April 27, 2011

Sent via email to ivsc@ivsc.org

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

Dear Sirs:

Re: Comments on IVPB Exposure Draft – Technical Information Paper 1 - The Discounted Cash Flow Method – Real Property and Business Valuations

The Canadian Institute of Chartered Business Valuators (CICBV) is pleased to provide our comments on the above noted IVPB Exposure Draft.

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Our comments are organized as follows:

(a) Overall Opinion on Technical Information Paper 1;
(b) Responses to the Questions for Respondents contained in the IVPB Exposure Draft; and,
(c) Specific Comments on the TIP.

Our comments are from a business valuation perspective only.

<u>Overall Opinion on Technical Information Paper 1</u>

The Technical Information Paper (TIP) 1 indicates that its purpose is to "provide technical guidance for valuation professionals on generally accepted best practice" as it relates to the use of the discounted cash flow valuation method. It is our opinion that, for an audience of valuation professionals that are competent in the area of business valuation, the level of detail in the TIP is insufficient to represent "best practice".

We do not believe that the title "Technical Information Paper" is descriptive of what the IVPB is trying to provide. We suggest that the TIPs be renamed "Guidance Notes" or" Guidance Papers".

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We are concerned with the use of the phrase "generally accepted best practices". We understand "best practices" to be methods and techniques that consistently produce results superior to those achieved with other means, and represent benchmarks to strive for. However, there is no practice that is best for every situation and new best practices evolve as better ways of doing things are found. It is unclear if the IVPB is attempting to set minimum guidelines or whether it is trying to set a high benchmark towards which each valuation professional should strive to attain. In order to clarify these issues it would be helpful to include some additional discussion around what the IVPB is trying to achieve through the TIP.

In paragraph 1 on Page 1, the introduction to the Exposure Draft indicates that the IVPB 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.*" We are unclear as to what the phrase "benchmark educational standards" is intended to mean. In particular, we are concerned with any reference to the term "standard" in a TIP, to avoid the potential for a misunderstanding or the implication that compliance with the matters which are addressed in the TIP are in any way mandatory. While we assume that this statement will not form part of the TIP; we are concerned that any reference that infers TIPs are in some way standards can be problematic.

In paragraph 2 on page 2 of the Exposure Draft, there is the following statement – "*Although the TIPs are designed to promote consistency of practice and support the application of the principles in the IVS, they are not intended to be mandatory.*" This statement should be included in the Introduction section of the TIP.

It would be helpful to include the following wording in the Introduction section of the TIP "*Departure from this TIP is not intended to provide a basis for civil liability and should not be presumed to create evidence that any duty has been breached.*"

There is a certain inherent limitation in attempting to combine a discussion of the application of the Discounted Cash Flow ("DCF") method to both real property and business valuation. Keeping the discussion at the level of commonality necessarily limits the usefulness of the TIP in achieving the objective of promoting consistency of practice and supporting the application of the principles in the IVS. Discussion at the level of commonality makes it difficult for the issues related to each of real property and business valuation to be addressed in as a complete and substantive way than if they were addressed separately. Having separate guidance on the DCF Method for each of real property and businesses valuation would allow for more useful discussion in each area.

Responses to Questions for Respondents Contained in the IVPB Exposure Draft

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?"

Our Response to Question 1

We agree with the statement that the DCF method, if properly applied, can be used as a method to arrive at market value. It is not clear to us how the preamble to Question 1 ties into the question, as the preamble appears to be dealing with assumptions, rather than approach.

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?"

Our Response to Question 2

We agree that from a conceptual perspective the underlying DCF method described in the TIP should apply to both the valuation of real property and businesses; however, we are concerned with the statement that precedes this question that "the underlying DCF method is identical in each case". While the underlying concepts are applicable to both, there are differences in application, making the use of the word "identical" inappropriate.

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?"

