OAK INVESTMENT MANAGEMENT GROUP

JULY (2) 2012: Financial Models and Real Estate

Financial modelling is short hand for understanding a value proposition. However, just like any tool it can be consciously abused or subconsciously misused to create unrealistic scenarios. For example, managers might be incentivised to present an over-optimistic picture should they wish to make the case for an investment or on the other hand, might well present an over-pessimistic picture should they wish to be rewarded for better-than-forecast performance.

Financial models can be subtly dialled up or down. Even seemingly transparent headline revenue such as raw rent roll assumptions can become blurred among a myriad of cost lines that affect operating performance. That is even before a drill down assessment into financing assumptions, which can produce some extraordinarily misleading scenarios for the investor or investors.

As a result the importance of a real estate financial model is predicated on the fact that the financial analysis controls it rather than *vice versa*. From a presentational point of view, this means that good real estate financial models should be transparent, clear and (even) simple. From a working point of view the two most important aspects to understand, appreciate and critique are; first, the assumptions underlying the model, and, secondly, how sensitive these assumptions are to affect the supposed end scenario(s).

These parameters sound simple – but often they are not. In reality, inputs and outputs can be easily enmeshed in one another, leaving someone who looks to the model for answers chasing their own metaphorical tail (or literal assumptions). So a real estate financial model needs to be clear what it is seeking to demonstrate. Generally, most investors look to real estate financial models to stress test the upper and lower case scenarios of an investment. And of those two potential trajectories, the lower case scenario is the one that investors pay most attention to.

For the debt holder, for the mezzanine provider, for the equity in a real estate project the downside scenario is almost always the most important scenario. What is the best way to model this? The best way is to have realistic inputs throughout a financial model and then put a margin of safety in at the end of the process rather than having margin safety upon margin safety throughout a financial model. The former will allow a correct evaluation, whereas the later will only create confusion and a false sense of security.

So far as actual programmes go, there is the ubiquitous Microsoft Excel and more specialised blackbox propositions such as Argus (almost universally used by real estate agency in Europe), as well as the smaller Brixx (promoted by Oak Investment Management Group) that typically offer to synthesise financial, real estate and managerial accounting assumptions and outputs much more but at the expense of complete control of the system. Generally, MS excel gives more margin for specific error, blackbox solutions offer greater margin for general error. Either way, the programmes can only be as good as the analysis that underpins them. Therefore, the investors must always be wary of financial real estate models that are misleadingly precise about an unprecise future.

Nicholas Frankopan is Managing Director of Oak Investment Management Group pan-European real estate investment manager. To contact the author please email nfrankopan@oakadvisors.co.uk or learn more about the group at www.oakimg.com. *© All rights are asserted please request permission for reproduction.*