# Real Estate Information Standards (REIS)

Via e-mail only
International Valuation Professional Board
CommentLetters@ivsc.org

April 26, 2011

**RE: Invitation to Comment: Exposure Draft "Technical Information Paper 1", The Discounted Cash Flow (DCF) Method – Real Property and Business Valuation**

To the International Valuations Professional Board:

Thank you for the opportunity to comment on the Exposure Draft of the "Technical Information Paper 1", The Discounted Cash Flow (DCF) Method – Real Property and Business Valuation. We applaud the efforts of International Valuations Standards Council in the development of guidance for real estate valuation industry.

**Responding Organization**

The Real Estate Information Standards Board is the official governing body of the Real Estate Information Standards (REIS). The REIS Board is responsible for establishing information standards for private institutional equity real estate in the United States, an industry estimated at $750 billion. The REIS standards are interdisciplinary and include standards for performance measurement, valuation, fair value accounting and fund/account reporting. We think the use of a single set of interdisciplinary standards will facilitate capital formation and help provide investors with comparable financial information needed to support informed decision making.

The International Valuation Standards Council (IVSC) is responsible for the development of benchmark educational standards and guidance, and for the development of technical guidance to support the application of the International Valuation Standards.

The valuation elements of the REIS standards address valuation policies and procedures, and reporting standards for the institutional valuation profession. We have, and continue to anticipate collaborating with your organization on matters of mutual interest.

Our responses to the specific questions are below. The numbers correspond to those in the exposure draft.

**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?**

***REIS Response:***

*Yes, if it is used by the market of purchasers. This is generally the case with larger income producing properties purchased by investors. Buyers of smaller properties, owner-occupied properties, land, non-income property, and special purpose or special use properties may not use this technique. While the DCF may be used in many of these cases to estimate market value, its usefulness and accuracy may be limited.*

**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?**

***REIS Response:***

*The DCF technique is similarly applied to businesses, and the fundamental analysis and techniques should be the same in both cases. That is, explicit consideration of future cash flow and reversion value after some holding period.*

**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?**

***REIS Response:***

*Agree.*

**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, e.g. 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 capitalization rate or exit multiple? If not please identify what other method you most commonly use?**

***REIS Response:***

*We do not agree as far as real estate is concerned. The most common technique for* *real estate is capitalization of net income (or stabilized net income, with the resulting value adjusted for unstabilized conditions) at the date of reversion. The assumptions concerning discount and growth rates are constantly changing - such that the observed capitalization rates are changing. While the constant-growth model may be used by some real estate practitioners, it may not address the change factor adequately. It could very well apply in business valuation.*

**5** The Exposure Draft explains that cash flows can be developed on the basis of alternative financial assumptions, e.g. 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?**

***REIS Response:***

*We generally agree, but the introduction of 'after tax' analysis may impact the value, since it is a variable that may be different for different purchasers. After-tax is purchaser-specific, thus essentially an investment value concept, as opposed to fair value. In general, market values of DCFs for real estate have trended in recent times towards all-cash and pre-tax, and away from leveraged and/or after-tax.*

**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 is 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?**

***REIS Response:***

*We generally agree, but it should be clearly stated that the interrelation and reasonableness of the assumptions utilized should be discussed and demonstrated. Further we believe that the Exposure draft should clarify that the valuation techniques used should be consistent with FASB Accounting Standards Topic 820, Fair Value*

*Measurement. We would suggest directives consistent with those in ASC 820, which state that a fair value measurement assumes that the asset is exchanged in an orderly transaction between market participants. The transaction to sell the asset is a hypothetical transaction at the measurement date, considered from the perspective of a market participant not the owner of the asset. Therefore, the objective of a fair value measurement is to determine that price that would be received to sell the asset at the measurement date (an exit price concept).*

## ***Additional Comments***

As requested, we have included comments on each of the questions in the Exposure Draft. Except as noted herein, we are generally supportive of the Exposure Draft of the "Technical Information Paper 1", The Discounted Cash Flow (DCF) Method – Real Property and Business Valuation. Exposure Draft of the "Technical Information Paper 1", The Discounted Cash Flow (DCF) Method – Real Property and Business Valuation. We offer the following comments for specific sections.

## The DCF Method – Overview

**7** A DCF analysis results in a value indication of the asset or business based upon the present value of the expected future cash flows that will accrue to the most probable buyer in the market at the date of value.

*Comment: **For fair value, most probable buyer. For investment value, owner. This is an ongoing problem in this paper, the concepts are fundamentally different. We suggest separating these concepts to avoid confusion, with one paper (presumably the primary paper) dealing only with fair value.***

**11** The discount rate will reflect the risk associated with the cash flows. Where the objective of the DCF model is to estimate market value, the discount rate should reflect market participants' view of risk, which may be determined from the discount rates, or return, implied by recent transactions involving similar assets. If there have been no recent transactions then it may be necessary to estimate an appropriate discount rate by considering the risk premium that would be required by an investor, i.e. the additional return required over that obtainable from a 'risk free' asset such as a AAA rated bond. Calculating the risk premium requires consideration of matters such as the certainty and security of the income, the strength of any counterparty and the prospects for future income growth.

*Comment: **Basically the value of investment grade real estate is equivalent to the risk adjusted present value of the in-place lease portfolio, plus the present value of the proceeds at the end of the estimated holding period. Therefore, the discount rate should reflect the combination of the two spectrums of risk.***

**16** The DCF model is structured for a specified forecast period. The duration of the forecast period, components of the projected cash flow and specific items addressed will vary between real property assets and businesses.

**Real property Assets**

e) An appropriate discount rate needs to be applied to the cash flow. If the frequency of the time points selected for the cash flow is, for example, quarterly, the discount rate must be the effective quarterly rate and not a nominal rate. Expenses may be placed at the accounting point in time rather than the point of time at which they are incurred. The best solution is to have a cash flow frequency that matches the timing of the most frequent aspect of the periodic cash flow.

*Comment: While the analyst may choose from a variety of discounting frequencies that selection should not materially produce a different estimate of the market participant's market or investment value. The use of a different discounting frequency to advantage or disadvantage the value estimate is inappropriate.*

***Conclusion***

Thank you for the opportunity to respond to this exposure draft. We appreciate the ongoing opportunity to collaborate with you on future initiatives. Should you have any questions or require clarification of our responses, please do not hesitate to contact John Baczewski, REIS Board Chair at 978-887-3750, or Marybeth Kronenwetter, Director REIS Operations at 630-469-4088.

Yours truly,

John J. Baczewski
REIS Board Chair