

European Valuer



European Business Valuation Standards Ready for Warsaw Launch



Dear colleagues,

On behalf of the Polish Federation of Valuers' Associations (PFVA), I welcome those of

you participating at the Warsaw launch of the 1st Edition of European Business Valuation Standards (EBVS) on 24th March. It gives me particular pleasure to do so, given that the initiative to develop EBVS stemmed from a PFVA proposal at a TEGOVA General Assembly.

Whilst the PFVA is largely focused on real estate valuation, it has the distinction of being the organisation which over a decade ago published Poland's only authoritative business valuation standards. I am pleased that TEGOVA has been able to draw on the experience of PFVA, among other TEGOVA member associations, in drafting EBVS, a move which will fill the "European" business valuation void and foster the development of a recognised business valuation profession in Europe.

With kindest regards,

Tomasz Ciodyk, President of the Polish Federation of Valuers' Associations

Real estate meets business on the valuation front



In the public mind, TEGOVA is real estate. It's 72 associations from 38 countries – 70,000 valuers in Europe – are all majority real estate valuers. Yet business valuation is also

prevalent among a number of members, with valuation firms or individual valuers often combining real estate and business practice. This is a welcome tendency for the profession and for European society at large, because land and buildings are such an important and integral part of most businesses that the combination of real estate and business knowledge provides a solid grounding for business valuation excellence. Conversely, business valuation is an attractive field of activity for real estate valuers in a mutating economic and professional environment, where no source of activity is permanently guaranteed and new opportunities arise.

Responding to increasing member demand, European Business Valuation Standards (EBVS) now provide fundamentals of best practice in business valuation,

with a quality that can be relied upon as a common benchmark by investors, the financial industry and valuers throughout the Union and beyond. Like EVS, European Business Valuation Standards are anchored in the EU legal order, putting all valuation definitions and concepts in step with EU law and providing a separate section on EU Legislation and Business Valuation. The EU has always been part of TEGOVA's DNA, underpinning our mission to provide Europeans with a common set of standards fit for their single market and emerging polity.

Our standards are founded on the understanding that Europe has reached a tipping point – the EU is now the dominant sculptor of our regulatory environment and valuers can no longer limit their horizons to the national policy and regulatory framework. This is at least as important for business valuation as for real estate, given the number of key business areas regulated by EU law.

Business valuers must master a fast-Europeanising business-regulatory environment and I trust that these, the first ever truly European Business Valuation Standards, prepared by highly skilled professionals in business valuation, will provide the grounding for that. ●

Krzysztof Grzesik REV FRICS, Chairman TEGOVA

European Business Valuation Standards – a beacon for European business valuation practice



TEGOVA has recognised the need of member associations, other valuation organisations, individual valuers, regulators and other stakeholders on the

European market – to have consistent and transparent business valuation standards in step with the Europeanisation of business activities.

European Business Valuation Standards (EBVS) will impose consistency in the most important issues in business valuation, across the European Union:

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- code of conduct
- terms of engagement
- definitions of bases of value
- valuation approaches
- reporting the valuation.

In this manner, EBVS will achieve its purpose – to institute procedures conducive to clearly prepared, unambiguous valuation reports that are consistent with EU and national regulation and accounting standards.

The Standards and Guidance Notes follow a regular layout, as far as is practical. There is also a list of what each Standard and Guidance Note contains, followed by detailed commentary and in some cases by country-specific interpretation.

“EU law impacts the principles and practice of valuation in many different areas, such as banking, the environment, social policy, financial accounts, new issues and prospectuses, taxation and competition.”

EBVS 2020 sets out four core standards:

- EBVS 1 – Market Value and Bases of Value other than Market Value, which defines various bases of value, applicable in business valuation, Highest and Best Use analysis in connection with Liquidation (disposal) and Going Concern business scenario, assumptions and special assumptions in arriving at an opinion of value
- EBVS 2 – the valuation process incorporates detailed Terms of Engagement, with appropriate commentary
- EBVS 3 – the valuation approaches and methods which present the recognised business valuation practice
- EBVS 4 – reporting the valuation, which

presents general reporting requirements and the content of a valuation report, as well as of a valuation review.

