

# FINANCIAL STRATEGIES

Smart use of fiscal planning & action



ALECI PACELLA

## Art Vs. Science

One constant challenge among real estate owners is what I'll call the "bird in the hand vs. two in the bush" dilemma. Suppose I own a 1960s-vintage shopping center. The property is showing its age a bit, mostly occupied but with local retailers. I've toyed around with the idea of completing a substantial update, including a modern exterior façade, new signage and adding an outdoor entertainment/dining area with associated landscaping.

By doing this, I hope to achieve a through one called 'differential' cash higher rental rate among the existing flow. This technique starts with a dose of tenants as well as improve overall occupancy a bit. But there is an upfront cost to complete these improvements – and thus my dilemma. Should I just leave things alone and continue to collect a lower but more certain income, aka bird in the hand. Or should I spend the money on an upgrade to create the opportunity to collect a more speculative higher income, aka two in the bush.

There are a few different ways to approach this and I'm going to walk through one called 'differential' cash flow. This technique starts with a dose of art then finished with a bit of science, providing an extremely valuable takeaway in the process.

The first thing I need to figure out is my anticipated cash flows in each scenario; if I leave the property as-is versus if I chose to renovate. The as-is scenario should be fairly straight-forward and based on the recent performance of the property. The simplest approach is to use net operating income (NOI) to represent the cash flows, even if there is financing in place

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on the property. While you can use cash flow after debt service for this scenario, you will also need to include a financing component in the renovate scenario. Any comparison needs to be apples-to-apples. I will need to estimate NOI over the next full year and then model it into the future over an anticipated holding period. This forward-looking projection is where a good bit of the art comes into play, as assumptions need to be made for things like renewal probability, downtime, cost to release and future rental rates for any leases scheduled to expire during the anticipated holding period.

While developing this type of projection is always laced with uncertainty, it should be based on what you think will happen versus what you would like to happen. The anticipated holding period is arbitrary. It should be long enough to be meaningful but not so long as to make the projections little more than a guess. A holding period between five and 10 years is generally used.

The last item needed for this scenario is the future value at the end of the holding period. This doesn't necessarily mean that we are going to sell the property at that time but rather what the asset is expected to be worth at that specific point in time. There are a few ways to estimate this and most will use an anticipated disposition cap rate applied to the projected NOI the year after the end of the holding period. The T-bar titled "As-Is," in the center of Figure 1, represents what I expect the as-is cash flows to look like over a seven-year holding period.

I now need to do the same thing for the renovate scenario. And there are a few wrinkles. First, an estimate needs to be made to capture the cost to upgrade. This should be all-in, including soft costs, hard costs, contingency and timing to complete. As with the as-is scenario, assembling the analysis is simpler if I do not introduce financing. Next, I need to develop an NOI over the first full year and then model that into the future. While similar to the process in the as-is scenario, this time I will need to incorporate the benefits associated with the improvements. And here comes another dose of that art thing, as I'll need to

Renovate		As-Is		Differential	
N	\$	N	\$	N	\$
0	(130,000)	0	0	0	(130,000)
1	66,000	1	52,000	1	14,000
2	67,100	2	53,250	2	13,850
3	68,000	3	54,000	3	14,000
4	69,200	4	55,700	4	13,500
5	71,000	5	57,000	5	14,000
6	72,400	6	58,200	6	14,200
7	73,000 + 890,000	7	59,200 + 737,500	7	13,800 + 152,500

IRR = 12.4%

Figure 1

estimate how much the rental rates will increase as well as any other impacts to overall occupancy, downtime, renewal probabilities, etc. Finally, I'll again need to have a future value at the end of that holding period. The process for developing this should also be the same; use an anticipated disposition cap rate applied to the projected NOI the year following the end of the holding period (which will be the same duration as the holding period for the as-is scenario). The T-bar titled "Renovate" on the left side of Figure 1 represents what I anticipate the renovate cash flows to look like over a seven-year holding period.

Now that I have these two scenarios boiled down to a series of anticipated cash flows over the seven-year holding period, I can introduce the science part. I'm going to

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old friend Internal Rate of Return in this analysis but in a unique perspective. The 'Differential' is the "Renovate" T-bar and the "As-Is" T-bar. For each time period, simply figure out the difference between the "Renovate" scenario and the "As-Is" scenario. Once that is completed for each time period 0 through time period 7, calculate the IRR of this series of differential cash flows. In this instance, the IRR is 12.4%.

A beautiful part of this analysis is that the number reflects. From a technical perspective, it represents the rate of return for each dollar invested (in this instance, \$130,000) in the investment. But in this instance, it also provides a critical decision point. IRR can be viewed as a predictor of risk versus return – is the risk anticipated to be worth the return that the investor is anticipated to achieve? This

## What I C @ PVC

**SLOW SLEDDING** While the residential real estate market has continued to be very active, the commercial market has not seen the same velocity. As we pass the three-quarter mark of 2020, aggregate sales volume for commercial real estate investment properties is significantly off the pace as compared to the last few years. Will the market get bailed out by a huge 4th quarter? Guess we will have to wait and see! –AP

perspective is particularly insightful in this application.

Despite our best efforts, assembling this analysis included some uncertainties. Remember all of that art part stuff – can the property achieve those projected future cash flows, especially in the renovate scenario? Will the renovation costs and time actually match the estimate? Will the property actually be worth the values estimated at the end of the holding period in each scenario? In my example,

the risk versus reward threshold is 12.4%. This can be thought of as a cross-over point; if I am willing to accept a return of 12.4% or less in this specific instance, then I should complete the renovation. But if I don't think that 12.4% is great enough given the anticipated risk this deal will incur, then I should continue as-is and not complete the renovation.

Differential cash flow is a terrific tool to compare as-is versus renovation alternatives. While it relies on a good bit of art to help create the underlying model, the resultant IRR provides a way to bring this analysis back to reality. As real estate assets continue to age, being comfortable using this approach can provide a significant advantage. **P**

*Alec Pacella, CCIM, senior vice president at NAI Pleasant Valley, can be reached by phone at 216.455.0925 or email at apacella@naidaus.com. Follow him on twitter @dausyouknow or on his blog at <http://blog.sbequitiesinc.com>.*

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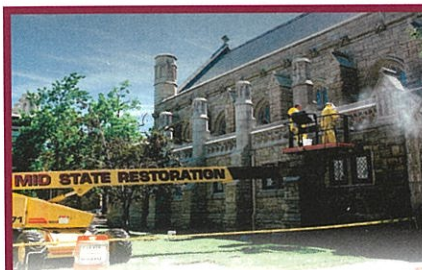
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