BiH BANKRUPTCY AND LIQUIDATION LAWS:

Guideline Book for Appraisers

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Guideline Book for Appraisers

A preliminary draft of the attached *GUIDELINE BOOK FOR APPRAISERS* was delivered to USAID on April 30, 2004, and circulated among a small group of practicing appraisers in BiH for their comments.

We have only received a limited number of comments, and few comments in depth, to date, due to the fact that there is only a small number of practicing appraisers in the BiH at this time and the profession is still in a generally undeveloped state. Also worth mentioning is the fact that the preliminary draft was circulated for review during the summer months, when it was simply more difficult, as a practical matter, to generate a dialogue focused on technical appraisal issues.

However, as there is a well-recognized urgent need for increased attention to market valuation and similar financial techniques in BiH, we were able to obtain some valuable assistance from the "Authorized Evaluators Association of the R. S." and the "Economic Institute," an appraisal-providing concern located in Doboj. This assistance came in the form of useful verbal comments, which we expect will be supplemented with more detailed written comments by these organizations, and others as well, in the following weeks.

We expect the development of this APPRAISERS GUIDELINE BOOK and our other FILE bankruptcy resource materials will be a continuing process. As additional comments and suggestions come in, further thought will be given to the content and structure of the Guideline Book for Appraisers and, if appropriate, revisions will be made and a "second edition" published.

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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 four valuation methods:

- The Depreciated Replacement Cost method
- The Conventional method based on direct capitalization
- The Discounted Cash Flow Method (DCF)
- The Sales Comparison method

A. The Depreciated Replacement Cost method (DRC)

This method is based on:

- determination of the market value for the existing use
- a structure similar to an existing structure and having the equivalent productive capacity, which could be built using modern materials, techniques, and design. Replacement cost is the basis used to estimate the cost of constructing a modern equivalent asset
- the Depreciated Replacement Cost is determined based on the Replacement cost less the physical deterioration and less functional and economic obsolescence

The advantages of this method are:

- very useful method for appraisal of specialized and limited market property

- extremely useful for application to real estate properties and machines where quantitative information and past cost accounting data is available and where are no or limited comparative sales data is available
- no "hidden" assumptions possible.

The disadvantages of this method are:

- does not reflect the market value of the functionality and usefulness of the appraised subject
- difficult to apply as it requires extremely large data on current market prices on cost elements
- time consuming

B. The Conventional Method based on direct capitalization

This method is based on:

- The estimated cash flow based on market rental value.
- Deductible entries for owners' expenses that are in conformity with the market.
- Valuation, via realization of the net returns, of comparable transactions.
- 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.

C. The Discounted Cash flow Method (DCF)

This method is based on:

- a pro forma with cash flows for at least the next ten years
- an assumed end value in the last year of the pro forma
- 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).

D. The Sales Comparison Method

This method is based on:

- direct comparison of the subject property with similar one for which actual data on recent market transactions are available.
- a subdivision development technique might be used as well and requires projecting the subdivision of a particular property into a series of indiviudal properties/units/lots, developing incomes and expenses associated with the process, and discounting the resulting net incomes into an indication of value.
- A subdivision based on key parameters could be also done (industry sector, output, sales, number of employees, price per share/equity ratio) and is useful when whole systems are being appraised based on the comparison sales method

The sales comparison method has the following advantages:

- directly relates to the current market value
- in some simple cases very easy to be applied, and
- easy to communicate

The sales comparison method has the following disadvantages:

- the segragation and subdivision technique may be supportable in some situations, but is subject to a number of assumptions that may be exceedingly difficult to associate with the Market Value definition.
- the selection of the most appropriate comparable parameters is essential
- the development of supportable assumptions might be decisive and appriaser is advised to make full disclosure.

4. Guideline for appraisal of land

Appraisal of land as if vacant or of land and improvements to or on the land, is an economic concept. Whether vacant or improved, land is also referred to as *real estate (Real estate* is defined as the physical land and those human-made items which attach to the land. It is the physical,

tangible "thing" which can be seen and touched, together with all additions on, above, or below the ground.)

