IVSC DCF TECHNICAL INFORMATION PAPER 1 EXPOSURE DRAFT

AFREXIM COMMENTS ON THE PAPER

A. Introduction

AFREXIM (*l'Association française des sociétés d'expertise immobilière*) is an association of eight of the most important and active real estate valuation firms in France, and particularly in the Paris market. Its members are:

- Ad Valorem Expertises
- BNP Paribas Real Estate Valuation
- Catella Valuation FCC
- CB Richard Ellis Valuation
- DTZ Eurexi
- Credit Foncier Expertise
- Icade Expertise
- Jones Lang LaSalle Expertises

Our member firms value a wide range of types of real estate, both commercial and residential, including some asset classes that are valued largely on the basis of the profits generated by the occupying entity, such as hotels and healthcare properties. Valuations are produced for a wide range of purposes, including IFRS accounting, secured lending, stock market operations (such as mergers and acquisitions), securitisations and for the specific needs of investors who are the subject of particular state regulations, such as insurance companies and collective investment vehicles such as OPCIs and SCPIs.

However, most member firms rarely, if ever, value companies. **Our comments are therefore limited to the use of the DCF method for the appraisal and valuation of real estate assets. We have not attempted to comment on its use for the valuation of companies.**

The directors of companies that are members of AFREXIM have obtained a copy of the IVSC's Exposure Draft of the Technical Information Paper 1 on The Discounted Cash Flow (DCF) Method of Real Property and Business Valuations and we have read it with great interest.

The DCF method is widely used in France for property valuations and has been so used since the arrival of American investors in France in the second half of the 1990s. However, French valuers will generally adopt at least two valuation methods, of which one may be the DCF approach, so the results of a cash flow approach are generally compared with those obtained from the capitalisation or capital value comparison methods that were predominant in France before the late 1990s.

While the French market has become much more transparent in the last 10 – 15 years, to the extent that Paris is recognised as one of the most transparent markets in Europe, it is rarely possible to obtain information about the discount rates implied in market real estate sales. This is a significant factor in some of our replies below.

While the DCF method is widely used, there has been comparatively little public discussion about it and such discussion is, in our opinion, overdue. We therefore greatly welcome the IVSC's initiative in releasing this draft paper and we are pleased to send you AFREXIM's comments, as below.

B. Answers to your "questions for respondents"

1. "Do you agree that the DCF method, if properly applied, can be used as a method to arrive at market value?"

The DCF method has been used in France for Market Value appraisals for a variety of purposes for over 10 years now. AFREXIM therefore firmly believes that, if properly applied, it can be used to determine market value of real estate assets.

As stated above, in France it is recommended that valuers use at least 2 valuation methods, of which one can be DCF (although it does not have to be). While its members are confident of their ability to properly apply the DCF method, AFREXIM nevertheless believes that in most cases it is important to check the results obtained from the DCF approach against those obtained by other valuation methods, in order to verify that the resulting values are in line with market expectations.

This checking can be as simple as cross-checking the running yield (the net yield that the projected cash flows represent over the first few years of the cash flow) against buyer expectations for this type of property at the valuation date, or as complex as preparing a detailed tenant-by-tenant capitalisation approach. In many cases a check against capital values per square meter observed in the market is also a valuable exercise for valuers and their clients.

Indeed, while the great strength of the DCF method is that all assumptions are made explicit, its principal weakness is that there are so many assumptions that a variation in one or two of them can have a significant effect on the final result. It therefore needs to be used by experienced practitioners, particularly in less transparent countries or markets where there may be little or insufficient quantitative evidence to validate some of the DCF assumptions. In such cases it is even more important to also use check methods.

We note that it is not inconceivable that a DCF approach and another valuation method may give significantly different results. This is particularly the case at or close to turning points in the market, as the DCF method is essentially forward-looking, whereas certain other methods focus more on the situation at a single date. We have seen cases during the high points in a cycle where a correctly-prepared cash flow can send a warning that the market is over-heating, or, at the low point in the cycle, indicate potential for future value increases.

