A practical guide to modelling uncertainty with Microsoft® Excel

Mastering Risk Modelling is a practical guide designed to provide useful templates for applying risk and uncertainty.

The book:
- Improves financial managers’ abilities with Excel
- Demonstrates a systematic method of developing Excel models for fast development and reduced errors
- Provides a library of basic templates for further development all on an enclosed CD for immediate use

This fully revised and updated guide is an essential companion for all those who work with risk model design and those who want to build more complex models.

New material in this edition includes:
- Thoroughly revised models
- More material on credit risk modelling such as portfolios, VaR and bankruptcy models
- Dual 2003/2007 Excel key strokes
- The use of statistics in Excel – tools and methods
- Advice on capacity to borrow and repay
- Finding optimum mix of risk and return
- Fixed income risk models
- Visual Basic approach

Alastair Day has worked in the finance industry for more than 25 years. He has held both treasury and marketing positions and was formerly a director of a vendor leasing company specializing in IT and technology assets. Following rapid company growth, the enterprise was sold to a public company and Alastair established Systematic Finance plc as a consultancy specializing in:
- Financial modelling – design, build, audit and review
- Training in financial modelling, corporate finance, and leasing on an in-house and public basis
- Finance and operating lease structuring as a consultant and lessor

Alastair is the author of a number of other books published by Financial Times, Prentice Hall, including: Mastering Financial Mathematics in Microsoft Excel and Mastering Financial Modelling in Microsoft Excel, now in its second edition.
Mastering Risk Modelling
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Mastering Risk Modelling

A practical guide to modelling uncertainty with Microsoft® Excel

Second Edition

ALASTAIR L. DAY
Alastair Day has worked in the finance industry for more than 25 years in treasury and marketing functions and was formerly a director of a vendor leasing company specializing in the IT and technology industries. After sale of the company to a public group, Alastair established Systematic Finance plc as a consultancy specializing in:

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- finance and operating lease structuring as a consultant and lessor;
- financial books including those published by the FT such as Mastering Financial Modelling (second edition), Mastering Risk Modelling, Mastering Financial Mathematics in Excel and The Financial Director’s Guide to Purchasing Leasing;
- eLearning material.

More information at www.financial-models.com
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Contents

Conventions xii
Overview xiii
Executive Summary xvi

1 Introduction 1
Scope of the book 3
Example model 5
Objectives of risk modelling 6
Summary 9

2 Review of model design 11
Introduction 13
Design objectives 13
Common errors 15
Excel features 18
Formats 20
Number formats 20
Lines and borders 22
Colour and patterns 24
Specific colour for inputs and results 24
Data validation 25
Controls – combo boxes and buttons 28
Conditional formatting 33
Use of functions and types of functions 33
Add-ins for more functions 36
Text and updated labels 37
Recording a version number, author, etc. 38
Using names 39
Pasting a names table 40
Comment cells 41
Graphics 42
Dynamic graphs to plot individual series 44
Data tables 46
3 Risk and uncertainty
   Introduction 59
   Risk 59
   Uncertainty 66
   Response to risk 66
   Methods 68
   Summary 73

4 Project finance
   Introduction 77
   Requirements 77
   Advantages 79
   Risks 79
   Risk analysis 84
   Risk mitigation 85
   Financial model 86
   Inputs 89
   Sensitivity and cost of capital 94
   Construction, borrowing and output 95
   Accounting schedules 97
   Management analysis and summaries 102
   Summary 110

5 Simulation
   Introduction 113
   Building blocks 114
   Procedure 119
   Real estate example 124
   Summary 130

6 Financial analysis
   Introduction 135
   Process 137
   Environment 137
   Industry 139
   Financial statements 140
   Profit and loss 141
   Balance sheet 143
   Operating efficiency 145
### Contents

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profitability</td>
<td>148</td>
</tr>
<tr>
<td>Financial structure</td>
<td>149</td>
</tr>
<tr>
<td>Core ratios</td>
<td>150</td>
</tr>
<tr>
<td>Market ratios</td>
<td>152</td>
</tr>
<tr>
<td>Trend analysis</td>
<td>152</td>
</tr>
<tr>
<td>Cash flow</td>
<td>154</td>
</tr>
<tr>
<td>Forecasts</td>
<td>158</td>
</tr>
<tr>
<td>Financial analysis</td>
<td>167</td>
</tr>
<tr>
<td>Summary</td>
<td>172</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit risk</td>
<td>173</td>
</tr>
<tr>
<td>Introduction</td>
<td>175</td>
</tr>
<tr>
<td>Cash flow</td>
<td>176</td>
</tr>
<tr>
<td>Cover ratios</td>
<td>176</td>
</tr>
<tr>
<td>Sustainability</td>
<td>180</td>
</tr>
<tr>
<td>Beaver's model</td>
<td>183</td>
</tr>
<tr>
<td>Bathory model</td>
<td>185</td>
</tr>
<tr>
<td>Z scores</td>
<td>186</td>
</tr>
<tr>
<td>Springate analysis</td>
<td>189</td>
</tr>
<tr>
<td>Logit analysis</td>
<td>189</td>
</tr>
<tr>
<td>H-Factor model</td>
<td>192</td>
</tr>
<tr>
<td>Ratings agency</td>
<td>193</td>
</tr>
<tr>
<td>Summary</td>
<td>197</td>
</tr>
<tr>
<td>References</td>
<td>197</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation</td>
<td>199</td>
</tr>
<tr>
<td>Introduction</td>
<td>201</td>
</tr>
<tr>
<td>Inputs</td>
<td>202</td>
</tr>
<tr>
<td>Cash flow</td>
<td>205</td>
</tr>
<tr>
<td>Capital structure</td>
<td>207</td>
</tr>
<tr>
<td>Valuation and returns</td>
<td>210</td>
</tr>
<tr>
<td>Sensitivity analysis</td>
<td>212</td>
</tr>
<tr>
<td>Management summary</td>
<td>214</td>
</tr>
<tr>
<td>Summary</td>
<td>215</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>217</td>
</tr>
<tr>
<td>Introduction</td>
<td>219</td>
</tr>
<tr>
<td>Bond prices</td>
<td>219</td>
</tr>
<tr>
<td>Interest rates</td>
<td>222</td>
</tr>
<tr>
<td>Yield</td>
<td>224</td>
</tr>
<tr>
<td>Duration and maturity</td>
<td>226</td>
</tr>
<tr>
<td>Convexity</td>
<td>230</td>
</tr>
<tr>
<td>Comparison</td>
<td>233</td>
</tr>
<tr>
<td>Summary</td>
<td>236</td>
</tr>
</tbody>
</table>
Overview of components 339
Single asset 341
Two-bond portfolio 348
Simulation 355
Summary 361

Appendix 1: Software installation and licence 363
Appendix 2: Microsoft Office 2007 (Office 12) 369
Index 382
Conventions

The main part of the text is set in Times Roman, whereas entries are set in Courier. For example:

Enter the Scenario Name as Base Case
Items on the menu bars are also shown in Courier.
Select Tools, Goalseek
The names of functions are in capitals. This is the payment function, which requires inputs for the interest rate, number of periods, present value and future value:

\[ =PMT(INT,NPER,PV,FV,TYPE) \]

Equations are formed with the equation editor and shown in normal notation. For example, net present value:

\[ NPV = \frac{(CashFlow)^N}{(1+r)^N} \]

Genders: the use of ‘he’ or ‘him’ refers to masculine or feminine and this is used for simplicity to avoid repetition.
Overview

WHO NEEDS THIS BOOK?

Business has always meant taking risks in order to secure a return. In the last century, this was often a game of chance where outcomes could not be accurately predicted. Developments in computing and theory have led to a big change in how risk and reward is perceived, priced and managed.

Financial modelling has come into its own since the original development of Visicalc and Lotus 1-2-3 as the preferred tool for financial calculations. Many people acquired their first computers in order to complete their budgets in Lotus 1-2-3. The omnipresence of Microsoft Office means that techniques can be demonstrated more simply in Excel than with hand-held financial calculators such as the HP12C or TI BA II Plus.

Banks and financial institutions increasingly use advanced risk management tools to manage portfolios and assess client credit risk. This is reinforced by the provisions of Basel II or Solvency II. Additionally, risk modelling plays a significant part in structured and project finance as a method of identifying and managing potential difficulties. In the corporate sector, directors of UK public companies are tasked with disclosing the main risks facing the company as part of the risk management process. In the US, the provisions of the Sarbanes–Oxley Act mean that critical spreadsheets have to be audited for accuracy. Given the emphasis on risk management, this book mixes financial theory with practice and introduces a number of Excel templates as the basis for more complex risk models.

The requirement for financial modelling is certain to develop further in future owing to:

- advances in computer technology and speed on the desktop and in mobile computing;
- the continued development of more specific risk software (e.g. @RISK and Crystal Ball);
- more historic data being available for analysis within organizations;
- the use of models being a required skill for financial executives and business students alike.
The key objectives of this book are to:

- provide financial managers with practical templates for applying risk and uncertainty to Excel;
- improve financial managers' abilities with Excel;
- demonstrate a systematic method of developing Excel models for fast development and reduced errors;
- provide a library of basic templates for further development as an illustration of the methods.

This book aims to assist two key groups:

1. Excel users with a basic understanding of model design and a wish to extend their Excel modelling skills;
2. Practitioners who want to be able to build more complex models using advanced Excel features.

The areas of responsibility are:

- CFOs and finance directors;
- financial controllers;
- analysts;
- accountants;
- corporate finance personnel;
- treasury managers;
- risk managers;
- middle office staff;
- general managers;
- personnel in banks, corporates and government who make complex decisions and who could benefit from a modelling approach;
- academics, business and MBA students.

Therefore, people interested in this book range from a company accountant who wants to be able to understand investment risk to managers who require more complex models.

The book is international in its outlook and will provide examples relevant to both the UK and overseas.
HOW TO USE THIS BOOK

■ Install the Excel application templates using the simple SETUP command. There is a key to the file names at the back of the book.
■ Work through each of the chapters and the examples.
■ Use the book, spreadsheets and templates as a reference guide for further work.
■ Practise and improve your efficiency and competence with Excel.

THE SECOND EDITION

Since the publication of the first edition, the power and use of spreadsheets has grown together with the need to measure and manage risk. Whilst there are bespoke tools available for decision trees and simulation, the presence of Office on most executives’ desktops means that the Excel interface is widely understood. At the same time companies are finding that models do not always provide the correct answers when applied to securitization, ‘sub-prime’ portfolios or options trading. The interpretation of results and the application of extreme scenarios also need consideration. The requirement is for modelling to promote a decision-making framework rather than provide all the answers.

Systematic Finance models follow a precise design specification and all the spreadsheet models have been rewritten to take account of this uniform approach to layout, colours and method, and to take advantage of more features in Excel. The introduction of Microsoft Office 2007 marks a radical redesign of the Office interface since the Excel versions of the early 1990s. Where possible the methods for Office 2003 and 2007 are shown to allow a transition from earlier Office editions.

Alastair L. Day
www.financial-models.com
# Executive summary

This is a summary of the book by chapter presented in a tabular form.

