IVSC DCF TECHNICAL INFORMATION PAPER 1 EXPOSURE DRAFT

APEI and SFEV COMMENTS ON THE PAPER

A. Introduction

APEI (Professional Association of Independent Experts) and SFEV (French Association of Valuation) gather people practicing, either in Auditing Firms, Research, Companies or Investment Banks, or teaching valuation. Both associations are founding members of FFEE (French Federation of Valuation Experts), member of IVSC.

Our member firms value a wide range of businesses in listed or unlisted companies, derivatives, insurance matters or claims. Valuations are produced for many purposes, fairness opinions, IFRS accounting, stock market operations, mergers and acquisitions, net asset value, technical or pension provisions, specific asset or liabilities.

APEI and SFEV directors 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 which we read with great interest.

The DCF method is widely used in France, generally matched with several comparison methods.

Despite the DCF method is widely used, there has been comparatively little public discussion about it, particularly on one of its main items, the market risk premium. Especially in bear market time, the DCF method gives a longer term vision of value. We therefore greatly welcome the IVSC's initiative in releasing this draft paper and we are pleased to send you our 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?"**

Our answer to this question will concern mainly business valuation. Most of the time the DCF method uses a specific set of forecasted cash-flows elaborated for the valuation purposes (one shot), such as a mid-term business plan or revenue projections. These assumptions, elaborated internally by the management or by the seller or the buyer in a transaction, may be significantly different from the market expectations regarding the sector at a specified time (which encompass tracking errors observed in the past). The differences observed in margins, growth and capex have to be cross-checked and explained. If possible, it is recommended to check the differences noticed in the past between budget and actual.

The discount rate, the cost of equity or the weighted average cost of capital, mostly refers to market data, thus leading to a market value. For IFRS purposes, it is possible to use longer means of market parameters which lead to investment value.

In most cases it is important to double-check the results obtained from the DCF approach against the results obtained using other valuation methods.

Indeed, while the great strength of the DCF method is that all assumptions are made explicit, its main weakness is that there are many assumptions. So to speak, a variation in one or two of them can have a significant impact on the final result. Therefore, it has 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 use check methods as well.

We understand that a DCF approach may give significantly different results from those obtained with another valuation method. This is particularly the case at market turning-points, as the DCF method being essentially forward-looking. It is then better to have a set of forecasts (worse, base and best cases) associated with probabilities.

In such situations it is the appraiser's responsibility to choose the value he will report. His judgement will be based on his expertise regarding the market conditions, the purpose of his valuation and the relative confidence he has in the outputs from the various methods. DCF outputs are not always relevant.

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?"

We fully agree with the proposition. There could be differences in displays, revenue projections in real estate being more accurate than for 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?"

We agree with the above proposition. One of the main drawbacks for the appraiser is to correct one error (ie a too aggressive set of projections), by using a higher discount rate which could be challengeable. The discount rate may change over the time in specific cases, such as significant change in the business (concession, specific agreement, obsolesce). Yield curve could be used in the evaluation of financial instruments.

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?

Constant growth method is widely used with the Gordon Shapiro formula to compute the terminal value. It is applied to normalized cash-flow. This cash-flow has to fit with average economical conditions (middle of economical cycle), fading to average profitability (outstanding competitive advantages do not last forever). Besides, the normalized cash-flow has to comply with the needed capex which matches with the constant growth rate applied and the obsolescence of intangible or tangible assets as well as the business model. Usually, the business plan is extended with a cash-flow fade, which could be theoretical, before computing the normative cash-flow.

It is important to indicate the implied multiples corresponding to the terminal value obtained with the constant growth method.

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.

Nevertheless, consumers of valuations should be under no illusions over the degree of accuracy that valuers can claim making forecasts over a forward 10 year period.

Thus, in an explicit approach the appraiser not only has to choose a discount rate that is growth explicit, but he also has to consider the assumptions adopted for a wide range of variables, such as growth of activity, margin and capex, and macro-economic assumption on inflation or income tax rate.

APEI and SFEV agree that, in theory, the implicit and explicit methods should give similar results, within the usual valuation tolerances as long as the discount rate is properly chosen.

Finally, if the span of the business plan is short, then the use of an exit multiple referring to transactions is recommended.

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?”**

We do observe that there is a large scope of valuations for assets and liabilities, realized for many purposes. Therefore it is impossible to establish accurate guidance for DCF method. APEI and SFEV agree that it is inappropriate for IVSC to enter into more detailed discussions in this paper.

The best practices involve the appraisers’ ethics and technical resources dedicated to the mission, as well as extended transparency whilst writing his report. The reader must understand the assumptions and conclusions made in a report, whether they are sound or more mitigated from the valuer’s point of view.

In most cases, it is still possible to check the value given by the DCF method with results obtained from others methods. In case of sizable differences, there must be fully explained in the report.