BiH BANKRUPTCY
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Guideline Book for Appraisers

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1. Introduction

This valuation guideline is used to illustrate the process of appraising and should be adjusted accordingly to the purpose and restrictions defined in the valuation assignment when used by an appraiser.

The value of the properties/businesses have to be determined according to the existing valuation standards. The determination of a value is dependent on the purpose for which the valuation is carried out. In addition, there are differences in the level of detail of the substantiation and valuation methodology.

To prevent this, it will be necessary to prescribe a valuation model to be used internally as well as externally. The model prescribes rules with respect to the choice of valuation models and their justification. It is aimed at a verifiable clear financial calculation.

2. Determination of the term: “value”.

The determined value for the purpose of the Guidelines is the *Market Value fully Rented*: the estimated revenue in case of a private sale after the vendor has put the object on the market after adequate preparation whereby the buyer accepts all conditions of the current rental contracts including all privileges and duties .

3. Permitted Valuation Methods/Models

The Guidelines permits two valuation methods:

- The conventional method based on direct capitalization
- The Discounted Cash Flow Method (DCF)

4. The Conventional Method based on direct capitalization

This method is based on:

a. The estimated cash flow based on market rental value.
b. Deductible entries for owners’ expenses that are in conformity with the market.
c. Valuation, via realization of the net returns, of comparable transactions.
d. Potential correction entries for, among others, initial vacancy and for the present value of the difference between actual rent and market rent, overdue maintenance, possible future renovations, etc.

The conventional method has the following advantages:

- easy to determine
- market-technically a good yardstick for comparison
- easy to communicate

The conventional method has the following disadvantages:

- a discrepancy between the Yield (excluding operating costs) in valuations, and the Yield (including operating costs) used for new investments.
- the yield is less reliable when based on a few market transactions.
- there are hidden assumptions in the Yield, especially the assumption that there will be an infinite rental income stream at the level established at the first year.
- it allows for some freedom in correcting for, for example, a big difference between market rent and contractual rent.

5. The Discounted Cash flow Method (DCF)

This method is based on:

a. a pro forma with cash flows for at least the next ten years
b. an assumed end value in the last year of the pro forma
c. the desired IRR percentage to be applied as the discount factor

The advantages of this method are:

- good insight into the development of costs and revenues over the period
- verifiable results because of the clarity of the method
- no “hidden” assumptions possible.

The disadvantages of this method are:

- assumptions have to be made with regard to the end value. Sometimes these are too optimistic, which can largely be attributed to the relation between the cap rate used in the end value calculation and the cap rate in the first year (Yield / cap rate in the end value calculation is completely different from the required return)
- assumptions have to be made with respect to the IRR percentage (which are not always clear).

6. Valuation guideline commercial properties

In the industry there is a wide diversity in the application of the Conventional and the DCF methods. The guidelines will aim to streamline these differences. The degree of freedom in the valuations has to be restricted and particularly the financial calculation should be as clear as possible. The valuation guidelines are:

A. Choice of the method

Only the direct capitalization or the DCF method is allowed for valuations. Preferably a chosen method should be used in the next year again. The DCF method is preferred when:

a. large expenses for investment, renovation or maintenance are to be expected over the next five years (more than 35% of gross annual rent);

b. more than 50% of the leases will expire in the next five years.

NB: This guideline does not apply for individual shop units.

If in these cases the direct capitalization method is applied, it has to be accompanied by a comprehensive explanation.

B. Operating costs and - revenues

Normally the appraiser assesses operating costs and revenues, which conform to the market, i.e., an average yearly pattern of, for instance, maintenance expenditures. These assessments have to be well substantiated, especially where it concerns market rental trends and vacancy estimates. As a guideline, the appraiser estimates all costs and revenues, as included in input forms 2,3 and 5 (respectively valuations, rents and operating costs) and possibly supplements these with, as yet unspecified costs or revenue categories. The assessment should be based upon an average of at least five years ahead.

C. Net yield

The net yield is the percentage used in the valuation to calculate the gross capital value.

The yield used (return percentage) should be based on the market. Its determination is typically regarded as the responsibility of the appraisers. In addition, the independence would be at stake if client funds were to prescribe yields. As a guideline, a clear justification should be given for the yield. This also applies to internal valuations. The substantiation of the yield (as applied to the direct capitalisation method) should go into:

- general property risks
- risks attached to the type of property
- specific object risks

these risks should be quantified as much as possible.

