance with IVS despite not complying with high quality application guidance is troubling and would not achieve the objective of improving the reliability of valuation reports.

Appendix 2

This appendix discusses specific issues noted during our review of the TIP not covered elsewhere in our letter

Ref	Page	Paragraph	Issue
1	5	n/a	We note the statement that "a TIP does not provide valuation training or instruction". We believe that this approach may cause TIPs to be written at too high a level which limits their utility and their ability to meet the objective noted on page 2, "to promote consistency of practice". We believe that an acknowledgement of the need to adopt a more comprehensive approach may be necessary to ensure that TIPs provide useful guidance.
	5	n/a	We note that the second paragraph states that examples may be included in TIPs. In our experience, examples are helpful to illustrate more complex issues. The absence of examples as well as a more comprehensive discussion of complex issues in the ED limits its utility.
	6	4	We note the reference to discounts for lack of control and/or liquidity. We believe that it would be useful for the IVPB to issue comprehensive guidance on such issues, which can have a significant influence on the value estimated under an income approach.
	6	5	The reference to "benefits and liabilities" may be confusing and reference instead to cash flows may be more useful.
	6	5	States that discount rate is a market return. Has the IVPB concluded that this is the case under other bases of value, e.g., investment value?
	6	5	States that free cash flow is derived on an annual basis. However, other periods may be selected.
	6	5	The definition of Free Cash Flow to the Firm refers to net debt without including any reference to other potential deductions such as pension obligations, one-off legal claims, etc. We note that Equity Value would also consider surplus assets not reflected in a DCF, e.g., surplus property.
	7	5	The definition of "Free Cash Flow to Equity refers to discounting at a Cost of Capital/Equity Discount Rate. However, capital can include items other than equity such as debt.
	7	5	We note a minor difference between the definition of market value in IVS and the definition in TIP 1.
	7	6	While we note that the DCF methods used for real estate and business valuation are very similar, some differences exist that are not explored in the ED. For example, many DCFs prepared for real estate valuations use pre-tax cash flows.
	8	8	There is a reference to the duration of the forecast period being the period for which cash flows are "known". Future cash flows cannot be known. This is especially the case in business valuation when future cash flows are not contractual (as may be the case in real estate valuations for part of the period in the DCF).
	8	11	We note the statement that the discount rate is intended to reflect market participant's estimate of risk. Is this intended when investment value is the basis of value?

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	8	11	We do not believe that AAA bonds are risk free.
	8	11	The discussion of risk is cursory. For example, it includes no discussion of systematic or unsystematic risk.
	8	11	We note the reference to the statement that the discount rate may be determined by reference to recent transactions. However, there is no discussion of how this could be achieved. We believe that the pricing of recent transactions is an important consideration. In our experience, one way that this is incorporated into DCF analysis is to consider the reasonableness of the value conclusion under the DCF method. For example, if the DCF value conclusion is significantly higher, in terms of implied market multiples, than recent transactions, this may indicate that the discount rate and/or cash flows are not consistent with market indication from recent transactions. In such circumstances, differences with market based measures may be supportable because of greater growth or profitability of the subject asset relative to the selected indicators but such differences should be explicitly considered. We note that care should be taken in applying observed yields as they may reflect assumptions on growth in rentals that may have been explicitly forecast in the cash flows.
	9	13	We note the comment that "sufficient research" should be done on the cash flow forecasts. We note that forecast risk may be adjusted in the discount rate as well as in the cash flows (though it should not be double counted).
	10	16(e)	We have not used "nominal rate" used in this context. In our experience, a nominal discount rate refers to a discount rate that includes inflation expectations.
	11	(j)	The reference to tax losses assumes that a transaction for a business would be structured as an acquisition of shares. It may be useful to clarify that acquisitions can be structured as acquisitions of assets or shares and discuss the ramifications.
	11	(k)	There is no discussion of how the factors mentioned would be incorporated into the estimation of the discount rate. For example, country risk premium is an increasingly important issue given the deterioration of sovereign credit risk in many countries. However, despite the fact that there is diversity in practice on how this should be addressed in practice, it is not discussed in the ED.
	12	22	We are unfamiliar with the term growth explicit.
	12	23	Word missing after "key"
	13	24	We believe that further attention should be given to the disclosure requirements.