Our Response to Question 3

From a Business Valuation perspective, there are other matters that may need to be taken into account in determining an appropriate discount rate. These matters include, as appropriate:

- The elements of the capital asset pricing model (risk free rate, equity risk premium and beta);
- Industry and country risk;
- A size premium;
- A company specific risk premium;
- The cost of debt (pre-tax or post-tax);

- The appropriate capital structure; and
- The treatment of inflation and taxes.

We also note that the paragraph reference in the preamble to the question should be to paragraph 11 not 10.

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, e.g. by reference to the implied exit multiple.

Do you agree that the most commonly adopted terminal value calculations 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?*"*

Our Response to Question 4

We agree.

Question 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 flow should not affect the valuation result?*"*

Our Response to Question 5

We agree.

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 are inappropriate? If not how much additional information do you think should be included in the best practice guidance?*”**

Our Response to Question 6

As previously noted in this response, we are of the view that there is a certain inherent limitation in attempting to combine a discussion of the application of the DCF method to both real property and business valuation. Keeping the discussion at the level of commonality necessarily results in the guidance or educational value being kept at a high level that precludes being able to address issues related to each in a more substantive way. It is our view that if the purpose of the TIP is to exemplify best practice in this area that it needs to go into greater depth as to the appropriate components of a DCF value analysis, separately for real property and business valuation.

Specific Comments on TIP

Our comments are referenced to relevant paragraph numbers, commencing at page 6 of the IVPB Exposure Draft.

Para 1

For the reasons outlined herein, the TIP does not meet the objective described.

Para 2

This paragraph is not necessary, as it is clear that the TIP is only addressing the DCF method.

Para 4

This paragraph seems very specific for an “Introduction” and should be relocated to be sub-paragraph 16 l). Given that “Dividend Discount Model” is a capitalized term, we recommend that you include a definition of the term, such as “***Dividend Discount Model*** *- a way of valuing shares in a company based on the theory that the shares are worth the discounted sum of all future dividend payments. Under this model, projected dividends are discounted back to present value using an appropriate discount rate*.”

In addition, it would be helpful to the reader to include the following sentence as the last paragraph in the “Introduction” – “*This TIP should be read in conjunction with IVS and other relevant TIPs and/or guidance. For purposes of this TIP, italicized words are defined in IVS and capitalized terms are defined in the Definitions section of this TIP.*”

Para 5

The “Discounted Cash Flow” definition should make reference to a business or an asset, at present it does not. In addition, the definition does not indicate that it is used to derive a Market Value or Investment Value for the asset or business. The CICBV and the ASA define “**Discounted Cash Flow” Method as** a method within the income approach whereby the present value of future expected net cash flows is calculated using a discount rate.

The “Free Cash Flow” definition refers to “income” as a starting point which, in Canada, we associate with accounting income (revenue less expenses) and does not refer to the adjustments necessary to translate such accounting income to cash flow. If “income” refers to revenue, you should make reference to excluding “non-cash” expenses. You may want to discuss/clarify whether “Free Cash Flow” is pre or post tax. You may want to discuss/clarify whether “Free Cash Flow” is inclusive or exclusive of debt servicing. You may also want to provide a definition of “income” for greater clarity.

The “Free Cash Flow to the Firm” definition includes information about Enterprise Value (“EV”) that is beyond the definition of the term. The definition should simply be “Free Cash Flow before deduction of interest and debt servicing requirements.” We note that there is no definition for Enterprise Value, even though it is a capitalized term. To the extent “Enterprise Value” is used in the TIP, we suggest that it be in italics, as it is a defined term in the IVS. The second sentence should be deleted.

The “Free Cash Flow to Equity” definition includes information about Equity Value that is beyond the definition of the term. The definition should simply be “Free Cash Flow after deduction of interest and debt servicing requirements, as appropriate.” We note that there is no definition for Equity Value, even though it is a capitalized term. You may want to consider defining it. Suggested wording might be “Equity Value is defined as the owner’s interest in a business or property after deduction of all liabilities”.