Contributing to value are real estate's general uniqueness, durability, fixity of location, relatively limited supply, and the specific utility of a given site.

A. The Highest and Best Use concept

- Land is regarded as permanenet asset, but improvements upon or to the land have a finite life. Because of the immobility of land, each real estate parcel possesses a unique location. Land's performance also means that it will normally be expected to outlast uses and improvements, which have a finite life.

- The unique characteristics of land determine its optimal utility. When improved land is valued separetely from improvements to or upon the land, economic principles require that improvements to or on the land be valued as they contribute to or detract from the total value of the propoerty.

- Thus, the *Market Value* of land based upon the "highest and best use" concept reflects the utility and the permanence of land in the context of a market, with improvements constituting the difference between land value alone and total *Market Value* as improved.

- Most properties are valued as a combination of land and improvements. In such cases, the apprasier will normally estimate *Market Value* by considering the highest and best use of the property as improved.

B. Choice of method

Several methods are used for appraisal of land. Their applicability differs according to the type of value estimated and availability of data. For Market Value estimates, any method chosen must be supported by market data.

Three valuation approaches are recognised in the Valuation Process: cost, sales, and income capitalisation.

While a well-evidenced market may make the cost approach less relevant, a lack of comparable data may cause the cost approach to be predominant. Unless there are such restrictions, or unless there are other compelling reasons for a particular omission, it is reasonable for the appraiser to consider each approach.

The cost approach establishes value by estimating the costs of acquiring land and building
a new property with equal utility or adapting an old property to the same use with no undue expense resulting from delay.

The cost of land is added to the total cost of construction. (Where applicable, an estimate of entrepreneurial incentive, or developer's profit/loss, is commonly added to construction costs.)

The *cost approach* establishes the upper limit of what the market would normally pay for a given property when it is new. For an older property, some allowance for various forms of accrued depreciation (physical deterioration; functional, or technical, obsolescence;and economic, or external, obsolescence) is deducted to estimate a price that approximates *Market Value.*

The primary methods of valuing land are the *sales comparison method and the subdivision development technique.* However, in practice for appraisal of land are applicable other inderect methods based on the primary methods which are listed below:

- *Allocation method* is an indirect comparison technique that develops a ratio between land value and improvement value or some other relationship between property components. The result is a measure that allocates a total market price between the land and improvements for comparative purposes.

- *Extraction method* is another indirect comparison technique (sometimes called *abstraction*). It provides a value estimate of improvements by applying a cost less depreciation analysis and extracting the result from the total price of otherwise

- *The land residual technique* for land appraisal also applies income and expense data as elements in its analysis. A financial analysis is made of the net income that can be obtained by an income-producing use and a deduction from the net income is made for the financial return required by the improvements. The remaining income is considered residual to the land and is capitalised into a value indication. The method is limited to income-producing properties and is most applicable to newer properties for which fewer assumptions are required.

- *Land can also be appraised by ground rent capitalisation.* If the land is capable of independently producing a ground rental, that rent may be capitalised into a *Market Value* indication where sufficient market data are available. Care must be taken, however, not to be misled by special terms and conditions in a ground-rent lease that may not necessarily be representative of the particular market. In addition, since ground leases may have been drawn up many years before the valuation date, the rents quoted therein may be outdated, and current income capitalisation rates may be hard to obtain.

5. Guideline for appraisal of 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 (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 (should be given as a 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.

6. 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.

7. Guideline for appraisal of 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. Appraisals

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 from the moment that sale is permitted again.

D. Appraisal 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).

8. Guideline for appraisal of machines and equipment

Machines and equipment are tangible, or physical, assets (as well as property and plant) intended for use on a continuing basis in the activities of an enterprise (including land and buildings; plant and equipment; less accumulated depreciation) and falls into group of *non-current assets*.

Where either historic or current cost accounting conventions are upheld, a distinction is drawn between operational and investment assets.

Operational assets are considered requisite to the operations of the going concern or corporation. Investment assets that are owned by a corporation are considered extraneous to the operational requirements of the corporate owner.