Part 2: European Business Valuation Guidance Notes

The Guidance Notes follow on from the Standards and provide more detail and explanation of key issues and techniques in the following topics:

- EBVGN 1 – Control Premiums and Discounts for Lack of Control and Discounts for Lack of Marketability
- EBVGN 2 – Discount Rates in the Discounted Cash Flow Method
- EBVGN 3 – Valuation of Intangible Assets.

Part 3: Business Valuation and Sustainability

Part 4: European Business Valuers’ Code of Conduct

Part 5: European Union Legislation and Business Valuation

EBVS 2020 considers business valuation issues in a European context and, in particular, addresses the valuation requirements and definitions of EU company law legislation.

This fifth part of EBVS is devoted to the body of EU law impacting enterprises and business valuation.

EU law impacts the principles and practice of valuation in many different areas, such as banking, the environment, social policy, financial accounts, new issues and prospectuses, taxation and competition. Much of this regulation falls under EU company law. Although there is no codified European company law as such, EU harmonisation of national rules on company law has created minimum standards in areas such as:

- the protection of interests of shareholders and their rights
- rules on takeover bids for public limited

companies, branch disclosure, mergers and divisions

- minimum rules for single-member private limited liability companies
- financial reporting and accounting
- easier and faster access to information on companies, and
- certain disclosure requirements for companies.

“The performance of business valuation services under the above EU rules requires a high degree of skill, and imposes upon the valuation professional a duty to communicate the valuation process and conclusion.”

The purpose of EU rules in this area is to enable businesses to operate anywhere in the EU, enjoying the freedom of movement of persons, goods, services and capital, to provide protection for shareholders and other parties with a particular interest in companies, to make businesses more competitive and to encourage businesses to cooperate or merge over the old borders.

The performance of business valuation services under the above EU rules requires a high degree of skill, and imposes upon the valuation professional a duty to communicate the valuation process and conclusion, as appropriate to the scope of the engagement, in a manner that is clear and not misleading.

With a vision for ensuring high quality work in business valuation practice across the European Union, these standards are effective from 24th March 2020. ●

Danijela Ilić REV FRICS, Chair, European Business Valuation Standards Board (EBVSB)

Business, the most European Valuation



Members of TEGOVA are well aware of the importance of EU policy to real estate valuation – EU banking law requires mortgage lenders to use qualified, independent valuers

and the European Central Bank polices valuation of bank collateral, repeatedly giving precedence to European Valuation

Standards over all others. EU Treaties and secondary legislation guarantee the freedom to buy and sell land and buildings all over the Union without obstacle, all real estate professions can practice freely anywhere in the EU, EU state aid rules control social housing for middle-income tenants, EU competition authorities break up building products and elevator/escalator cartels, the European Semester process for coordinated, systemically secure national economic

governance includes house prices as an indicator of member states’ macroeconomic stability, EU equal treatment law extends to access to buildings by the disabled, EU environmental protection, energy efficiency and renewables law targets buildings and there are clear valuation elements to all these issues.

And yet, in the greater scheme of EU action, real estate is a latecomer and not totally within the EU ambit. Most EU real

... continued on page 3, column 1

... continued from page 2, column 3

estate policy has developed over the last twenty-five years and there are fundamental aspects of real estate that are not Union competence, at least in terms of hard law – housing policy, property taxation, planning and zoning law.

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Furthermore, what look like “EU real estate freedoms” when considered in isolation, are in fact offshoots of wider, more comprehensive rights – the freedom to buy and sell land and buildings is just one (very important) aspect of the free movement of capital; almost all service providers of any kind have European freedom to practice anywhere with or without establishment; competition law concerns almost all enterprise; equal treatment covers all forms of discrimination; environmental and energy law encompasses all climate warming factors (of which, admittedly, buildings are the most important by far).