In such situations it is for the appraiser to choose the value he will report, based on his judgement of market conditions, the purpose of his valuation and the relative confidence he has in the results obtained from the various methods. Depending on the circumstances, it may be that the valuer will prefer to adopt the results obtained from one of the methods, preferring them to those obtained from another.

2. "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 exist?"

As AFREXIM member firms only value real property, and not companies, we will not attempt to comment on the use of the DCF method for the valuation of businesses.

3. **“This exposure draft states that the discount rate should be determined based on the risk associated with the cash flows, whether the DCF method 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?**”

AFREXIM agrees that the discount rate or rates should be determined based on the risk associated with the cash flows, whether the DCF method is being used to determine a market value or investment value.

The assessment of risk may not be the same for a market value approach as for an investment value analysis, as the aim of the latter is to appraise the value of an investment opportunity to a particular individual (whether a person or a body), whereas the former aims to assess the best price that can be reasonably obtained in the open market and thus has to take account of the potential bids of a number of different actors.

Nevertheless, the underlying idea of expressing the risk of an investment opportunity in terms of the discount rate remains the same.

AFREXIM notes that there may be cases where the risk level changes significantly during the cash flow period, or where the risk level of the cash flow period may be very different from that of the revenues that are to be capitalised to determine the exit value. A real estate example would be the situation where a financially sound occupier had taken a lease for a certain fixed period of a property that the appraiser considers may no longer suit the general occupier market by the time the lease ends.

In such cases the appraiser may decide to apply two or even more discount rates to the various revenue flows in order to reflect their different risk profiles.

4. **Do you agree that the most commonly adopted terminal value calculation at the end of the explicit period is a “constant growth” method, cross-checked for sensibility to an implied capitalisation rate or exit multiple? If not, please identify what other method you most commonly use?**

In the valuation of long term real estate investment assets by the DCF method the appraiser will usually adopt a cash flow period that extends to beyond the expiry of the current occupational leases and the period required to re-let the various units and achieve a stabilised net income stream. The exit value is, in AFREXIM’s experience, usually determined by capitalising the stabilised net rental income in perpetuity at an appropriate yield.

It is possible to prepare either growth implicit or growth explicit cash flows. In France the former approach is comparatively rare, but if it is used the appraiser will adopt an exit rental value based on rental values observed in the market as at the valuation date, with whatever adjustments he may consider appropriate.

The growth explicit method is much more common in France. This involves applying estimated future rental growth factors to currently-observed market rents in order to estimate the levels of market rental values at the end of the cash flow period.

While it is always be for the individual appraiser to choose the details of his method, in AFREXIM’s experience valuers will often attempt to model rental growth for the first few years after the valuation date, using their professional judgement (possibly linked to financial forecasting models) to forecast likely rental trends in the short to medium term. Such forecasts can include falls in rental values if market conditions lead the valuer to anticipate such changes.

However, in our experience few appraisers attempt to model the likely changes in future rental growth over a period of more than, say 3 or 4 years. In general at the end of his initial short to medium term forecast period the valuer applies a single constant growth rate to market rents thereafter.

Thus we would not agree that a constant growth model is always adopted for the whole of the cash flow period.

Finally, it is important to consider those cases where the property may undergo a fundamental change at the end of the current lease or leases. This would most commonly be due to obsolescence (physical, technical or regulatory obsolescence) or to a change to a higher and better use, but it could also be due to a number of other reasons. In such cases it may be more appropriate, for example, to adopt as the exit value the estimated future sale price of the site for redevelopment, as the current owner may prefer to sell to a developer rather than undertaking a project himself.

We note, in passing, that as sustainability issues become increasingly important in real estate valuations we expect a significant increase in the recognition of property obsolescence in the life of real estate assets. It may well be that we will see a corresponding increase in the number of cases where a redevelopment or change of use is anticipated at the end of the current lease income.

5. **"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 result?"**

The implicit and explicit growth methods each have their own advantages and disadvantages.