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Topic</th>
<th>Items</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Overview</td>
<td>Scope of the book&lt;br&gt;Example model&lt;br&gt;Basic statistics in Excel – tools and methods&lt;br&gt;Objectives of risk modelling</td>
</tr>
<tr>
<td>2</td>
<td>Review of model design</td>
<td>Model design and structure – key steps&lt;br&gt;Advantages&lt;br&gt;Disadvantages&lt;br&gt;Modelling objectives&lt;br&gt;Design objectives and mistakes&lt;br&gt;Useful features&lt;br&gt;Auditing methods</td>
</tr>
<tr>
<td>3</td>
<td>Risk and uncertainty</td>
<td>Definition of risk&lt;br&gt;Uncertainty&lt;br&gt;Response to risk&lt;br&gt;Methods used</td>
</tr>
<tr>
<td>4</td>
<td>Project finance model</td>
<td>Sources of risk&lt;br&gt;Forecasting financial data&lt;br&gt;Risk process&lt;br&gt;Methods</td>
</tr>
<tr>
<td>5</td>
<td>Simulation</td>
<td>Simulation methods&lt;br&gt;Building blocks of simulation&lt;br&gt;Procedure and programming&lt;br&gt;Real estate example</td>
</tr>
<tr>
<td>6</td>
<td>Financial analysis</td>
<td>Process&lt;br&gt;Environment&lt;br&gt;Industry&lt;br&gt;Financial statements&lt;br&gt;Profit and loss&lt;br&gt;Balance sheet</td>
</tr>
</tbody>
</table>
Executive summary

- Operating efficiency
- Profitability
- Financial structure
- Du Pont or core ratios
- Market ratios
- Trend analysis
- Cash flow
- Forecasts
- Financial analysis summary

7 Credit risk
- Cash flow
- Cover ratios
- Sustainability formulas
- Capacity to borrow and repay
- Beaver model
- Bathory model
- Z scores
- Springate model
- Logit analysis
- H Factor
- Ratings agencies

8 Equity valuation
- Introduction and methods
- Cash flows
- Capital structure
- Risk factors
- Sensitivity analysis
- Management summary

9 Bonds
- Bond prices
- Interest rates
- Yield, duration and convexity
- Duration and maturity
- Convexity
- Comparison of methods

10 Options
- Reasons to manage risk
- Options
- Options example
- Options hedging strategy
- Options simulation
- VBA approach
- Black–Scholes
- Binomial trees

11 Real options
- Introduction and method
- Project – determining value
- Option to delay a project
- Option to abandon a project
- Option to expand a project
<table>
<thead>
<tr>
<th>Section</th>
<th>Topic</th>
</tr>
</thead>
</table>
| 12      | Equities | Portfolio optimization  
|         |         | Historic data  
|         |         | Returns summary  
|         |         | Simulation to find optimum risk and return  
|         |         | Portfolio  
| 13      | Risk adjusted return on capital | Capital allocation  
|         |         | Risk adjusted return on capital calculation  
|         |         | Inputs and calculations  
|         |         | Sensitivity  
|         |         | Returns  
| 14      | Value at risk | Value at Risk methodology  
|         |         | VAR for a single asset  
|         |         | VAR for a two asset  
|         |         | Three asset VAR  
| 15      | Credit risk and credit metrics | Introduction and theory  
|         |         | Portfolio approach  
|         |         | Overview of components  
|         |         | Single asset  
|         |         | Two bond portfolio  
|         |         | Simulation method  
| Appendix | Appendix | Excel 2007  
|         |         | Software specification  
|         |         | Installation  
|         |         | SFL  
|         |         | File list  

Mastering Risk Modelling
Introduction

Scope of the book

Example model

Objectives of risk modelling

Summary
**SCOPE OF THE BOOK**

*Mastering Financial Modelling*, an earlier book, provides an introduction to Excel financial modelling and shows how to use Excel in a disciplined manner to develop applications. Since spreadsheet models are often poorly planned and developed with significant errors, it provides a specific method for developing applications. This book develops these ideas to include risk analysis and to show how techniques can be added to simpler models in order to:

- make the models more comprehensive;
- accept that the real world is uncertain and models should be able to cope with a range of possible outcomes;
- derive more useful management information;
- understand how the model ‘flexes’ with change;
- act as a further method of checking the model’s outputs.

Financial modelling is the term often used for applications from simple spreadsheets to complex models. In this book, the term *financial model* is used to denote a dedicated spreadsheet written to solve a business problem. Here are two definitions:

1. **Spreadsheet**: Program for organizing numerical data in tabular formats allowing rapid calculations with changing variables.
2. **Model**: Theoretical construct in a spreadsheet that represents numerical processes by a set of variables and a set of logical and quantitative relationships between them.

The basic need is to answer a business problem such as the minimum budgeted cash flow over the next 12 months, the net present value of an investment or the price of an option. The spreadsheet does not simply hold data but is organized as an analytical tool for decision making. The objective is often to represent a closed system such as the investment in new equipment, together with forecast revenue and expenditure. The model therefore represents a computer program written to solve the problem, which is different to using the spreadsheet merely for holding data or adding up a few numbers. The model could be written in Visual Basic or C++ but it is usually quicker, easier and more intuitive to develop a model in Excel.

You could also consider a spreadsheet for personal use where you can keep in your head the workings of the sheet. Where a spreadsheet requires distribution to others then it should be considered as a model where there should be some rules in how it is developed and presented.
Models underpin decisions and the basic risk process could be described as:

- defining objectives, since you need to be clear about objectives and output answers or reports;
- identifying all possible courses of action to weigh up advantages and disadvantages;
- assembling data or variables that are relevant and understanding the extent of the accuracy and relevance of the data available;
- building the computer models to assist and organize any decisions;
- assessing the decision and comparing options by using the data outputs;
- implementing a decision and monitoring the subsequent variances to the original plan;
- monitoring the effect of decisions and if the project fails ensuring that lessons can be learnt.

However much effort is expended on the ‘correct’ variables for the model, there must always be some potential for error or variance since a model is only a best guess of the likely outcomes. Risk here is often considered to be the potential downside resulting from a business decision.

The advantage of Excel is that most people have had some exposure to the language and are comfortable with the interface and commands. Since there is a similarity of presentation within the Microsoft Office suite, users can write simple spreadsheets quickly. The disadvantages of such a free approach are when decisions need to be taken or when an application needs to be distributed or maintained. Whilst you can write fragments of code for your own use, any files for use by others should be clear and auditable. In particular, the disadvantages of many Excel models are as follows:

- wide range of abilities on the part of the authors;
- most people use less than 10 per cent of capability (e.g. they may never have used the statistical or array functions or inserted a pivot table);
- a lack of standard structure or design method making auditing all but impossible;
- a poor structure leads to a lack of clarity and confusing output reports;
- it is easy to make mistakes since errors can lie undetected (for years!) – users are often overconfident about their abilities and often assume their code is error free;
- Excel is not a recognized programming language and therefore there are no standards for naming cells or documenting the work;
- duplication of effort arises since most users do not develop templates for specific types of applications;
- spreadsheets do not cope well with text (but then there is the option of Microsoft Word).

Companies usually assume that executives are proficient in Excel since they have qualified in finance, but this is not always the case. Financial modelling demands a disciplined approach just like any other programming language. Since Excel does not have to be compiled before use, people often produce disorganized designs with little regard for future development or maintenance. For instance, dates can be hard coded and of course will work this year, but next year you have to search through the model and change all entries. Similarly, authors often mix numbers and formulas in the same cell so that others cannot work out where to input data and of course the author finds it impossible to check for mistakes. Owing to a lack of clear objectives, the model may also not even produce a clear answer to the original question.

Most financial models consist of input variables, calculations and some kind of output. The objectives of modelling should include some of the following:

- analysing and processing data into information;
- modelling a considered view or forecast of the future (e.g. project cash flows);
- processing data quickly and accurately into clear and relevant management information;
- testing assumptions in a ‘safe’ environment before mistakes are made (e.g. project scenarios);
- supporting management decision making through a structured approach. (Modelling often produces too much information and one objective may be to reduce the detail in summaries.);
- understanding more precisely the variables or rules in a problem to ensure that the whole system is modelled;
- learning more about processes and the behaviour of variables, in particular the importance of key variables and how they behave;
- discovering the sensitivity and risk inherent in the model.

### EXAMPLE MODEL

Figure 1.1 shows a simple example of revenue and costs. The inputs are shown tinted grey and the schedule below calculates the net revenue at the end of the five-year period. This is the sum of cells C27:H27.
This is a deterministic or input–calculation–output model since the inputs or variables are fixed. For example, sales growth is 3 per cent from a base of 1000. These figures represent the best estimate of the value of each input variable but they are still single points rather than ranges.

**OBJECTIVES OF RISK MODELLING**

The deterministic model above may not provide all the answers. The future is uncertain and there are factors that are within the organization’s control and those, such as the weather, over which it has little or no control. Whilst analysts may wish to control or know the future, risk modelling seeks to apply mathematical theory to the problem. In the simple problem above, the organization may wish to know how likely it is to achieve the forecast net revenue. Corporate finance theory advises that organizations and individuals are rational and risk averse. This means that they take a defined risk for a desired return. Translated into this example, this could be rephrased as the forecast net revenue and the possible variance or standard deviation. There would be no point in accepting this budget if possible results ranged from 100 to 700 since a result of 100 would be unacceptable. The managers may then wish to know what the chance is of the forecast net revenue falling below 200. Developing a more sophisticated model could help to uncover the risk and uncertainty in the budget.
To illustrate the concept of return and variance, Figure 1.2 shows the result of 1000 random numbers on the Normal_Distribution2 sheet based on a mean of 584 and a standard deviation of 50. The data were generated using the random number generator in Tools, Data Analysis.

The table uses a FREQUENCY function as an array to count the values within pre-defined ranges.

\[ \text{FREQUENCY}($C$6:$C$80, $E$6:$E$20) \]

Note that the distribution has extended tails on either side of the mean. Analysis concentrates on the downside and the number of potential results that fall below a required level. Table 1.1 uses Tools, Data Analysis, Descriptive Statistics to generate a description of the distribution.
Risk models provide:
- an understanding of risk since a single answer may not be enough for decision making;
- multiple answers to better understand the range of outcomes;
- the inclusion of elements of risk or uncertainty (e.g. future cash flows);
- the chance to test inherently inaccurate forecasts;
- likely outcomes under a number of different assumptions or scenarios;
- information on the behaviour of key variables.

Modelling helps to identify risk since you need to be able to test all the variables. Sales forecasts are notoriously optimistic and so what happens if you downgrade the timescale when an item of equipment starts to generate revenue? The percentage is a variable that must be modelled to gauge its effect on the eventual answer.

Alternatively, risk could be divided into:
- risk, which can be measured and is subject to probability mathematics;
- uncertainty, which consists of random events or variables (e.g. the weather) or which emanates from a lack of knowledge about the system being modelled (model risk). In the latter case variables are not included in the model, but could have a significant impact on the outcome.