Plant and equipment may be valued for a variety of reasons. When valued for financial reporting purposes, plant and equipment are valued in the same manner as other assets, applying Market Value and depreciated replacement cost (DRC) concepts in accordance with the international Valuations Standards 1.

A. Choice of method

The most commonly applied methods for appraisal of machinery and equipment are absed on the following approaches to value:

- *sales comparison approach.*
- *cost approach (depreciated replacement cost* application), and
- *income capitalisation approach.*

Plant and equipment valuation situations are varied, and circumstances may even require the estimation of more than one type of value in a single assignment. Accordingly, plant and

equipment will be valued on a basis that is appropriate for the circumstances, and that basis will be appropriately defined in the Appraiser's Report.

B. Practical guidelines when appraising machinery and equipment:

- ***Categorizing of assets that are to be appraised***

  For financial reporting purposes, items comprising plant and equipment must be separated into operational, surplus, and investment property categories.

  Although this process can be extensive and is frequently complicated when there are large inventories of items to be valued, proper and detailed identification and classification of assets constituting plant and equipment are fundamental requisites for a valuation to be performed. Client instructions regarding these classifications should be obtained at the beginning of a valuation assignment.

- ***Categorization of Depreciation loss of value***

  The term depreciation is used in appraisal and in accounting, and can lead to confusion. To avoid misunderstanding, appraisers may use either the term depreciation or the term accrued depreciation in Reproduction or Replacement Cost methods to refer to any loss in value from the estimate of total cost new.

  Such losses may be categorised as attributable to physical deterioration, functional (technical) obsolescence, or economic (external) obsolescence.

  The term accruals for depreciation denotes allowances made by accountants as offests to the original cost of assets and, importantly to appraisers, accrued depreciation is a function of the market. Accruals for depreciation are a function of an accounting convention and do not necessarily reflect the market.

9. Guideline for appraisal of Going Concern Companies

A business is any commercial, industrial, service, or investment entity pursuing an economic activity. Business are generally profit-making enterprises operating to provide consumers with products or services.

Closely related to the concept of business enterprise are the terms operating company, which is a business that performs an economic activity by making, selling, or trading a product or service, and *going concern*,which is an enterprise normally viewed as continuing in operation in the forseeable future with neither the intention nor necessity of liquidation or of curtailing materially in the scale of its operations.

Going Concern Value is the value of a business as a whole. The concepts involves valuation of a continuing enterprise from which allocations, or apportionments, of overall *going concern value* may be made to constituent parts as they contribute to the whole, but none of the components in themselves constitutes a basis for *Market Value.*

Therefore, the concept of *Going Concern Value* can apply only to a property that is a constituent part of a business or entity, i.e. *Going Concern Value* expresses the value ascribed to an established business, not to any of its constituent parts.

The value allocated, or apportioned, to individual assets making up a part of the going concern is based on their contribution to the whole, commonly referred to as their *value in use* when related to a specific business and its owner. It is not market related.

Going concern has several meanings in accounting and appraisal. In some contexts, going concern serves as a premise under which appraisers and accountants consider a business as an established enterprise that will continue in operation indefinitely.

The premise of a going concern serves as an alternative to the premise of liquidation. Adoption of a going concern premise allows the business to be valued above liquidation value and is essential to the development of the *Market Value* of the business.

In liquidations, the value of most intangible assets (e.g., goodwill) tends toward zero, and the value of all tangible assets reflects the circumstance of liquidation. Expenses associated with liquidation (sales fee, commissions, taxes, other closing costs, administrative costs during close-out, and loss of value in inventory) are also calculated and deducted from the estimate of business value.

The going concern value requires the application of the income and sales comparisson approach. The most applicable method for appraising a company as a going concern, however is the Depreciated Cash Flow method. Alternatively, with careful consideration and developping of an appropriate set of comparable parameters could also be applied the Sales Comparisson method.

The folowing guidelines should be used for final adjustments to going concern value:

- The estimated cash flow is based on market value.
- Deductible entries for owners' expenses that are in conformity with the market.
- Appraisal, via realization of the net returns, of comparable transactions.
- 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.