In France the explicit method is principally used. It has the advantage of setting out the appraiser's assumptions on a large number of future variables in detail. This is particularly appreciated by "consumers" of valuations, including auditors and financial analysts, as well as valuers' clients.

Consumers of valuations should nevertheless be under no illusions over the degree of accuracy that valuers can claim in making forecasts over a future 10 year period. In this respect AFREXIM thoroughly endorses your statement that "…the DCF method should not be judged on the basis of whether or not the specific DCF expectation was ultimately realised but rather on the degree of market support for the DCF expectation at the time it was undertaken".

The principal advantage of the implicit method is that the valuer can adopt a discount rate that is derived from yields observed for real estate transactions in the market. Such yields reflect the view of market actors on a number of future risk factors, some of which are not detailed in the implicit approach.

In some countries and markets the growth implicit method is therefore considered to be more satisfactory, as the discount rate is derived entirely from real estate market evidence. The real estate valuer remains within the area of his own specialisation and the choice of the discount rate may therefore be easier for him.

In our experience, in countries such as France where discount rates are not published, property professionals will find it more difficult to determine discount rates to be used in a growth-explicit cash flow, as they are no longer so clearly linked to yields observed in real estate transactions. In any case, as the explicit approach involves many more variables it can more easily give rise to variations in the cash flow and exit profiles, according to the degree of optimism or pessimism that has been adopted in choosing the various variables.

Thus in an explicit approach the valuer not only has to choose a discount rate that is growth explicit, but he also has to adjust it to take account of the assumptions adopted for a wide range of variables, such as levels of future rental growth, the probability of tenants renewing at lease end or breaking their lease at an option date, etc. In a market where discount rate comparables are not available, the possibility of differences between the results of growth implicit and growth explicit methods is higher.

Having said all this, AFREXIM agrees that, in theory, as long as the discount rate is properly chosen, the implicit and explicit methods should give similar results, within the usual valuation tolerances.

6. **"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?"**

For many European countries the DCF method arrived with American buyers of distressed debt in the mid to late 1990s. Local valuers had to apply it with sometimes little if any previous knowledge or experience of it. In France the method has generally been backed by the use of more traditional methods and thanks to this French valuers have developed sound competence in its use over the last 10 – 15 years.

Nevertheless, given the importance of this method to the valuation profession there has been comparatively little public discussion of its use and application. We believe that practitioners, even senior ones, would welcome the possibility to debate the various aspects of the method in a public forum, as long as such a debate could take place in an open manner, with no suggestion of individual valuers or valuation companies being judged upon the questions they posed or the opinions they expressed.

If such a debate resulted in guidance being given to practising valuers that would, in our opinion, be welcomed, as long as such guidance left the ultimate choice of methodology and the choice of assumptions to the individual valuer, who would, of course, take the responsibility for his choices.

The question is then, is it appropriate for a standard setting body, particularly an international one such as IVSC, to issue such guidance?

AFREXIM itself is in the middle of a step-by-step process of examining the various stages in a DCF valuation and issuing guidance notes to valuers and consumers of valuations in France. We are fully aware of the difficulties of issuing guidance in a way that explains the various choices and makes recommendations, without either closing down options for valuers in the event of market conditions or practices changing or preventing them adopting pragmatic professional solutions for specific cases with which they may be confronted.

This process is already sufficiently difficult when applied across a whole country with local sub-markets that vary greatly in terms of the transparency of market information and local real estate practices. It is likely to be much more difficult in the context of the world-wide audience that IVSC would have to address – a recommendation that suits the most transparent western markets may not be very practicable in a developing country and may be completely unrealistic in the most opaque markets of the world.

On balance AFREXIM agrees that it is inappropriate for IVSC to enter into more detailed discussion in this paper, even if valuation professionals in many countries would welcome the opportunity for further debate and guidance. It would, however, be appreciated if an open forum for debate among international valuation professionals could be created –in due course this might even result in guidance on best practice being issued.