The notion that risk exists in all business decisions is therefore key; however, risk may not always be negative since simple analysis may lead to missed opportunities. Analysis may confirm that the potential downside is minor or
that a project is too pessimistic and greater sales growth is possible. One approach is to review the impact and likelihood as a matrix and try to group and prioritize risks. The approach then hinges on three questions:

1. What is the source of the risk?
2. What is its likely impact and likelihood?
3. Can it be managed, priced, reduced or handled in some other form?

Management can then concentrate on those variables that fall in the top right-hand box of the matrix shown in Figure 1.3.

Excel provides techniques and functions for generating multiple answers and dealing with uncertainty. These include:

- Data tables, which are one- or two-dimensional grids of possible answers. Since most models include a few key variables, this allows more information of how a model ‘flexes’ with variation in key variables.
- Scenarios which allow the inclusion of individual cases within the model (e.g. best case, worst case).
- ‘What if’ analysis involving the use of several scenarios with probabilities assigned to them. For example, you could value a company based on several future scenarios of market penetration and assign probabilities to each scenario. A single net present value (NPV) could then be transformed into an expected net present value (ENPV) based on probability.
- Decision trees using probability mathematics and utility theory to place a value on decisions.
- Optimization techniques such as Solver where the desired result is known but there is uncertainty about the inputs required.
- Simulation techniques involving the generation of large numbers of possible scenarios to find the range of possible results. Simulation is considered in more detail in Chapter 5.

One other factor in modelling is perhaps the perception of risk in the process. In only relatively few circumstances are the probabilities and possible outcomes completely clear and risk is bounded by perception. Modelling is one part of the process and you have to look at the perception of risk and the potential upsides and downsides. One individual may be less risk averse than another, which will have an effect on the process and the outcome.
This chapter has introduced some ideas of risk and uncertainty and the objective in the following chapters is to demonstrate how single-answer deterministic models can be made more useful and provide better management information. The following chapters provide a number of techniques and discuss several applications:

- projects and investments
- financial analysis
- credit and credit risk
- portfolios
- equity valuation
- fixed income
- derivatives.
Review of model design

Introduction

Design objectives

Common errors

Excel features

Formats

Number formats

Lines and borders

Colour and patterns

Specific colour for inputs and results

Data validation

Controls – combo boxes and buttons

Conditional formatting

Use of functions and types of functions

Add-ins for more functions

Text and updated labels

Recording a version number, author, etc.

Using names
Pasting a names table

Comment cells

Graphics

Dynamic graphs to plot individual series

Data tables

Scenarios

Spreadsheet auditing

Summary

File: MRM2_02
INTRODUCTION

A book on modelling would not be complete without a chapter on model design. Modelling should help with crystallizing the variables in a particular problem and clarifying the calculations and outputs required. As stated, models are often ill thought out and therefore may not answer the problem or be flexible enough for further development. As institutions develop larger libraries of Excel models, it is becoming increasingly important to build in future maintenance into modelling.

DESIGN OBJECTIVES

Users should develop a systematic method for developing spreadsheet models. Initial questions should include:

- What is the overall objective of the model?
- What reports or outputs are needed?
- What is the key question to be answered?
- Who will use it?
- What are the components of the problems and how can the problem be sub-divided into smaller sections?
- What should be the overall structure of the model?

The rule is to spend more time on initial planning in order to save time later. The aims should be:

- A clear layout with easily visible inputs, calculations and outputs. Users need to understand the structure quickly: otherwise they tend to get frustrated. Badly designed models can cloud thinking rather than enhance understanding.
- A clear area for user inputs, in one place with a distinctive input colour.
- Easy-to-understand workings with areas set aside for derivation of interim variables.
- Simplicity in the formation of cell formulas. Some spreadsheet users appear to think it is good practice to make the cell formulas as complex as possible. This only makes the model difficult to understand and more costly to maintain.
- Consistency in approach and method. You will notice that all the spreadsheets in this book follow a consistent design method. The method has been developed over a number of years and it works well. For example, there is always a cell name called ‘Version’ or ‘Contact’, and a title at the top left of every sheet (see Figure 2.1).
Ease of use so that users do not have to understand the full structure of the model. For example, it is always useful to have a management summary close to an inputs area. As you change variables, you get immediate feedback on the answer. This saves clicking along several sheets to the answer.

Future ease of maintenance and modification through a modular design. This means that you can add more features as needs change, without a complete redesign.

To reduce code as far as possible by not calculating any answer more than once. For example, you calculate the dates for the top of the schedule on the first schedule and then look them up on all other schedules. This is true also of text labels where the first instance should be entered and then further instances looked up from the first. The objective is always to reduce the amount of ‘hard coding’ to ensure that all changes cascade through the model.

In most cases, a single point model does not provide enough information. A model should demonstrate how the answer varies or ‘flexes’ when you change key variables.

Moving on from variances, the model should cope with levels of risk and uncertainty. This book provides techniques for widening the scope of models with risk techniques.

Precise and clear management reporting through the use of sensitivity or charts in order to demonstrate clear analysis. The ultimate answer needs to be clear and accessible to any user. You should bear in mind that different users have varying priorities.
COMMON ERRORS

Below is a checklist of common spreadsheet errors encountered when auditing and checking models. This list is not exhaustive, but merely serves to confirm the weaknesses exposed by poor design and method.

- No form of layout with inputs, calculations and outputs clearly marked.
  A common mistake is not to put all the inputs together and mark the areas as inputs, calculation and output.
- No inputs section since it is always clearer to set up an inputs area or sheet and bring together all the key variables.
- No specific colour for inputs and results. This book uses bold for inputs and grey boxes for outputs. This improves understanding since you expect certain elements on all sheets. In Excel, blue cells are always inputs.
- No use of names for key variables since it is usually clearer to name the main variables in the inputs section. Formulas throughout the rest of the workbook are then easier to understand.
- No borders or shading leading to a bland design. You can quickly include simple borders and colours to improve the appearance if you keep the Formatting toolbar visible. The models in this book all follow the same principles of tint and appearance.
- No data validation of inputs to allow users to enter any value. Using Data, Validation, you can allow different data types and set maximums and minimums or other operators (see Figure 2.2).

![Data validation](Figure 2.2)
A mixture of number formats used on the same sheet with differing numbers of decimal places. Users also often use numbers and decimals as percentages on the same sheet. You can save custom number formats (see Figure 2.3), which can be useful, for example for adding inputs. It is possible to use the syntax to create new formats using these rules:

Syntax: "Positive";"Negative";"Zero";"Text"

For example, 12 months could be entered as #0 “Months”.

No version number or author name to show the exact version being used. It is a good idea to have a version number and record the differences.
between one date and another. In a few months’ time models should produce the same answers as today. It is a good idea to have a sheet in a model to record changes from one version to another as a form of document control.

- No menu system or macro-driven buttons for easy navigation around a workbook.
- Users often mix numbers and formulas in the same cells. The calculation area of the model should have no ‘hard’ inputs and the only input numbers should be in the inputs area. Any mixture leads to auditing and consistency problems as below:

\[=E16\times1.05\times1.02\]

- More than one formula per line is a common problem since again it makes spreadsheets hard to understand. On a cash flow model with months as the column headers, you expect the same formula for each month rather than a mixture.
- Cell formulas can be overwritten with numbers where users have not checked sheets for consistency and allowed errors.
- Labels are sometimes hard coded and it makes sense to make labels as dynamic as possible. For example, it makes more sense to label a cell with a dynamic label such as ‘Price with a volatility of 20 per cent’ rather than ‘Price’.
- No use of graphics in reporting in order to show clearly the results. Most people are usually inefficient in understanding grids of data and the important results are best confirmed by graphics.
- No commenting of individual cells to show workings or provide explanations. This can be achieved by Review, Comments or the use of Data, Validation. In the latter case, you select the second tab for input message. Here you can insert a message, which will be displayed when you click on the cell.
- No conditional formatting to highlight answers or change the cell formatting dependent on the answer. This is a useful feature of Excel since you can establish rules for each cell.
- No use of functions to reduce the amount of code and the possibility of errors. Whilst you can calculate monthly rentals, such as the formula below, it is usually better to use a built-in function such as PMT:

\[=1/\left(\left(1-\left(1/(1+\text{Monthly}_\text{Rate}\right)^\text{Term}_\text{Months}\right)\right) /\text{Monthly}_\text{Rate}\right)\]

- Sheets are often not set up for printing. Good design means thinking about the output and making sure that the information can be printed out.
Management reporting or summary is often unavailable. For example a complex model usually contains too much information to be accessible to users of different levels. A summary demonstrates the answers to key questions without the levels of detail in the rest of the model. For example, a project finance model could contain a summary of the costs and potential net revenues to fund debt and equity. The important ratios such as return on equity and debt service covers could also be shown.

Following on from management reporting, sensitivity analysis helps to show the behaviour of the model to changes in variables. Forecasts are often too optimistic and you need to test the model to ensure that the inputs are sensible.

Documentation or explanation on how the model works is often omitted. For the purposes of maintenance, details of variables, key calculations, structure of the model and any other relevant information can be presented as notes on a separate sheet in the workbook.

**EXCEL FEATURES**

The model is MRM2_02.xls as shown in Figure 2.4. Each of the sections in this chapter is covered on a sheet in the model. Open the file and click along the bottom to see the progression of sheets.

This is a simple net present value model which adds up the cash flows for a period and multiples them by a 10 per cent discount factor. The net present value in cell C14 is gained by adding up the discounted cash flows.

![Original present value model](image)
If you go to Formulas, Formula Auditing, you can select Show Formulas, which allows you to see the formulas. Alternatively, you can press Ctrl and ` together and this toggles between view formulas and normal view.

**Office 2003 – Tools, Options, View or Tools, Formula Auditing, Formula Auditing Mode**

As you can see, this is only producing a net present value based on the cash flows using the formula:

\[
Period\_Factor = \frac{(1)}{(1+10\%)^{Period\_Number}}
\]

Figure 2.6 shows the formulas view displaying all the cell references.
FORMATS

The model is presently a mixture of inputs and calculations (see Figure 2.7) and the first job is to reorganize the layout. This involves:

- inserting lines and moving the inputs;
- referring to the inputs in the cash flows and calculations;
- labelling where possible to look up the values in inputs, for example B9 is now C3;
- correcting the factors with an input;
- using different fonts and typefaces to break up the monotony.

The title, inputs, summary and answer are now clear in a bold typeface and the model follows a defined layout (see Figure 2.8).

NUMBER FORMATS

The number formats are inconsistent with no separators and two different sets of decimal places.
Go to Home, Number, Number, More Number Formats (Excel 2003 – Format, Format Cells, Number) to change the default settings (see Figure 2.9).

You can experiment with different custom formats where positive, negative and zero is separated by semi-colons. Colours are inserted in square brackets. Text is enclosed in inverted commas (e.g. Format) so that ‘years’ is added to the number: 0 “years”. You insert your custom format in the Type box or amend an existing format.

This extract in Figure 2.9 shows the accounting format with positive numbers slightly set to the left and negative numbers in red with brackets around them. Zero is a dash to avoid confusion or schedules of zeros. This type of format is easy to read on laser printers whereas a minus sign is often hard to read on negative numbers.