The “Gross Present Value” definition is missing the word “cash” in first line before “inflows”. From a business valuation perspective, we do not use this concept. If the term is used in real property valuation, the definition should be clarified to acknowledge this fact.

As Investment Value is already defined in IVS it is not necessary to include a definition in the TIP. To the extent “Investment Value” is used in the TIP, we suggest that it be in italics.

As Market Value is already defined in IVS it is not necessary to include a definition in the TIP. To the extent “Market Value” is used in the TIP, we suggest that it be in italics. From a business valuation perspective, the CICBV and the ASA define “Net Present Value” as “*the value, as of a specified date, of future cash inflows less all cash outflows (including the cost of investment) calculated using an appropriate discount rate*”. If the “Net Present Value” definition in the TIP is used in real property valuation, it should be clarified to acknowledge this.

The “Weighted Average Cost of Capital” definition refers to only the weighted average of the cost of equity and debt. It might be preferable to refer to “the cost of all financing sources”. The issue is that the reference is to a weighted cost based on a business’s existing capital structure. This definition might be viewed as precluding a Weighted Average Cost of Capital that is based on an optimal weighing, which is very often the appropriate approach to employ. This is recognized at paragraph 16 k) with the reference to “a typical WACC rate for businesses in the sector”.

From a business valuation perspective, we suggest that a definition for “Terminal Value” or “Residual Value” be included. A suggested definition is “value as of the end of the discrete projection period in a discounted cash flow model”.

Para 6

Further to our earlier comment regarding Question 2, we are concerned with the notion that the underlying DCF method is identical in each case for both real property and business valuations. From a business valuation perspective, it seems to us that there may be fundamental differences between the DCF method used for each of real property and business value determinations. For example, a business valuation analysis using the DCF method may take into account tax shields associated with making capital investments and with existing tax positions. In addition, consideration is given to the impact on value of redundant assets and liabilities. We are not sure if readers will interpret these types of difference as being in the nature of “distinct terms and inputs”, as referred to in the TIP.

Para 7

This paragraph does not appear to contemplate the application of the DCF method to determine Enterprise Value.

At the start of this paragraph DCF is referred to as “DCF analysis”, whereas in the title of the section, it is “The DCF Method”. The definition in paragraph 5 also refers to “DCF” as a “method”. It would be helpful to keep terminology consistent.

In the 1st bullet, the term “income” is used; the term “cash flow” would be better suited. See our comments on paragraph 5 above.

In the second line of the first bullet, should “expenditure” be “expenditures”?

Para 8

Reference is made to using “actual” income or expenditures in future periods. From a business valuation perspective, we would prefer “projected” income or expense be used. Alternatively, the words “actual and” could be replaced by “expected contractual and/or”.

The use of the term “reasonably predictable” implies a level of certainty that is likely not appropriate to an analysis predicated on the making of assumptions. The term “reasonably estimated” would be more appropriate.

We have the same issues with “income” and “expenditure” referred to above. There is reference to “cash inflows” and “cash outflows” and “cash flows”. It might be helpful to refer to “net cash flows”, being the difference between “cash inflows” and “cash outflows”.

In the first line of this paragraph, we suggest replacing the word “constructed” with “developed”.

Para 9

In the second line of this paragraph, we suggest replacing the word “constructed” with “developed”.

With respect to the fourth sentence, we suggest that the words “depend upon the purpose of the valuation” be replaced by “depend, in part, upon the definition of value”.

Para 10

What does the term “current value” mean? Should it be replaced with “Market Value or Investment Value”? We note that “vigilance” is a strong word – you may want to consider softening it.