In addition, the yield applied in the previous year should be specified. Any changes should be justified in terms of changing market conditions, or changes in perspective at project level.

D. The derivation of the IRR (required return/discount factor for the DCF method)

Appraisers using the DCF method derive the required return composed of a risk free rate (bonds) plus a premium, which varies according to the property type, and a property specific risk. As a guideline, a clear justification needs to be given for the derivation of the chosen IRR percentage (discount rate for the DCF method). The chosen discount rate, the term (minimum 10 years), as well as the rate of return, which underlie the residual value calculation, should be stated explicitly.

The total should be a rate of return, which can be substantiated as typically required by investors in that particular property type and category.

E. Interest rate for correction entries in the direct capitalization method

The appraiser should add a risk premium (determined by the appraiser) to the risk free return rate. The interest rate on 10 years state bonds is used.

F. Vacancy

Using the direct capitalization method, it is possible to include the rental value of vacancy as costs in the gross-net differential, and also as a (discounted) correction entry after the valuation. It has proven necessary to bring some uniformity into this. The guidelines for the various types of vacancy are as follows:

a. **Actual vacancy** is a cash flow item and as such only has informative value for the appraiser in the judgment process.

b. **Structural vacancy** is included in the gross-net differential. This relates to vacancy arising due to market-technical circumstances. This can be due to general market conditions (structural oversupply) as well as to the property concerned (difficult to lease due to obsolence, location, etc.)

c. **Friction vacancy**:

- once-off when a major tenant leaves. In that case it will be a (discounted) correction entry after the valuation.

- continuous, for instance an office with many tenants where there is always a certain vacancy level. Include in the gross-net differential.

d. **Initial** vacancy:

- this occurs on completion of a building which has not been fully pre-let. This can be entered as a correction on the valuation up to two years after the completion, after which it becomes structural (see b.).

G. Comparable transactions

Valuation reports sometimes include comparable transactions. For small market segments, or in case of minimal investment activity, this can be a problem. Nevertheless, some starting points should be looked for. As a guideline, a minimum of three reference transactions should be included for market rents (per sqm) as well as the yield. These reference transactions should be substantiated as comparable transactions. In case of a small market or minimal investment activity, transactions in comparable towns or past transactions (max. three years back with explanation) may be used.

Reference to market reports will also be acceptable, as will references/transactions from the (fund's) own portfolio (as long as comparability of market scenario and the property to be valued are kept in mind).

H. Inflation

Appraisers use many, often very different sources, which leads to wide inconsistencies (sometimes 50% variation in inflation estimate). Only official resources should be used that apply for the concrete economy and industry, to which the actual property belongs.

I. Interim investments (capitalized expenditures)

The capitalized expenditures - interim investments should be mentioned explicitly when there are large expected investments, renovation or maintenance expenditures between now and 5 years.

J. Factors which have an impact on the value

All factors which have a significant influence on the valuation result should be stated (overdue maintenance, renovation/upgrading, etc.)

K. Definitions

Standard definitions (as given on the separate list of definitions) should be applied as much as possible.

L. Frequency valuations

The Guidelines require that each property is valued frequently depending on the change in the economy and/or at least once in the year internally. The variables that have been used for internal valuations should be checked externally.

7. Additional guideline for retail properties

It is not realistic to appraise retail properties based on the market rent when this market rent is not achievable because of various reasons.

In these cases the appraiser should determine a 'rent review rental value' to be used as a market rent to determine the value. The 'rent review rental value' is a percentage of the market rent. Recent studies show that the rental review rental value, in 86% of the cases of retail properties with a floor space of up to 200 m2, lies within a bandwidth of 60% and 90% of the market rent. The appraiser can deviate even further, also above 100% in a declining market. The determination of the deviation is the capability of the appraiser. The appraiser should provide a foundation for the used rental review rental value.

8. Valuation guideline residential properties

Even though there are a number of similarities with respect to the guidelines for offices and shopping centres, there also appear to be a number of obvious differences. A different guideline is used for the valuation method (A) as well as for the rental value (B).