Accounting style format: _-* ,##0.00_;[Red] (#,##0.00);-* "" _-

The effect is to control the view of the numbers to a maximum of two decimal places. This format can be simplified to: #,##0.00 ;[Red] (#,##0.00); -
Lines and borders assist in breaking up the cell code and make the model look more interesting for the audience both on the screen and in printed output. It is best to keep the Formatting toolbar visible (see Figure 2.10). In Excel 2007, these controls are under Home. In Excel 2003 go to View, Toolbars, Formatting to show this toolbar. This saves always going to Format, Cells, Borders, etc. to add lines.

Figures 2.11 and 2.12 show highlighting cells and then applying a border from the toolbox. Thick lines are placed around the main sections and double lines to indicate a total.
2 - Review of model design

Borders

![Figure 2.11](image)

Completed borders

![Figure 2.12](image)
COLOUR AND PATTERNS

Colours and patterns also help to define inputs and outputs. In Figure 2.13 a neutral colour is used for the inputs and grey for the answers, although the screen colours do not show up here. Notice that there are more colour options in Excel 2007 through the use of themes than are present in earlier versions of Excel. These colours are personal, but it is important to be consistent in the use of colours and formats.

Specific colours for inputs show where data is required. The author always uses blue for inputs, green or black for totals and red or black for calculated results (see Figure 2.14). Colour should be used sparingly as the effect can be too garish for most tastes. Colour is used for function not decoration.
Office 2007 – Home, Font, Theme Colours

With limited colour, the model becomes much clearer for the user and forces the author to keep inputs together for the sake of consistency. The model is now organized and easier for user input than the original model.

DATA VALIDATION

Data validation allows you to set limits for cells so that if you want a date, the user can only enter a date, or if you want a seven-character text string, the user has to enter this to proceed. In Excel 2003, this is accessed using Data, Validation on the main menu bar (see Figure 2.15).

Office 2007 – Data, Data Tools, Data Validation

In this case, it would be a good idea to limit the three inputs as follows:

- Capital value: Positive number greater than zero
- Periodic cash flow: Positive number greater than zero
- Discount rate: Positive number between 0 and 1, i.e. 100 per cent.

The dialog box has three tabs (see Figure 2.16): for settings, an input message when the cursor is close to the cell, and the error alert to be shown on
incorrect entry. You can choose not to show the Input Message by deselecting the box.

![Validation settings](Figure 2.15)

The Error Alert (see Figure 2.17) shows if you enter a wrong figure and will not let you proceed until you comply with the validation terms. This means that the capital value should always be a positive figure, errors are avoided and auditing becomes easier. Note that you should always use Stop as other options allow you to proceed with incorrect data.

![Validation: input message](Figure 2.16)
Validation error alert

Figure 2.17

Paste Special validation

Figure 2.18
Since the periodic cash flows share the same validation, you can Copy and then go to Home, Paste, Paste Special, Validation (Excel 2003 – Edit, Paste, Paste Special, Validation) rather than typing in all the parameters again (see Figure 2.18).

The final validation is simply to ensure that the discount rate is less than 100 per cent. The effect is to narrow the inputs and hopefully ensure that a user will get the correct answers. If he tries to enter a discount rate of 120 per cent, the error message shown in Figure 2.19 appears.

Again, this is simply looking at the model from a user standpoint and trying to coach the users on what they are required to do to get satisfactory answers. Many auditing errors arise from incorrect inputs and this is one way of controlling potential errors.

**CONTROLS – COMBO BOXES AND BUTTONS**

A further tool to speed up inputs and assist users can be found under Developer, Controls, Insert, Form Controls (Excel 2003 – Forms toolbar under View, Toolbars). These are the same controls, which you also find in Access or Visual Basic. In this example, you might wish to allow the user to input a discount rate between 8 per cent and 12 per cent at 0.5 per cent intervals. This cannot be done by validation and a different approach is needed. Validation will only permit an upper or lower value.

The first stage is to insert a workings area at the bottom of the sheet and to cut and paste the discount rate into it (see Figure 2.20). This is to ensure that the model continues to function when a control is placed at cell C7.

The Workings box shows an interval and then rates starting at 8 per cent and incrementing by the amount of the interval (see Figure 2.21).
The finished workings box shows the discount rates between 8 per cent and 12 per cent. The interval is not ‘hard coded’ and is dependent on cell C26. Whilst these are variables, most users do not need this detail and so these items are placed in the workings area and clearly marked.
The combo box control returns a number for the index of the selection. Here there are eight possible selections and the index number will be placed in cell C27. If you click on the Combo Box in the toolbar, you can draw a combo box in cell C7.

You have to tell the control where to get the input information from and where to put the result. Here the discount rates that need to be displayed are in B28:B35 and the result should be placed in cell C27 (see Figure 2.22).

The final stage is to link the discount rate cell C28 with the index cell C27. Since C28 will now be calculated, the colour has been changed to red to avoid confusion. This requires a simple function called OFFSET from the Lookup group, accessed by selecting Formulas Insert Function (Excel 2003 - Insert Function).

The OFFSET function allows you to nominate a starting cell and then go down by X rows and across by Y columns and return the value (see Figure 2.23). Here the example should start at cell B27 and go down by the number of rows returned by the control. You start at B27 and go down by C27 and no columns (see Figure 2.24). This should return the discount rate to be used in the present value calculations.
Paste function

![Figure 2.23]

Offset

![Figure 2.24]

2 · Review of model design
The combo box controls the user input and makes it faster to select the individual discount rates (see Figure 2.25). Note that a user could still input data to cells B27, C26 and C27. The combo box runs a macro or routine to update the cell, but does not protect it.

There are other controls in the Developer toolbox that you could use to make the inputs more intuitive. For example, spinners and scrollbars allow you to increment a value by one click and provide an input variable for specifying the click value.

Office 2007 – Developer, Controls, Insert, Form Controls

The Scroll Bar sheet shows the inclusion of these two controls as an alternative. Here you right click to format and select an upper and lower value and an incremental value. The solution is slightly more complex since the control does not accept fractions. You therefore have to calculate the eventual discount rate from the position of the scroll bar.

The scroll bar is set to accept values from 1 to 8 and to increment by one. The cell link is cell C26 and the OFFSET function in cell C27 uses this index number (see Figure 2.26).
Conditional formatting allows you to display cells differently depending on the value in the cell. This means fonts, borders and patterns. In this example, it could be useful to introduce a management test to show if the project succeeds or fails and then display the result accordingly. You can set various types of rules in Excel 2007 and this is more comprehensive than previous versions. (see Figure 2.27).

There is now a new cell C7, which defines the management test requiring a minimum net present value of 7000. The formatting is set using Home, Styles, Conditional Formatting. In Excel 2003 this is found at Format, Conditional Formatting. The result changes to pink when the value is greater than or equal to the value in cell C7. The result is shown in Figure 2.28, where, at 9.5 per cent the project achieves the goal.

You can add further formats by clicking on Add and also copy using Edit, Paste Special, Formats.

Use of functions and types of functions

The model already includes the function OFFSET, but the net present values could more easily be calculated using the NPV (net present value) function. At present, there is code in cells C17 to H19, which means there are potentially 12 mistakes. The goal should be to reduce code in order to reduce the potential for errors. The solution at present is equivalent to using Excel instead of a set of discount tables.
**Figure 2.27**

Conditional formatting

![New Formatting Rule dialog box](image)

**Figure 2.28**

NPV result

![NPV result](image)
You can use Formulas, Function Library (Excel 2003 – Insert, Function from the Menu Bar or the Standard toolbar) and functions are divided into sections for easy reference. Select Financial Functions and scroll down to NPV (see Figure 2.29).

The NPV function discounts outstanding cash flows and so the years one to five are selected. You then add the cash flow at period 0.

\[ =\text{NPV}(C25, \text{D15:H15}) + C15 \]
This results in the correct answer of 7511.85 at the discount rate of 9.5 per cent.

Notice the spreadsheet is now much simpler with a reduction in the necessary rows. You can always obtain help on the functions by pressing the Question Mark (see Figure 2.30). Within the Help for the selected function, you can view a listing of alternative functions by selecting See Also.

**ADD-INS FOR MORE FUNCTIONS**

The typical installation of Excel contains the basic functions, but more functions are available in the Analysis Toolpak. For example, NPV assumes that each period contains the same number of days. XNPV allows you to enter dates when the cash flows are received.

To ensure that you have access to extended functions go to Office Button, Excel Options, Add-ins (Excel 2003 – Tools, Add-Ins, Analysis Toolpak). Tick this item and press OK to install it. The Toolpak will then be available every time you open Excel. If it is not available as an add-in, you will need to reinstall Excel using the original Office disks.
The next sheet uses the XNPV function and EDATE, which is a date function that advances the date by multiples of one month at a time (see Figure 2.31). You provide a start date and then the number of months to be advanced. Since the interval is a variable, there is a new control in the inputs area which points towards a set of workings to derive the number of months for the EDATE function in cells D13 to H13.

Again, you add the initial cash flow and the result is 7502.58, which compares with the previous answer of 7511.85.

**TEXT AND UPDATED LABELS**

You could improve the clarity of the model by allowing the labels to update and providing some text on the result. If the net present value is above the limit, then you could have a label informing the user. The Text sheet in the model provides two improvements:

1. it shows the discount rate in the label;
2. it provides feedback on the calculated net present value.

Cell B20 is now an updated label. The Text function converts numbers to text following the number formats. This will display the percentage to two decimal places. The ampersand (&) is used to join or concatenate the text strings.
“NPV at ”&TEXT(C31,”0.00%”)

The management feedback uses an IF function to display one text string if the project is above the limit and another if it is below. In order to reduce the code, the IF statement substitutes a zero above or below depending on the net present value.

=“NPV is ”&IF(C20>=C7,”above”,“below”)&” the limit of ”&TEXT(C7,”#,##0”)

The spreadsheet will now inform the user of the discount rate used and provide a comment of the answer (see Figure 2.32). Excel takes the decision rather than the user having to spend time reviewing the result.

**Figure 2.32**

**Text labels**

**RECORDING A VERSION NUMBER, AUTHOR, ETC.**

As detailed in Chapter 1, there should be some documentation as part of the model. With complex models, it is good practice to record version numbers, author name and contact details together with notes on how the model works. As a model develops over time, you can record the changes between one version and another. This is particularly important if you find a major error. In addition, it means that a version reference is at the top of every sheet that you printed out (see Figure 2.33).
This section could of course run to several pages with diagrams and notes. It is, of course, better to put the notes in the model and you can always hide a sheet by selecting Format, Sheet, Hide.

**USING NAMES**

Names can make formulas easier to understand: for example rather than using cell C28, you can have PeriodInterestRate. The standard cells above such as Version, Author, etc. would also be better standardized across all your models such that =Version will always insert the version number. The files with this book use several standard names such as Author, Company, Version and Product.