It shouldn’t come as a surprise, then, that business is the most European valuation, because business covers the whole economy. The EU has been regulating business since the inception of the European Economic Community, but whilst the initial goal was to dismantle the most glaring and egregious obstacles to “trade” between member states, today the goal – already partially achieved – is a completely integrated EU “internal market” ensuring that nothing can stop industry and services from developing to a European scale with seamless, “just-in-time” production chains nourished by a European capital market and a European industrial policy, European R&D and corresponding EU funding, all properly protected from unfairly advantaged foreign predators, “foreign” now meaning “non-European”.

In this context, Europe is truly the business valuer’s oyster. A single, ever more integrated European economy and market covering the EU and, *de facto*, all the many candidate member states who have to legislate for integration before they can join the Union, creates exponential growth in business and valuation work permeated with

EU regulatory aspects. Indeed, as the EU regulates mostly through Directives that are transposed into national law, it is important for the valuer to be able to recognise the EU hand behind the national or sub-national law when estimating the likelihood and timescale of possible changes to regulatory impacts on the business being valued.

In light of this, EBVS, like EVS, is designed in lock-step with EU law so as to provide public authorities and clients with the assurance that the Standards fit with the EU normative framework and also to didactically imbue the practising business valuer with awareness of EU impacts and the ability to exploit that knowledge to produce better adapted Valuation Reports. As in EVS, this is done in two ways:

- by systematically adopting EU definitions in all Standards and Guidance Notes – for example, explaining that the EU definitions of Basis of Value are to be applied in case of valuations performed within a framework for the recovery and resolution of credit institutions and investment firms
- and by devoting a separate, bespoke Part 5 to European Union Legislation and Business Valuation.

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Part 5 is no mere general culture add-on; it is basic knowledge for European business valuers. A general introduction and overview shows how EU regulation of companies has covered formation, capital and disclosure requirements, rules on takeover bids for public limited companies, mergers and divisions, minimum rules for single-member private limited liability companies, financial reporting and accounting and easier and faster access to information on companies. It shows how the EU has evolved from concentrating on regulating listed companies to now covering SMEs with the specific goal of reducing their administrative burdens and has also created a statute for a European Company (the *Societas Europaea* or “SE”). Part 5 goes on to highlight the specific valuation aspects of EU regulation of company law, credit institutions, insurance and reinsurance institutions, investment funds, taxation, transfer pricing, state aid, enforcement of intellectual property rights and insolvency proceedings or restructuring plans.

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The EU regulatory aspects of the body of the Book and of Part 5 are highly complementary – for instance, European Business Valuation Guidance Note 3 on Valuation of Intangible Assets is complemented and enhanced by Part 5’s section 9 on Valuation for Enforcement of Intellectual Property (IP) Rights. The Guidance Note provides:

- the EU Accounting Rule definition of intangible assets for the purpose of financial statements
- the definition of IP as defined by EU Regulation
- the instruction to business valuers that they must consider all relevant legal factors of valuation of IP – protected status, copyright, patents, licensing agreements or third party claims – at all levels, national, EU and international.

Seamlessly, Part V outlines:

- the EU Directive on enforcement of IP rights, its measures, procedures and remedies that allow effective civil enforcement and provide a common high level of protection throughout the internal market
- the European Commission Guidance Communication clarifying the Directive in light of the case law of the Court of Justice of the EU
- the valuable advice on the valuation of IP rights in the final report of the European Commission’s Expert Group (including business valuers) that reviewed valuation methods for IP rights and their use, identified bottlenecks in the valuation methods used for companies’ financial reporting, access to finance and litigation and provided recommendations.