A. Valuations

Point of departure with respect to the valuation remains the property's open market value: The estimated yield in case of sale of property when the owner, after ample preparation, has put the property on the market in the usual manner, whereby the buyer accepts the property with all privileges and obligations of the current rental contracts.

Value concepts

In the case of private dwellings, the situation is such that the vacant value is higher than the open market value. In fact, we could speak of four value concepts:

- ***Open market value fully rented***- This value is determined among other things on a market technical yield demand without considering the probable property yield, c.q. losses in case of sale. This is why the valuation will be somewhat theoretical, besides being on the safe side. As a result of this, the valuation does not correspond sufficiently with the value of the economic transactions and, consequently, cannot be considered as a basis for Guidelines purposes. A transaction will materialize based on all potential cash flows and not exclusively on rent income.

- ***Vacant value* -** This value is usually given by the Realtors' Organizations with respect to the open market value of sold dwellings. Because of the fact that the calculation is based on property sale in rented state, these values will not be considered as a basis for the valuations. However, it is used as a parameter when calculating the value. Moreover, the results of the valuations may be compared to these values, which is an indication with respect to the plausibility of these results.

- ***Sale of an entire complex to a third party*** - This means considering the highest affordable price a party could offer, usually taking into consideration the effects of individual sales of the dwellings. As a rule, dependent on the mutation level, the rate of possible property gain is determined by considering the market value development, interest rates and possibilities of sale to present renters.

The cash value of this yield is subsequently used to determine the present value.

These calculations usually are done by parties who generally buy private dwellings by the complex from institutional investors and subsequently sell the dwellings individually. With respect to this kind of transactions, the market is generally limited to dwelling complexes built 15 to 20 years ago.

However, there used to be a constant trade in this type of properties, so that one could speak of a reasonable rate of market evidence, c.q. reference projects. Of late, the trend amongst investors has been to handle the individual sales either themselves or through agents. The spectacular rise in house prices may be credited to this fact. Because of taxed economic transfer this situation has become less attractive financially. Even though the description concurs with the points of departure of the valuations, market evidence could be a problem.

- *Individual sale* - As mentioned above, the trend has become more and more that when an investor decides to sell a project, he subsequently handles the sale either himself or he will contact an agent to do this for him. In fact this represents the open market value, whereby existing cash flows (= rent income) and potential cash flows (= property yield) as much as these could be realized, will be taken into consideration.

This means that dependent on the availability of market evidence, the parameters used by third parties may be used (*conform Sale of a dwelling complex to a third party)*. If this information is not sufficiently available, the participants will have to estimate the parameters in question and they will have to establish a discount rate that will justify the market - and price risks.

As a rule this decision in based on a Discounted Cash Flow model. The most important parameters used in this case are:

- discount rate
- average rate of mutation
- total vacant value, if necessary listed per separate dwelling
- rent increase
- exit yield and market rental value within 10 years.

This is in accordance with the way the DCF model is used in the commercial property business.

In principle, the same parameters, which are also used by a third party, will be used in case of *sale of a dwelling complex to a third party,* theoretically resulting in minimal changes with respect to *Sale of a dwelling complex to a third party.* Limited differences may develop because different parties use different risk tables. Also factors like degree of specialization, scale size, etc. may play a role.

The guideline is that the value is based upon the sale of an entire complex to a third party.

B. Market rental value vs. actual rent

Most appraisers use as point of departure the actual rent and not the market rent value, arguing that the market rent value is not easily attained by rent protection. The fact is that often the market rental value goes up faster than the periodic rent raises, which creates the situation the renters pay relatively less rent than would be attainable market technically. Even though this deviates from the point of departure used in case of commercial property, this approach corresponds to the actual cash flows, which is why the maintains this situation.

The guideline is to use the actual rent in the valuation and not the market rent.

C. Sales restrictions

When a property can't be sold because of external restrictions (i.e. agreements with local governments or residential corporations) only the cash flows should be capitalized and not possible value changes because of possible part sales. This is only possible again fro the moment that sale is permitted again.

D. Valuation of private dwellings above retail properties

No sale value of an entire complex to a third party should be used In the valuation of private dwellings above individual retail properties but the cash flows should be discounted in a DCF model or the conventional method should be used.
This adjustment does not count for residential complexes above retail (centres).