You can use Formulas, Defined Names, Define Names (Excel 2003 – Insert, Name, Define) to define names; alternatively, Excel will create multiple names using the labels to one side of the selected cells using Create from Selection (see Figures 2.34 and 2.35). This creates the names in the left-hand column (e.g. Start_date). The function is now easier to understand since it refers to the periodic interest rate in cell C20.

![Documentation](image1)

![Create names](image2)
If you copy a sheet containing names, then the new sheet will continue to refer to the original sheet. Similarly, if you copy a sheet to a new workbook, Excel creates a link between the two workbooks. You can always check for links by selecting Edit, Links. If this is the case, you have to remove them manually and reinsert the cell formulas. To help with names, Excel 2007 has a more comprehensive Names manager, which allows you to manage them more effectively than in previous versions.

**PASTING A NAMES TABLE**

It is useful to paste a list of names as part of the documentation to provide an audit trail. Any deleted names should be removed so that all names are current and usable. You select Formulas, Defined Names, Use in Formula, Paste Name, Paste List (Excel 2003 – Insert, Name, Paste, Paste List). (See Figure 2.36.)
COMMENT CELLS

Commenting cells allow notes to be placed against cells to provide background or help the user. Go to Review, Comments, New Comment (Excel 2003 – Insert Comment) or right mouse click on a cell. Enter a text message and then format the font size and colours (see Figures 2.37 and 2.38).
You can control how Comments are viewed using Office Button, Excel Options, Advanced, Display (Excel 2003 – Tools, Options, View). You can turn them off, show the indicator or have the comment permanently visible. In the second case, the cell displays a red triangle at its top right-hand corner. Again, comments can assist in explaining important formulas or telling the user what to do. For example, some people use numbers for percentages and then divide by 100 in code. A comment could inform a user to insert a number rather than a percentage.

**Figures 2.38**

**Comments options**

Graphics assist in management reporting and showing a user important results. The example now adds a cumulative cash flow and graphs the cash flow. You can use Insert, Chart, Chart Type (Excel 2003 – Insert Chart). (See Figure 2.39.)
This is just charting a single series and so a column graph will produce a clear printout. You can right click the series and review the source data. Each series should consist of a reference for the names, X and Y axis (see Figure 2.40).
This will plot the cumulative cash flow values with the dates as the X labels across the chart (see Figure 2.41). The name is also in code as Graphics!$B$20. If you click on Next, the chart title and legend titles are displayed. Excel will not allow you to enter a cell reference against the name, but you can do this when you have finished the Wizard.

If you right click the X axis, it can be formatted so that the tick marks are low as an option in Patterns. The chart title is entered as =Graphics!$B$20 so that it updates itself. This is important since you do not want labels to be ‘hard-wired’. The objective is always to reduce the hard coding and allow changes to cascade.

Payback is a non-time value of money method of investment appraisal. Essentially, you check how long it takes to get your money back. Figure 2.41 shows clearly that this will happen in year four.

**Figure 2.41**

**Cumulative chart**

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
</tr>
</thead>
<tbody>
<tr>
<td>18</td>
<td>Net cash flow</td>
<td>$100,000.00</td>
<td>$28,000.00</td>
<td>$28,000.00</td>
<td>$28,000.00</td>
<td>$28,000.00</td>
<td>$28,000.00</td>
</tr>
<tr>
<td>19</td>
<td>Cumulative total</td>
<td>($100,000.00)</td>
<td>(72,000.00)</td>
<td>(44,000.00)</td>
<td>(16,000.00)</td>
<td>(12,000.00)</td>
<td>(4,000.00)</td>
</tr>
<tr>
<td>21</td>
<td>NPV at 9.50%</td>
<td>1.87/25</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>NPV is above the limit of 7,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**DYNAMIC GRAPHS TO PLOT INDIVIDUAL SERIES**

A single chart is very useful, but a dynamic graph would allow you to review any of the rows. This is a simple example but this approach would be useful for examining individual lines in a cash flow or company analysis.
Office 2007 – Developer, Controls, Insert, Form Controls (Office 2003 – View, Toolbars, Forms)

The steps are:

- Set up a combo box with the inputs as the labels to the individual lines and a cell link to update (F25).

- Use an OFFSET function to look up the relevant line using the cell link from the control. The OFFSET function starts from row 14 and moves down by the number in cell F25.

- Point the chart at the look-up lines and ensure that the series and chart names are not hard-coded. The name of the series is cell B27 to ensure that it updates. The formula in cell B27 is:

  \[ \text{OFFSET}(B14, F25, 0) \]

Figure 2.42 displays the combo box with each of the available rows.

In the file, there is also a sheet called Dynamic_Graph_Example, which puts together a table of figures, a combo control, an OFFSET function and a graph to display the results (see Figure 2.43).
The model so far has produced a single-point answer: the capital and cash flows discounted at 9.5 per cent result in a net present value. The model would be more powerful if you could display the net present values for a range of discount rates simultaneously on the same sheet. This can be achieved by the array function Table, which can be found under Data, Data Tools, What-if Analysis (Excel 2003 – Data, Table).

The steps are:

- Set up a grid with an interval as an input.
- Enter the function.
- Graph the results.

The dynamic graph has been moved down on the Data_Tables sheet to make room for the data or Sensitivity table (see Figure 2.44). The grid consists of an interval and then a row of discount rates in line 29. The 9.5 per cent is an absolute and is marked as an input. The cells on either side are
plus or minus the interval. Cell B30 looks up the answer in cell C22. When complete the data table will show the net present value at each of these interest rates.

The next stage is to highlight the grid area and enter the data table (see Figure 2.45).

![Sensitivity table](image)

**Figure 2.44**

The next stage is to highlight the grid area and enter the data table (see Figure 2.45).

![Table function](image)

**Figure 2.45**
Cell C81 in this interim version is the periodic discount rate derived from the combo box. Excel inserts the figures in the grid and the answer of 7502.58 at 9.5 per cent is visible. This shows the sensitivity of the final answer to changes in the discount rate (see Figure 2.46).

Table is an array function, which means that you cannot alter individual cells within the group. If you try to alter any of cells C31 to H31, you will get an error message. Similarly, if you copy a data table from one sheet to another, only the values will be pasted. You have to highlight the grid and reinput the table on the new sheet.

Rather than create a further chart, this example uses the existing ‘dynamic graph’ and increases the inputs to line 31. Line 31 is simply a variance to the original answer. The OFFSET function merely requires the rows to index down by and so no other programming changes are necessary.

Data tables can be single-dimensional, as above, or two-dimensional. There are often two dominant variables in a model and this approach allows you to ‘flex’ the variables. It is important to use a grid to set out the table and best not to hard code the interval. This means that you can always change the interval quickly and see on any printouts the interval used. In addition, it is best practice to input the current value for the variable in the middle so you can see the values on either side. Some applications with the book then use a macro to update the input values on the table by copying down the values from the inputs area.

**Figure 2.46**

Composite table
SCENARIOS

If there were several versions of this simple example project, producing multiple spreadsheets would be wasteful and potentially introduce errors. Similar spreadsheets tend to diverge over time and be more difficult to maintain. Scenarios provide the facility to ‘remember’ inputs so that you can load them at any time. As an added bonus, Excel will produce a management report based on the scenarios.

Scenarios are accessed using Data, Data Tools, What-if Analysis (Excel 2003 – Tools, Scenarios), Add (see Figure 2.47). There are saved cases on the Scenarios sheet.

You can select multiple cells by separating them with a comma (or a semicolon in continental Europe). When you have selected them, Excel allows you to review the values in each of the cells before saving them. Press Show to display the scenario.

There are further examples on the sheet which vary only the capital value and periodic cash flow. If you press Summary as in Figure 2.47 and select
cells C22 and E22 as the result cells, Excel produces the management report shown in Figure 2.48.

It is always best to start from a Base Case and vary these inputs rather than developing further scenarios. Here Worst Case and Best Case vary only two cells from the original scenario. It is therefore clearer what exactly changes from the initial estimate.

![Scenario report](image)

Only one cell is named on this sheet: this is Scenarios!$C$22, which shows as a name in line 17 rather than a cell reference. This is a static or values only report, which will not change if the underlying values change. If the model changes, you have to run the report again. It also acts like an audit trail since you could print this out and keep it in a file to show what inputs produce the range of results.

**SPREADSHEET AUDITING**

There are a number of techniques which can be used separately or together to check the inputs and calculations in a model. It is of course important that any model is free of errors which could arise from:

- technical design, such as high-level analysis of ideas or principles;
- conceptual errors, for example, flaws in logic, rationale or mechanisms;
user errors, such as individual cell coding errors or overwritten cells;
compounded errors, such as errors on errors, especially in distributed models.

The methods described below include:

- manual review
- show formulas (also known as formula auditing mode)
- audit toolbar
- pattern matching to ensure consistency
- FIND for hidden errors
- known test data
- data to all inputs
- chart – known patterns

Using some of the design techniques earlier in the chapter reduces the opportunity for errors, for example:

- design method in segregating inputs and calculations;
- splitting out workings;
- keeping individual cell coding as simple as possible;
- self-checking, such as making sure a balance sheet adds up on both sides.

A manual review often reveals simple errors and other features such as the spell checker will show up text errors. Other methods involve other features in Excel.

Show formulas

![Show formulas](image)
View formulas

This function is called Show Formulas at Formulas, Formula Auditing (Excel 2003 – Tools, Formula Auditing, Formula Auditing Mode). Viewing formulas shows the formulas and if there are constant values these cells will not change (see Figure 2.49). You can select View Formulas in Excel 2003 at Tools, Options, View. Alternatively, you can press Ctrl and ' to toggle between the two views. This is a good check on the quality of the underlying sheet and will reveal overwritten cells or inconsistencies.

Using the above example, the errors again become apparent. The errors in cells G10 and H10 show up against cell F10, which contains the correct code.

Audit toolbar

The audit tools can be displayed by pressing Formulas, Formula Auditing (Excel 2003 – Tools, Auditing, Show Auditing Toolbar). The example shown in Figure 2.50 is in the data table sheet, which traces the derivation of the net present value.

You can trace precedents and dependants for a cell (see Figure 2.51). The NPV at cell C22 is derived from the dates, cash flows and discount rate. The arrow from below refers to the frequency of the periods.

Pattern matching

Pattern matching allows you to search for constants, formulas, arrays, etc. In the above example, this would highlight the errors in the calculations. Select cell B15 to H20 and access Home, Editing, Find & Select,
Go To Special (Excel 2003 – Edit, Go To, Special) to display this dialog box (see Figure 2.52). Formula errors are shown in Figure 2.53.

If you highlight formulas, Excel shows them. You would expect to see formulas in the cash flows rather than anything hard coded from above.

**Use known data with an entry to every input cell**

You need to enter data to every entry cell to ensure that the results are as expected. In an accounts spreading model, you could enter data to every possible cell and make sure that the balance sheet balances and that the cash flow agrees with the change in cash. With the current example, there is data in each of the inputs, but it is always a good idea to see what happens if unusual data were entered. Users can always be relied on not to follow instructions. Techniques such as data validation obviously help in avoiding ‘rubbish in, rubbish out’.