Anchorage in the EU legal order is fundamental to these European Business Valuation Standards, that can be relied upon by public authorities, investors, the financial industry and valuers throughout the Union and beyond. ●

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EVS 2020 – the income approach to real estate valuation



The launch of a new edition of TEGOVA's European Valuation Standards (EVS) in May this year will see a welcome improvement to the methodological Section II, in particular

guidance concerning the income approach to valuation and discounted cash flow.

Valuers across Europe apply the income approach in diverse ways, which EVS 2020 seeks to rationalise in a clear and logical manner.

“If at the date of valuation, the rent paid differs from the Market Rent, then account must be taken of the actual rent and how long it will be paid until reversion to Market Rent, usually at the end of a lease and at rent review.”

EVS 2020 divides the income method used within the Income Approach into two types of model:

- a. traditional income growth-implicit models, known as **Capitalisation methods**, including direct capitalisation, term and reversion, layer (hardcore and top slice) and growth-implicit discounted cash flow models, and
- b. income growth-explicit models usually known as **Discounted Cash Flow (DCF)**. The main feature of the growth-explicit discounted cash flow method (explicit DCF) is that anticipated growth in income and costs is explicitly incorporated into the model by the valuer.

Capitalisation methods are further broken down into two types:

- a. **Perpetual models** where the Market Rent is, for the purpose of the implicit model, considered to be the same forever (all growth and future sales are captured in the yield), and
- b. **Reversionary models** where in today's terms the rent passing is below or above the Market Rent that will be received at a future reversion to Market Rent.

It is made clear that Capitalisation is a market-based model which relies on strong evidence of market rents and market yields (capitalisation rates). It relies on an active and liquid property market, both for investment and for lease, and requires sound analysis of property sales and property leases. If at the date of valuation, the rent paid differs from the Market Rent, then account must be taken of the actual rent and how long it will be paid until reversion to Market Rent, usually at the end of a lease and at rent review. In such a case, the valuer reflects projected changes in net income at certain defined future events - particularly at the end of a lease, rent review, or when major capital expenditure may be required. EVS 2020 in turn describes three models for dealing with such situations:

1. **Term and Reversion** divides the cash flow vertically, and is usually applied when the term rent is below Market Rent (under-rented property)
2. **The Layer Model** divides the cash flow horizontally, and is usually applied when term rent is above Market Rent (over-rented property)
3. **Growth Implicit Discounted Cash Flow** is a more sophisticated form of the term and reversion method typically presented in the form of a five to ten year cash flow and a terminal value both discounted at a so-called **Equivalent Yield**, being the single discount rate which, when applied to all income flows, results in a present value equal to the capital value of the investment. It is in the internal rate of return that the cash flow changes are allowed for implicitly. The income flows reflect current, actual and market rents and costs.

As regards **Explicit Discounted Cash Flow** models, EVS 2020 observes that these are based on present value calculations of expected income or cash flow projected over a specific calculation period. Unlike the capitalisation models (which imply

a future sale but don't explicitly express its date), a reversionary value is normally calculated and discounted at the end of a notional hold period. Consequently, a time horizon, projected cash flow and reversionary value have to be determined. To calculate present value, the estimated income or cash flow has to be discounted and a discount rate has to be determined.

Whilst EVS 2020 consider that the conventional model for assessing the market value of commercial properties is direct capitalisation or derivatives thereof (term and reversion or layer techniques) because it is grounded on comparison and the exclusive use of market data at the date of valuation, the explicit DCF model – once predominantly used for project feasibility analysis and estimation of investment value – is today also widely applied. However whichever model is used, valuers must be sure that it reflects the behaviour of market participants – *“it is always better to use comparable evidence generated from market transactions whenever possible with application of a pricing technique that is commonly used by market participants.”*

The above overview of the Income approach described in EVS 2020 has focused only on the income side of a valuation. Part II of EVS 2020 also deals in detail with the derivation of a capitalisation and/or discount rates, too detailed to be covered in this short article. An article on discount rates will follow in a future edition of European Valuer. ●

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