Para 11

This paragraph appears to imply that a value derived with a discount rate determined without reference to recent transactions is not as reliable as one that is determined with reference to recent transactions. In the field of business valuation, using “recent transactions involving similar assets”, as stated in the TIP, often is a difficult if not impossible task as businesses are often very difficult to compare. Further, there is often a lack of information regarding such transactions making the transaction metrics either difficult to obtain or unreliable. The TIP implies that only if there have been “no recent transactions” is it necessary to estimate an appropriate discount rate. The issue is not limited to a lack of recent transactions as even if there are recent transactions that are comparable, there is often a lack of suitable information about them available to the business valuator. We are concerned that this paragraph has been written from the perspective of real property valuations. From a business valuation perspective, significant work goes into developing the discount rate, using either a CAPM or built-up approach. The TIP may be interpreted as implying that estimating an appropriate discount rate is an inferior approach to relying on recent transactions. We are concerned that this inference could unnecessarily cast a business valuation that relies on an estimated discount rate as being suspect or inferior in some manner.

We suggest that “market value” should be either a capitalized or italicized term in the second line.

Consider replacing “income” in the second to last line with “cash flow” after “security of the”.

Para 12

Reference is made to the present value of the” income stream” whereas, in the context of a DCF analysis, it should be to “cash flow”.

Para 15

Reference is made to growth or decline in “income” whereas, in the context of a DCF analysis, the reference should be to “cash flow”.

Para 16 f)

Reference is made to a stabilized level of “earnings” whereas, in the context of a DCF analysis, the reference should be to “cash flow”.

Para 16 h)

It may be helpful to include a description or definition of the “constant growth model” and the “fading growth models” to give more detail about these models in the TIP.

The paragraph indicates that the results obtained by applying the constant growth or the fading growth models in calculating terminal value “would normally” be cross-checked for the reasonableness of the implied exit multiples. In some instances there may not be sufficient information to complete this analysis and for this reason the wording might more appropriately indicate that if possible, such results “could be” crossed-checked.

It may be helpful to include a description or definition of “implied exit multiples”.

Para 16 i)

The adjustments to normalize free cash flow should not refer to depreciation or amortization expense as these would not form part of cash flow.

Para 16 j)

The examples of adjustments might be expanded to include the impact on value of the future benefit of tax deductions associated with existing assets.

Para 16 k)

The TIP would benefit from a more detailed explanation as to how the appropriate WACC is determined. For example it would be useful to discuss the Capital Asset Pricing Model and the Build up Method rather than just referring to a WACC selected from a comparable business in the market. The paragraph also does not deal with the notion that the discount rate needs to be consistent with the basis of the cash flow projection in that some adjustment for risk may be required beyond what might be considered a “typical” WACC.

Para 17

The paragraph might be better positioned if it came before paragraph 16.

Para 19

In the second sentence, the word "will" should not be included before "used".

Para 22

The second sentence starts with the word "I" in error. In addition, the last sentence has the word "is" included after "discount rate assumptions are" in error.

Para 23

This paragraph repeats what is already in the IVS; hence, it is not necessary.

If the paragraph is left in, the word "assumptions" is missing at the end of the third line after "key".

Para 24

The first sentence should be deleted or re-worded. The second sentence should be softened, such as "*Examples of information that the valuer might consider providing, where relevant, include, but are not limited to: …*". Disclosure of the details of any propriety software used is not necessary, as the valuator's report should contain all the information necessary for a reader to understand the valuation analysis and conclusions. If this is a specific requirement for real property valuations, it should be clarified. The 6th and 15th bullets appear to deal with the same issue, although the 15th bullet provides more detail. You may want to delete the 6th bullet.

Para 25

A recommendation that there should be a reconciliation of the results obtained from a DCF analysis to the results obtained from some other valuation method is not appropriate to a discussion that is limited to the DCF method.

<u>Conclusion</u>

We hope that this submission is helpful to you. If you have any questions regarding our comments, please do not hesitate to contact Robert H. Boulton, CA, CBV, CICBV Director, Education and Standards.

Yours truly,

Gordon G. McFarlane, CA, CBV
Chair, Professional Practice and Standards Committee