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IVSC Standards Review Board
1 King Street
London
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Your ref

Our ref dm/ivsc061218

6 December 2018

Dear Sirs

Exposure Draft – IVS2017 Proposed Revisions

We appreciate the opportunity to comment on the above exposure draft. We set out below our comments.

Question 1: Do you believe that IVS should define the terms Price, Cost, and Value? If so, please discuss why you think the additional definitions are necessary.

We believe that there is no requirement to define these words. Important variations of these terms such as fair value or market value, replacement cost or reproduction cost, weighted average cost of capital (“WACC”), etc. are appropriately defined with the relevant modifier so that their application in a valuation are well understood.

We believe that the proposed definitions of the individual terms *price*, *cost* and *value* may lead to potential inconsistencies between the resulting definition and how the modified terms are used. For example, the IVSC’s definition of WACC is inconsistent with the proposed definition of cost.

Question 2: Do you believe IVS should define Calculation and Calculation Engagement? Please explain why.

We do not believe that the IVS need to define a Calculation or Calculation engagement. As indicated in our response to question 3, we believe that the type of reports that may claim compliance with IVS should be restricted to valuations. Valuers perform a range of other engagements, which may or may not meet the proposed definition of a Calculation. The key issue for users is disclosure of whether or not the report is a valuation that is compliant with IVS.

It may be useful for users to understand the reasons why the report is not compliant with IVS so that they can assess the effect of these on their interpretation of the report.

Question 3: Should a Calculation be IVS compliant, and if so, what differences in the scope of work and disclosures outlined in IVS should be required by the valuer?

We believe that stating that a Calculation is compliant with IVS may confuse users of valuations about the scope of work that has been performed, especially relative to a valuation that is compliant with IVS. This could lead a user to place undue reliance on a Calculation. As such, we believe that IVS compliance should be restricted to valuations and should not cover Calculations.

Question 4: Should IVS provide examples of “substantial” limitations? If so, please provide examples of such limitations.

We believe that what constitutes substantial limitations will vary depending on the facts and circumstances of each valuation. As a result, we believe that this is ultimately a matter of professional judgment on the part of the valuer based on the facts of each case.

We do not object to examples of how professional judgment may be applied in specific circumstances if the example is sufficiently comprehensive to address the relevant factors and how judgment may be applied. Such examples may provide particular assistance to less experienced valuers. However, if examples are given, it should be clear that they are intended to be illustrative only and a professional valuer may reach an alternative decision based on the facts and circumstances of a particular case.

Question 5: Do you agree with the suggested changes to IVS 105 section on Discount Rates? If not, please provide details of the additional information you think should be included or excluded from this section.

We believe that the proposed guidance is useful. However, because investors' required rates of return are generally not observable, we believe that it is important that guidance emphasise the importance of professional judgment. Examples of the judgments frequently encountered include the following:

- “Pure CAPM” provides that an investor's required rate of return is related only to a share's systematic risk, as measured by its beta. However, many appraisers believe that other risk factors should be considered such as the size of the entity, its country risk, etc.
- The measurement of beta depends on the interval at which returns are measured, the historic period selected, etc.

- The equity risk premium is not observable and different valuers use different ERP estimates.

Given these and other uncertainties, we do not believe that all potential adjustments to discount rates are subject to exact quantification and that adjustments based on a qualitative evaluation may be necessary. We believe that this can be addressed by valuers having a nuanced understanding of discount rates, which is enhanced by the discussion in the ED, and disclosure of the factors considered by the valuer.

Other relevant issues include the following:

- In corroborating a discount rate, we consider internal rate of return estimates but some of the issues that arise may be unclear to users. These include:
 - The relevant IRRs are expected IRRs rather than historic IRRs realised on investments.
 - The implied IRR in a business combination is a key factor in a valuation of acquired intangible assets. However, this rate may reflect forecast risk in addition to the expected rate of return.
 - Certain investors, e.g., private equity funds, often use IRR hurdle rates to assess acquisition opportunities. However, such rates may reflect sought returns rather than market prices. In addition, such returns are often required equity returns and the ability to achieve such returns may reflect higher leverage than might be assumed by other market participants. In addition, investor required IRRs often reflect returns over their holding period, rather than the expected return on the asset over its entire life. For example, a portion of the investor's return may result from an expected de-risking of the business over the investor's holding period and its sale to investors with lower return requirements. An example of this life cycle effect is where developers of renewable energy projects have high rates of return to reflect their risk. However, they often hope to sell the completed projects to pension funds and other investors with lower risk (and return) appetites, when the projects are completed.
 - One measure of assessing forecast risk is whether the resulting value from applying the discounted cash flow technique is consistent with other value indications such as those resulting from the use of market multiple. For example, if a DCF results in a value indication that is significantly higher than the value from a market approach, the valuer must assess to what extent the DCF value indication represents a real value difference or is the result of overly aggressive forecasts.

Question 6: Do you agree that the methods are more relevant to business valuation and the placement in IVS 200 is appropriate? If no, please explain why.

