Institut canadien
des évaluateurs
Appraisal Institute
of Canada

May 5, 2011

Jean-Florent Rerolle
Chairman
International Valuation Professional Board
41 Moorgate
London EC2R 6PP
United Kingdom

Dear Mr. Rerolle:

I am writing on behalf of the Appraisal Institute of Canada in response to your request for comments on the exposure draft, Technical Information Paper 1, The Discounted Cash Flow (DCF) Method.

As you may be aware, the Appraisal Institute of Canada (AIC) is the leading professional real property valuation organization and standards setter in Canada. The Institute is a founding member of the International Valuation Standards Committee and a long-time supporter of the IVSC. The AIC publishes the Canadian Uniform Standards of Professional Appraisal Practice (CUSPAP) and confers its professional designations on members that fulfill its educational and professional requirements.

The comments provided are specific to real property valuation as the AIC does not provide training in business valuation.

With respect to question No. 1 – The AIC would agree that the DCF method, if properly applied, can be used as a method to arrive at market value.

The AIC provides no answer to question No. 2 , as it relates to the business valuation comparison.

With respect to question No. 6 , the AIC agrees with the statement that more detailed discussion and examples of the valuation inputs into a discounted cash flow model are inappropriate.

For your consideration and review we have included in the text that follows, excerpts from our Standards titled Practice Notes (similar to the IVS TIPS) and Comments to our Appraisal Standards as they relate to Discounted Cash Flow.

Sincerely,

Paul Olscamp, AACI
Past President and IVSC Representative

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From Practice Notes CUSPAP:

Discounted Cash Flow Analysis

[see 6.2.16]

12.37.1 Discounted Cash Flow (DCF) methodology is based on the principle of anticipation i.e., value is created by the anticipation of future benefits. DCF analysis reflects investment value and market value appraisals, as well as for other purposes such as sensitivity tests.

12.37.2 DCF analysis is an additional tool available to the appraiser and is best applied when developing value opinions in the context of one or more other approaches.

12.37.3 To avoid misuse or misunderstanding when DCF analysis is used in an appraisal assignment to develop an opinion of market value, it is the responsibility of the appraiser to ensure that the controlling input is consistent with market evidence and prevailing market attitudes. Market-value DCF analyses should be supported by market-derived data and the assumptions should be both market and property specific. Market-value DCF analyses are intended to reflect the expectations and perceptions of market participants along with available factual data. They should be judged on the market support for the forecasts when made, not whether specific items in the forecasts are realized. An appraisal report that includes the results of DCF analysis must clearly state the assumptions on which the analysis is based and must set forth the relevant data used in the analysis.

12.37.4 DCF accounts for and reflects those items and forces that affect the revenue, expenses, and ultimate earning capacity of real estate and represents a forecast of events that would be considered likely within a specific market. For example, in the appraisal of a multi-tenant property, a lease-by-lease analysis addresses contract and market rents, specific escalations, operating expenses, pass-through provisions market-derived or specific concessions, capital expenditures, and any other measurable specific provisions applicable. Revenue growth rate or decline rate assumptions are premised upon analysis or supply/demand factors and other economic conditions and trends within the market area of the subject. Operating expense change rates should reflect both overall expense trends and the specific trend of significant expense items.

12.37.5 Discount rates applied to cash flows and estimates of reversion should be derived from data and information in the real estate and capital markets. Surveys of investor opinion and yield indices are also useful in the rate selections process, but only when the type of and market for the real estate being appraised is consistent with the type of and market for the real estate typically acquired by the investors interviewed in the survey. Considerations used in the selection of rates are risk, inflation, and real rates of return.

12.37.6 When reversion capitalization rates are used, they should reflect investor expectations considering the real estate type, age and condition, cash flow characteristics, and related factors. The projection period is a variable and should be set out on the basis of the facts and circumstances of each analysis.

12. Practice Notes Canadian Uniform Standards of Professional Appraisal Practice Effective 01/01/2010

12.37.7 The results of DCF analyses should be tested and checked for errors and reasonableness. Because of the compounding effects in the projection of income and expenses, even slight input errors can be magnified and can produce unreasonable results. For example, it is good practice to test whether cash flows are changing at reasonable rates, and to compare the reversion capitalization rate with the inferred entrance capitalization rate to see if the relationship between these rates is reasonable and explainable.

From Comments section CUSPAP:

7.17.4 When a discounted cash flow analysis is applicable, an appraiser must: [see 12.37, 7.31.3]

7.17.4.i. analyze such data as are available from the real estate and capital markets and from surveys of investor opinions;

7.17.4.ii. ensure that input data is specific to the type of property being appraised;

7.17.4.iii. clearly display all relevant data, cash flow projections and assumptions on which the analyses are based; and

7.17.4.iv. identify and describe any computer software used in the analyses

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