**Graph or data ‘looks right’**

The cumulative cash flow graph is smooth with no kinks as expected (see Figure 2.54). If the series were curved, then this could point to an error in the calculations. People are better in assessing pictures than grids of numbers and can ‘see’ errors more quickly.
FIND for hidden errors

You can use Home, Editing, Find & Select (Excel 2003 – Edit, Find) to look for errors such as N/A or Div/0 since errors are not always
obvious. You could also do the same by choosing Home, Editing, Find & Select, Go To Special (Excel 2003 – Edit, Go To, Special, Formulas, Errors). While you should find errors by other means, this is useful for checking entire sheets and workbooks.

Stress and range testing

You need to be sure that unusual inputs will not cause errors or answers which appear to be correct, but which are incorrect. Users are easily upset by a page of errors, which they have to audit. There are a number of things to look for:

- Extremes in range of inputs. This can be controlled through validation or using controls to limit the range of inputs.
- Test the likely range of results to make sure that the model can display them. For example, a column should be able to display the potential range of numbers.
- Negative numbers where positive numbers are expected.
- Text in place of numbers and vice versa.
- Large or small numbers to test the number of decimal places required.
Decimals in place of integers to ensure validation and use by continental European versions of Excel.

- Numbers in place of decimals.

- Dates in wrong order (31/12/00, 12/31/00) to test for US and other date formats.

- Blank inputs and checks for subsequent errors in formulas. The function ISBLANK can help to identify problems and suppress errors.

- Zero inputs to correct #Div/0 errors. This can be rectified by ISERROR functions or IF statements such as: =IF(Income!J10<>0,(Income!J24/Income!J10)*100,0)

**SUMMARY**

This chapter reviews a distinct design method for spreadsheet applications known as Systematic Design Method. Models for distribution or use by third parties require a rigorous and disciplined approach and this chapter suggests a number of points for good design and a list of useful features. The application discussed in the chapter progresses using a number of features to show the importance of design. You will note that the quality of presentation and the management information produced progressively improves. Finally, there are a number of auditing techniques to ensure consistency in the design and coding of the model. It is important that models can be checked, and these techniques provide a basic framework for auditing.
Risk and uncertainty

Introduction
Risk
Uncertainty
Response to risk
Methods
Summary

File: MRM2_03
INTRODUCTION

The methodology in the previous chapter suggests developing a single-point model and segregating areas of a workbook into:

- inputs
- calculations
- outputs.

Correct design ensures that all inputs are visible and all have been modelled. This means you can change the inputs and note the immediate effect on the output. What-if analysis is much more difficult without this organization. The next aspect to address is sensitivity to a change of key variables.

The simple model derives a single result and thereby limits the analysis. The result neither provides information on the potential variance nor backs up decision making. In business modelling, risk is always present since forecasts are inherently inaccurate. You can sub-divide risk into two components:

1. risk
2. uncertainty.

RISK

In corporate finance, you need to be able to explore the potential upsides and downsides, and to understand how the anticipated result could vary. With any project, you want to understand how likely you are to fail to reach a minimum target or, alternatively, the effect on the result of important variables.

Risk can be defined as the chance of making a loss; this could be making a loss on an asset sale or the possibility of machine failure. Alternatively, you could describe a risk in quantitative terms such as a 30 per cent possibility of a loss. In finance, you are normally more concerned with downsides since any upside always seems a remote possibility. In order to control risk, you first have to be able to describe and measure it and then decide if the anticipated return is worth the risk. Whilst some individuals may differ in the perceptions, it is usually assumed that decision makers are rational and weigh up the potential pros and cons. Here are some other definitions of risk:

- combination of the probability of an event and its consequences;
- symmetrical chance of a loss or a gain;
- probability of a different outcome;
possibility of occurrence of undesirable contingency;
possibility of loss;
hazard;
divergence of actual from expected results.

The Capital Asset Pricing Model (CAPM) is a useful example of risk and return. Portfolio theory shows how the risk in a portfolio can be mitigated by diversification based on standard deviation and correlation. The CAPM formula deals with individual risk and the beta score is a measure of individual stock risk against the market. The formula is:

\[
\text{Return} = R_f + \beta \times R_p
\]

Where:
- \( R_f \) = Risk free rate
- \( \beta \) = Measure of risk
- \( R_p \) = Risk premium

This formula defines the return that investors should demand and is defined by the excess return on the share against the market index. Investors can deposit funds at the risk-free rate or in a diversified portfolio at the market rate. This means that there is a basic return to be gained with no chance of a loss. The premium is therefore a measure of the extra return to be derived from taking the market risk. In the example below, a share with beta of one produces a result of 10 per cent.

\[
R_f = 5\% \\
\beta = 1.0 \\
R_p = 5\% \\
\text{Return} = 5\% + (1 \times 5\%) = 10\%
\]

The variance is therefore the variability against the market: a beta of more than one indicates a greater than market risk and the opposite is true of a beta of less than one.

Figure 3.1 shows the prices for 10 shares over a five-year period against an index. The values are converted into logarithms and plotted against each other. The beta is therefore the correlation of the share’s return with the market. The formula in cell E73 (see Figure 3.2) is:

\[ = \ln \left( \frac{D73}{D72} \right) \]

Columns D and H can then be plotted as a scatter graph with a trend line through the series to illustrate the slope (see Figure 3.3).
For company AAA, the slope of the trend line from the function SLOPE, is 1.06. It is highly correlated with market movements. The other shares in this example portfolio show a range of variance with the index. The beta table is shown in Figure 3.4.

The beta is therefore a historic score of risk, which shows that some shares in this collection have been more volatile than the market and therefore investors should, in theory, demand a higher return. Risk can therefore be measured and, in theory, the past should broadly equal the future.
Figure 3.3  **β scatter chart**

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Select: AAA</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Current Regression Results:

<table>
<thead>
<tr>
<th>Company</th>
<th>Constant</th>
<th>Beta</th>
<th>Corr</th>
<th>RSG</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>0.00</td>
<td>1.06</td>
<td>0.84</td>
<td>0.70</td>
</tr>
</tbody>
</table>

Figure 3.4  **β table**

<table>
<thead>
<tr>
<th>Number</th>
<th>Beta</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1.063</td>
</tr>
<tr>
<td>2</td>
<td>1.055</td>
</tr>
<tr>
<td>3</td>
<td>1.051</td>
</tr>
<tr>
<td>4</td>
<td>0.419</td>
</tr>
<tr>
<td>5</td>
<td>1.148</td>
</tr>
<tr>
<td>6</td>
<td>1.031</td>
</tr>
<tr>
<td>7</td>
<td>0.957</td>
</tr>
<tr>
<td>8</td>
<td>1.341</td>
</tr>
<tr>
<td>9</td>
<td>1.139</td>
</tr>
<tr>
<td>10</td>
<td>1.142</td>
</tr>
</tbody>
</table>
The model sheet is a simple real estate model. This is a buy for let model where you invest in property and receive rental income. The first section shows all the variables where the cost inputs are percentages of the purchase price (see Figure 3.5).

There are a significant number of variables which can be multiplied out to produce returns and profits. These include both the one-off costs of purchasing and refurbishing a property, but also the on-going costs of maintaining and letting it. Since the owners' funds will be leveraged through a form of loan or mortgage, the cost of borrowing is a significant cost to be placed against the gross rental yield. In addition, the percentage voids or rent-free periods could also be a significant factor. Lastly, property may afford the benefit of capital growth over and above the rental income.

The objective of the model is to calculate the projected annual income and the owners' return on the equity investment. The second profit measure includes the benefit of capital growth and there is an overall yield measure from income and capital.

The answer is a yield on income of 2.65 per cent or 10.10 per cent including capital growth (see Figure 3.6). Whilst there are financial and non-financial risks, property rental has inherent risks which could significantly lower the yield, for example:

- maintenance and other regular costs;
- assumed rental per month and the state of the rental market in the area;
capital growth on the property;
- voids defined as the number of days when the property lies empty;
- interest rate to be paid on loans.

The model only allows single-point entry and the inputs are best guesses. Given the cyclical nature of the property market, it is fair to say that there are significant risks or, alternatively, variables not fully modelled. For example, interest rates could rise and rents fall in a depressed economy. This could make it hard to find suitable tenants and therefore voids could rise. These factors together would then significantly impact on the overall yield. Based on historic experience, it could be possible to plot both the average and variability in these factors in order to quantify the chance of a significant loss.
Risk is also allied to theories of probability. Suppose that an investor could invest in shares and over one year the expected probabilities and returns are shown in Figure 3.7.

Figure 3.7 shows the possible returns in column C and the expected probabilities for shares A and B in columns D and E. Columns G and H are the probability return for shares A and B multiplied by the return. Share B suggests a much wider range of returns than A and the higher adjusted return is a profit of 1300. Share A possesses a narrower range and therefore appears to present the less risk.

The range shows up clearly on a probability chart, where option B displays a flat distribution whereas A is a more normal bell curve distribution (see Figure 3.8). The profit or loss at each point is set out in Figure 3.9 and this shows the possibility of a significant loss on share B.

The return can therefore be expressed as an amount and a range or probability. There is always the option of not investing and the perception of risk and potential return may be important. In most situations, the outcomes are not completely clear and perception of risk is affected by subjective factors: for example, it depends on how you perceive losses or gains. In addition, the concept of risk adversity may not always be correct. Some individuals are risk takers while others will always opt for safety.
UNCERTAINTY

All the possible outcomes on a model cannot be predicted and there will always be uncertainty or randomness – which cannot be predicted exactly. There are two areas of uncertainty:

1 Random or unexpected events that are outside the control of the organization: for example, earthquakes or multiple occurrences, which are the result of chance and do not conform easily to probability distributions.

2 Ignorance about the variables or inputs to the model arising from a lack of understanding. Further analysis and information could reveal more factors for modelling and thereby increase the validity of the system.

The single-point model is the best guess, which may or may not occur. In the real estate model above, the future may not equal the past because of unforeseen events.

RESPONSE TO RISK

A generic model for responding to risk should:

- Identify sources of risk in a project or organization (see Figure 3.10), in particular the financial risks where an organization may be more skilled in dealing with this form of operational risk.
Describe risks and how they impact on the organization using some form of probability impact diagram. The questions could be: why might it happen? and what would lessen the impact?

- Analyse and understand relative importance which could include risk mapping.
- Mitigate and control, through structuring or other changes to operations, to increase the controllable elements.
- Accept or reject residual or incontrollable risk.
- Price accordingly in a credit or project model to ensure a ‘correct’ risk/return ratio.
- Build up a database, monitor and learn for the future.

Risk mapping should reveal the potential severity and possible frequency with which potential problems could occur. The response on a project could be:
Increase the size of the project as the original plan could be too cautious.

Do nothing, since the potential cost of dealing with risk outweighs the perceived benefits.

Collect more data on the problem to better understand the potential downsides.

Add a contingency to the planning and thereby allow for risk.

Reduce or build in an abandonment option as a less risky approach.

Share the risk with a partner or contractor in return for lesser fees.

Transfer risk through an insurance contract.

Eliminate risks by redesigning the plan to reduce uncertainty.

Cancel project or financing since the potential losses are perceived to be too high or uncontrollable.