We agree that that these methods are more relevant to business valuation and that placement in IVS 200 is appropriate.

We generally agree with the proposed guidance and welcome the broader dissemination of sophisticated techniques such as the current value method (“CVM”), the option pricing method (“OPM”) and the probability-weighted expected return method (“PWERM”). However, we note the following in relation to the proposed language:

- The use of a direct equity valuation approach rather than an enterprise valuation approach is common in valuing financial services companies such as banks or insurance companies. For example, such companies may be valued using P/E or P/B ratios rather than EV/EBITDA multiples.
- The proposed language in 130.5 states that enterprise value is often estimated and this is allocated between the various classes of debt and equity using techniques such as the CVM, OPM and the PWERM. In our experience, the overall equity value is often estimated, perhaps by deducting the fair value of third party, non-convertible debt from enterprise value and it is the equity value rather than the enterprise value that is allocated between different classes of ordinary and preferred shares using the CVM, OPM and PWERM.
- While we agree that the CVM is generally most relevant when a sale of the overall enterprise is imminent and that it may undervalue certain securities at other times, we believe that language such as “should only be used” may unduly constrain valuer judgment in exceptional cases.
- The statement that CVM may be appropriate when no reasonable basis exists for estimating the amount and timing of any such value above the liquidation preference that might be created in the future could be deleted. Otherwise this statement might be used to support attributing no value to securities with highly uncertain payoffs.
- Other option valuation models other than the Black-Scholes model may be necessary, depending on the complexity of the rights of different classes of securities. Moreover, we find that the use of a secondary option valuation model can be a useful check that the payoffs have been correctly modelled in a Black Scholes model. For example, a binomial model can be used to more explicitly model the payoffs to different classes of shares at different equity values as a useful check on the application of the Black-Scholes model. Where a valuer has a binomial model “engine” to generate future risk-neutral equity values, this can be quickly implemented, providing the valuer comfort that the Black-Scholes model, which is otherwise somewhat a “black box” to users, has been correctly applied.

- Examples of the application of the CVM, OPM and PWERM would be useful to increase valuers' familiarity with these models and their adoption. Such guidance could also address key assumptions such as the calculation of expected volatility, e.g., adjustments for different levels of financial leverage.
- In reconciling the probability-weighted expected returns to the current value, consideration should be given to the implied rates of return implicit in the expected outcome.

Question 7: Are there additional methods that should be included in the proposed revisions, for example the Hybrid Method? If yes, please discuss the additional methods to consider.

We believe that the methods described are the most relevant methods of which we are aware but recommend that alternative approaches identified in the comment process be adequately considered. Other methods so identified may be less well understood and so if included in the final revised standards, further guidance may be required.

Question 8: Are there additional topics within Early Stage Company Valuation that you feel should be included in IVS or explored further by the Boards? Please provide an outline for any topics suggested.

Other topics that may be relevant include the following:

- Early stage discount rates. Some discount rates quoted for early stage investing may reflect forecast risk adjustments rather than expected returns.
- Incorporation of the risk of failure. For example, most forecasts provided by a company assume successful growth, whereas many early stage companies, especially in the technology sector, fail.

Question 9: Do you feel that the inclusion of the “As Is” and “As Proposed” value for the Development Property will reduce the risks in relation to the valuation of development property? If no, what additional information would you like to see included?

We believe that the proposed inclusion of as-is and as-proposed values is useful.

Question 10: Should the valuer be compelled to state the method of valuation they have used in their calculation of market value and report the assumed (or calculated) Developers Profit when reporting market value? If no, please explain why not?

We believe that the method of valuation used to calculate market value should be disclosed. We do not believe that disclosure should be required on the actual amount of



the assumed or calculated Developers Profit but the process used to estimate this profit should be.

I hope you will find our comments to be useful and please do not hesitate to contact me with any questions on this letter.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'DMcPhee', written in a cursive style.

Doug McPhee
Partner – Deal Advisory
Global Head – Valuation Services

Appendix I

The proposed revision to 50.6 states the following:

(e) Expected versus most likely values: Typically a cash flow forecast that represents expected values is used. However, occasionally other forecasts may be used in certain circumstances, such as most likely values.”

In our experience, the term expected cash flows is often not fully understood. An expected variable is a statistical concept that means the probability weighted outcome of the relevant variable from a range of possible outcomes, in this case cash flows. In our experience, a single cash flow estimate is often presented as an expected value. This is often accepted on the assumption that the higher and lower possible outcomes, if separately presented and appropriately weighted, would result in the single cash flow estimate presented. In many cases, the expected and most likely outcome may be the same and the same discount rate may apply. A circumstance where a difference would apply is best illustrated using a bond, e.g., the most likely outcome for many bonds is repayment in full of the contractual cash flows. However, the expected value would differ because it would consider downside outcomes when the bond defaults and there is partial or zero recovery (there is no countervailing upside potential given that bond repayments are limited to contractual amounts).