The above list could give an organization the opportunity to examine the basis for trying to control risk and later chapters explore credit, project and other scenarios.

**METHODS**

The discussion of risk and uncertainty above shows that a single-point answer may not reveal the prospect of loss inherent in any business decision. The methods for dealing with risk can be summarized as follows:

- sensitivity analysis using data tables and charts;
- scenario analysis and scenario manager;
- manual scenarios using functions;
- decision trees;
- simulation.

**Figure 3.11**

Sensitivity table
Sensitivity analysis

This technique uses data tables in Excel as one- or two-dimensional grids to show multiple answers on the same sheet. In the real estate example, the percentage of voids is plotted against the degree of leverage. This helps to show the effect on the yield before capital growth.

Office 2007 – Data, Data Tools, What-if Analysis (Excel 2003 – Data, Table)

Figure 3.11 illustrates the losses increasing with leverage as the percentage of voids increases. Tables of numbers are not easy to interpret and therefore a chart always helps to show the degree of change. Figure 3.12 demonstrates the gross and net yield and the line series is the middle row in the table.

Scenarios

Scenario planning can be a powerful tool for ‘thinking the unthinkable’. There are always different views of the future and history reminds us that the future cannot be fully explained or controlled.
There are many techniques for gaining ideas, such as:

- brainstorming;
- mental mapping;
- panels of experts such as in the Delphi technique.

Within Excel, the built-in Scenario Manager allows for different views to be held and loaded at will (see Figure 3.13). You can use it to save an audit trail of previous inputs or as a considered view to different futures. Saving the inputs means that you can always get back to the same answer. This can be useful in ensuring the integrity of a previously created model. For example, you can test the model at a future date and ensure that it has not been corrupted by comparing answers with the scenario summary. An audit trail is useful and scenarios also reduce the requirement for multiple copies of the same model.

There are three saved scenarios in the model to show the effect of a poor or growth economy on the result. This focuses the decision makers’ attention on the possibility of falling rents, lowered occupancy and increased borrowing costs. The Summary button produces a management report of the inputs and outputs.
The report provides a concise report and in this case demonstrates how an adverse economy removes any possibility of a positive return on the investment (see Figure 3.14).

**Manual scenarios**

You can also use functions such as *OFFSET*, *CHOOSE* or *LOOKUP* to load different sets of variables. The advantage is the visibility of all the variables. The example on the Manual_Scenarios sheet uses a combo box to generate the index number in cell H5 (see Figure 3.16). Row 16 contains *OFFSET* functions to look up the rows above based on the index number.

**Decision trees**

Decision trees are used to select the best course of action in situations where you face uncertainty, and many business decisions fall into this category. You face a complex problem that seems to make it impossible to choose the right option. Although you do not know the exact outcome, you may have some
information about the range of possible outcomes and how likely each is to occur. This information can be used to select the option that is most likely to yield favourable results. Modelling provides the framework to consider the quantitative factors and uses Bayes theorem to apply the probabilities.

**Simulation**

Scenario analysis allows you to keep different views of the world on the same sheet. You can load, for example, base case, optimistic and pessimistic. While this offers advantages over a single answer, there are times when there are significant elements of risk to be captured in a model. In the real
For each variable you could probably define a minimum, maximum and most likely, as in a triangular distribution. If there are 10 variables, then there are $10^3$ possible states and therefore it quickly becomes impossible to model all possibilities. Another example is a bonds portfolio of 100 instruments where there could be eight possible credit states for each bond on expiry of a time period. Again, there could be $100^8$ possible combinations on expiry.

In a simulation model, you specify the probability distribution of each uncertain variable. The model generates random numbers within the distribution and produces a large number of possible scenarios. You could plot the number of results between intervals and the resulting histogram of results provides information on the mean score, standard deviation, percentiles and other statistics. Simulation is dealt with in more detail in Chapter 5.

SUMMARY

The presence of risk in business underlines the need for initial analysis and identification of all key variables in a business problem. The problem should drive the modelling and not the other way around. Objectives should be clear to allow for risk identification, assessment, mitigation and inclusion. Simple techniques include tables and scenarios for identifying a range of possible outcomes.
Project finance

Introduction

Requirements

Advantages

Risks

Risk analysis

Risk mitigation

Financial model

Inputs

Sensitivity and cost of capital

Construction, borrowing and output

Accounting schedules

Management analysis and summaries

Summary
INTRODUCTION

This chapter introduces a project finance model as an example of the design method outlined in Chapter 2 and an illustration of the range of risks associated with financing a project. The text below outlines the risk process in financing and then provides a generic model for projects. The aim is to show the process of identifying the sources of risk and the modelling approach as a complete model. The eventual model is complete with all the elements of a finished model and aims to illustrate both the types of risks and also the modelling approach including all the possible variables.

Project finance is the creation of a separate entity for a project that can stand apart from the sole business of the sponsor and the debt providers. The brief could be to design, construct and operate, for example, a power station or infrastructure improvement. Generally, the future cash flows can be forecasted and used as the sole security for the project financing. The objectives are:

- to establish a vehicle to receive capital in the form of equity and debt;
- to expend the funds on constructing assets;
- to generate a revenue stream to pay back the loans; and
- to provide an acceptable return to the equity participants and demonstrate the security in the project to debt participants.

REQUIREMENTS

The difference between project finance and a traditional loan is that the former depends on the ability of the project to generate sufficient funds for loan repayment. Usually the loans are without recourse to the sponsor’s balance sheet. In a traditional loan the borrower is responsible for repayments, whereas the project vehicle is ‘ring fenced’ from other assets from the sponsors.

Therefore, project finance is a means of raising finance, which seeks to bring together specialist parties and allocate risk and reward in accordance with the level of each participant’s involvement. Financial engineering and capital structuring seeks to allocate the potential gains and losses between the parties. Funders need to examine carefully the sources of risk since there is no diversification of risk as there would be when a company undertakes a range of projects. The key objective is to assess the project’s ability to repay debt from cash flow. In addition, projects are typically sizeable and perhaps too large for one participant to accept all the risk. The key elements are as follows:
a stand-alone vehicle to hold all the contracts and manage the project;
- long-term contracts to purchase outputs to act as security for debt;
- contracts for the design, construction and operation of project assets;
- a market for the output (e.g., electricity from a power station and road tolls from a road construction);
- mechanisms and covenants for injecting further funds in the event of future financial problems or regulating cash distributions.

The basic project structure is shown in Figure 4.1.

![Figure 4.1: Basic project structure](image)

Whilst a company seeking a loan can show the bank an operating history and annual reports, a project plan can only point to future profitability and cash flow. The funds are required today in anticipation of positive cash flows in the future based on use of the assets. There are a number of feasibility factors to take into account, for example:

- technology and implementation of technical processes;
- economic factors to allow a project to generate sufficient cash flow, and there may be factors such as political upheavals which cannot be anticipated;
- availability of raw materials and other inputs together with effective management.
ADVANTAGES

Project financing arrangements usually include mutual interests in structuring over and above separate financing for allocating risk and reward. Advantages include:

- pooling of benefits between the interested parties;
- means of spreading risk among specialists in particular fields (e.g. financiers, constructors and operators);
- a fixed life arrangement releasing excess cash flow to equity participants after debt servicing has been covered, which could allow higher returns than from traditional financing;
- the project vehicle manages the cash flows to lenders, equity participants and sponsors to ensure that debt providers are paid directly from project flows without recourse to a stand-alone company;
- increased debt capacity and increased gearing possible by securing the projected cash flows;
- lower cost of capital than traditional finance because of increased leverage and risk premiums;
- economies of scale greater than two corporations acting separately;
- contractual arrangements for resolving disputes and potentially lower legal costs.

RISKS

Figure 4.2 summarizes the sources of risk in an example project. The methodology is initially to describe risks in order to analyse and then mitigate the risk through structuring and other methods. This list details some of the elements to be modelled, which are in effect the key elements of credit analysis:

- Environment and macro factors are those that an organization cannot directly control. A simple model is the STEEPV model (see Figure 4.3). In a long-term project shifts in politics, taxation or other factors can have profound effects on demand and cash flow. These factors are a source of uncertainty:
  - social and lifestyle developments that affect demand and costs;
  - technological changes, where an industrial process can be rendered expensive or unsustainable in the face of advances in technology.
- Economic and activity cycles, which affect future demand for goods and services and the availability of raw materials.

- Environmental factors especially for power and oil and gas projects. This is important during the project’s life and demands are made upon the operators to clean up sites on expiry of the project.

- Political climate and support through changes of government both at home and in any country where the project operates (e.g. changes in tax methods, rates of corporate tax and environmental legislation).

- Values and other 'soft' factors, which develop over time. Each decade exhibits certain values, such as the 'green 1990s'.

- Industry type, since each industry exhibit different risk factors in its ability to insulate itself against future change. A road scheme and an industrial plant require a different approach, and demand for product can vary over time.
- Choice of project vehicle could be important. There are advantages to limited companies, unlimited and limited partnerships, joint interest ownership or an off-balance-sheet vehicle. Each method has tax, accounting and legal consequences. The elements are:

- Business risk is efficiency in the operating cycle. Ratios such as debtor, creditor or inventory days demonstrate the measure of management control over working capital. It is obviously important that a project can generate cash in order to service the loans.

- Performance risk means profitability and margin such as gross and net profit margins. Profit is dependent on accounting standards and conventions and therefore it is important to review accounting policies, such as the depreciation period for assets. For example, long depreciation periods enhance earnings in the early stages. Other return ratios combine the balance sheet and the income statement, such as the return on equity, return on assets or return on investment.

- Financial risk emanates from the financial structure and the level of debt to equity. Since interest has to be paid on debt, whereas dividends can be suspended, higher leverage brings more financial risk. Similarly, a company needs working capital and the structure of the balance sheet should provide for both short- and long-term capital.
I

Cash flow should be evident if business, performance and financial risk are controlled. A company producing profits should also produce cash. It is also important that there is both volume and a lack of volatility in cash flow in order to meet commitments.

Sample ratios are set out in Figure 4.4, which lists analysis ratios for each of the factors above.

Other factors are less easy to quantify, especially over time, but nevertheless these factors have to be considered for their impact on the overall plan:

- Management makes all the strategic decisions rather than the banks. In a structured finance transaction, depth of management is important and must have all the necessary skills to deliver on the covenants. There is, of course, the truism that managements rather than companies fail.
- Partners may also provide future instability, given that many projects last for 10 or 20 years. In a co-generation scheme, there are sponsors, construction companies and other specialists, banks, equity investors, raw material suppliers and customers for the generated power. The cash flows are only as sound as the partners' ability to manage all the processes.
Legal considerations are always a factor across national borders and therefore the documentation should confirm the understanding of all parties and deal with all ambiguities in order to reduce the latitude for interpretation. The contracts must not only be in place, but also be capable of enforcement through the courts. This is especially true of acceptance, cost and negligence clauses.

Information, knowledge management and communication are becoming more important as a separate area, since most companies depend on management information systems and their ability to leverage knowledge into competitive advantage. This is also true of a project, especially in cost control and gaining a deep understanding of the underlying business.

Analysis of the above factors should reveal the list of factors which will eventually become inputs for a financial model. The aim is to investigate, as thoroughly as possible, all the variables to save revisions to the financial model at a later stage. Key considerations are:

- the significant sources of risk and uncertainty associated with each stage of an investment;
- the causes of each risk;
- any links between factors and how risks could be grouped for classification and analysis.

Figure 4.5 shows the response sequence.
Only risks that are identified can be evaluated and then managed. Risk matrices are helpful in assessing the impact and probability and highlighting factors for subsequent sensitivity analysis (see Figure 4.6). Whilst there are a large number of inputs and rule to the model, there are usually a small number of input variables, which are clearly significant. For example, what happens to financial ratios and benefits of the project if construction were delayed by six months? Experience from earlier projects can help to outline difficulties and areas of concern.

RISK ANALYSIS

Analysis of significant risks can take qualitative and quantitative forms using some of these methods:

- likelihood or frequency of occurrence per year or 100 years as a way of expressing likelihood;
- potential consequence (with respect to one or more of the factors or related cash flows) if the risk occurs;
- most likely frequency of the risk occurring during the whole lifetime of the project;
- possible timing of the risk’s impact;
- risk scores.
It is sometimes beneficial to allot a score for the likelihood and one for the impact and then combine the figures as a score. Risk with the highest scores can then be identified by these two factors and selected for further analysis. Combinations of risks can be evaluated together as one factor. Examples of occurrences are:

- once and for all chance of occurrence;
- average rate of occurrence over the duration of the project;
- variable rate of occurrence;
- extent of occurrence (e.g. per kilometre of road);
- probability of each of a series of possible values or ranges of values over the life of the investment (i.e. a probability distribution).

**RISK MITIGATION**

Project modelling assists with the risk analysis by providing a closed system for evaluating the inputs and likely outputs. All the costs and likely revenues can be calculated and then ‘stress-tested’ to see if the results are acceptable. Example outputs are:

- net present value (NPV);
- internal rate of return or modified internal rate of return;
- payback or discounted payback;
- cover ratios on the funding to ensure that there are sufficient funds to repay debts;
- maximum borrowing and other financial covenants;
- maximum possible tariff or optimum tariff required to cover debt and produce returns.

There are various phases to any project through construction, commissioning, operation and closure, and with long-term cash flows the level of error increases over time. Risk mitigation could include a number of techniques, such as:

- insurance;
- risk sharing through partnerships;
- structuring;
- financial engineering.

The above discussion seeks to demonstrate the degree of complexity in a project model and the risk faced at each stage of the process. The next section outlines the Excel model.
FINANCIAL MODEL

The file, MRM2_04, is an example feasibility model which brings together the main variables in a project with the objective of providing two key results: cover ratios and returns. The model contains a construction schedule to be funded through debt equity and then repayments against a forecast revenue and cost structure. Investors need to be certain of a return on their investment, while bankers need reassurance that loans can be repaid in full and on time. The audience is therefore a range of stakeholders with different agendas and varied risk appetites, and the model needs to flexible enough to incorporate all the variables so that their contribution can be tested. By performing stress or sensitivity analysis, the model should reveal more information on the sources of risk and uncertainty, and assist with the structuring of the equity and debt injection.

It is assumed that analysis has been carried out and reveals areas for further research which are:

- plant completion date and the time required to rise to peak production;
- interest costs and loan structure, where interest rates are higher than planned;
- equity/debt gearing percentage;
- cost of construction rising in local currency;
- contingencies and possible overruns in construction and other costs adding to the strain on cash and the loans to be serviced, especially in the early stages, thereby reducing the cash available to investors;
- tax rates and retrospective changes in the nature and timing of tax payments;
- other costs, such as management fees;
- production volumes and selling prices failing to meet initial expectations;
- costs of raw materials altering drastically owing to economic shock or times of political instability;
- overhead costs rising above planned levels;
- escalators and inflation rates over the period reducing the selling price in real terms.

The model needs to be able to incorporate all these factors and store a number of individual cases. The organization must develop a number of individual scenarios to be considered and tested rather than adopt a solitary view of the future. Experience shows that macro (external) factors increase in importance over time together with the possibility of seemingly random events.
Therefore, the cases have to encompass both a poor and a more positive economic outlook. The result of each case will be a cash flow with related financial statements and ratio analysis in order to assess:

- NPV of the project at the risk-adjusted weighted average cost of capital or a nominated hurdle rate;
- internal rate of return to investors;
- debt service capacity of the project.

The organization of the model naturally splits into a number of sheets or areas. This makes it easier for co-workers and other users to understand and will make maintenance easier in the future. Adding more schedules will not require a fundamental redesign of the underlying workbook. The schedules are:

- menu;
- control area to look up individual scenarios from input sheets;
- input sheets for construction, timing, production, costs, contingencies and all the other variables;
- financial schedules – income statement and balance sheet;
- analysis – cash flow, ratios and sensitivity;
- management analysis – dynamic chart for line-by-line examination;
- management summary – annual summary and single-page report;
- explanation, user help and notes.

Figure 4.7 shows a model structure.

The only inputs allowed are on the Control, Inputs and Sensitivity sheets, and these are always marked in blue on the screen following the Systematic Design Method. The model is based on the App_Template and follows exactly the same style and design method (see Figure 4.8). This includes:

- use of colour – green for headings and totals, red for negative numbers, black for positive numbers;
- formats such as the use of a dash for zero;
- borders to break up sections of the schedule and highlight totals and answers;
- version numbers, units and project title in the same positions on each schedule.
Mastering Risk Modelling

**Figure 4.7**

**Model structure**

- **Menu**
  - Control/Inputs
  - Inputs – Scenarios
  - Production Scenarios

- **Construction**
  - Borrowing
  - Project_Output

- **Income_Statement**
  - Balance_Sheet

- **Cashflow**
  - Dividend_Cashflow
  - Ratios
  - Sensitivity

- **Management_Analysis**
  - Schedule

- **Management_Summary**
  - Annual_Summary

- **Menu sheet** – macro driven
- **Inputs and assumptions**
- **Individual scenarios**
- **Production scenarios**

- **Capital expenditure**
- **Loan and equity requirement**
- **Quantity, revenue and costs**

- **Profit and loss**
- **Balance sheet**

- **Derived FRS 1 cashflow**
- **Annual ratio analysis**
- **WACC calculations**
- **Sensitivity tables and charts**

- **Dynamic charts for any line on any schedule**
- **Data only – do not delete**

- **Single page flash report**
- **Summary of cash flows for each year**

---

**Figure 4.8**

**Layout**

```
<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Title</td>
<td></td>
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</tr>
<tr>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Inputs</td>
<td>100.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>50.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>25.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>10.00</td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td>0.00</td>
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<tr>
<td>Calculations</td>
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<tr>
<td>Answer</td>
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<td></td>
<td></td>
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<td></td>
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<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sensitivity or Graphics</td>
<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Workings</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
```

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It is important to adopt a consistent style for spreadsheet models and all the models in this book follow the same pattern. This makes them easier to understand and faster to develop with fewer errors. The menus sheet below includes a combo control and assigned macro to access any sheet on the list. This is called GetSheetNames, which loops through and updates the list of sheets starting at row 50 and then selects the sheet number from the combo box. Excel uses index numbers internally so that Worksheets(1) is the first sheet in the workbook. This is the text of the macro:

```vba
Sub GetSheetNames()

    Dim Number, Counter, SheetName(25)
    Dim IndexNumber
    On Error GoTo Error:

    Application.ScreenUpdating = False 'Turn off screen updating
    Worksheets(1).Select 'Select first sheet - always the menu
    Range("B51:B69") = "" 'Zero existing list
    Range("B50").Select 'Start at the top of the list
    Number = ActiveWorkbook.Sheets.Count 'Count number of sheets in book
    For Counter = 1 To Number 'Loop through each sheet

        SheetName(Counter) = Worksheets(Counter).Name 'Put in the name of the sheet

    Next Counter

    Error:
    Range("A2").Select
    On Error Resume Next
    IndexNumber = Range("C50") 'Access the sheet number you selected
    Sheets(IndexNumber).Select
    Range("A2").Select
    Application.ScreenUpdating = True 'Turn on screen updating

    Application.Calculation = xlAutomatic End Sub
```
Figure 4.9 shows a project menu. The menu also contains a number of standard inputs such as the name of the application and the author. Again, these are standard names that are used on all workbooks developed by the author.

Version = Menu!$C$15
Product = Menu!$C$6
Author = Menu!$C$7
Company = Menu!$C$8
Telephone = Menu!$C$9
Fax = Menu!$C$10
Email = Menu!$C$11
Web = Menu!$C$12
Objective = Menu!$C$14
Contact = Menu!$B$28
There are a large number of inputs for this model in order to provide future flexibility:

- **Basic inputs** – project name, revision, dates, currency, units (millions, thousands, etc.).
- **Funding costs**, period, fees and degree of leverage (debt to equity split). Since the model will produce the cash available to debt and equity, the degree of leverage may be important in increasing the NPV of the project.
- **Escalators** for future costs and revenues since prices are expected to rise.
- **Predicted products**, output quantities and sale price per unit.
- **Costs for materials and establishment** divided up into individual costs.
- **Capital expenditure** split into construction and subsidiary costs together with potential cost overruns and an option to include or discard. There are also inputs for post-completion capital expenditure.
- **Cash and other starting balances** for the balance sheet and cash flow. These would normally remain at zero.

The Control sheet uses a combo box at the top to look up information on the Inputs_1 and the Inputs_2 sheets which hold up to ten scenarios. This means that the individual scenarios are always visible. Whilst you can use the Scenario Manager in Excel, this method is often used on project models for the individuals cases.

### Office 2007 – Data, Data Tools, What-if Analysis (Excel 2003 – Tools, Scenarios)

The control workings are at the bottom on Inputs_1 and the cell link is named Scenario_No. The data is derived from the cell inputs across the top entered by the user and looked up using the TRANSPOSE array function. The formula is as below and entered as an array function using Control, Shift and Enter together.

\[ \{= \text{TRANSPOSE}($D$9:$M$9)\} \]

OFFSET functions are used to collect the data from the Inputs sheets with a changing starting point and the same column offset number from the named cell Scenario_No. For example in cell D8:

\[ = \text{OFFSET}(	ext{Inputs}_1!C8,0,\text{Scenario}_\text{No}) \]

The Control sheet incorporates problems such as delays and contingencies so that the effects can be tested at a later stage. Similarly, there is a choice of funding out of cash or using an annuity method (see Figure 4.10).
The construction table uses combo boxes for contingencies and provides totals with and without cost overruns (see Figure 4.11).

It is important to be able to review answers on an input sheet so that you do not have to tab to the other end of the model every time you change an entry. This summary table provides the main return numbers from the cash flow (see Figure 4.12). There are also minimum and maximum rules for
return and gearing, and the model uses an IF statement and conditional formatting to show up the answer.

The formula in K16 is \( \text{IF}(J16<I16, \text{"Fail"}, \text{"Pass"}) \) and column J uses \( \text{MAX} \) or \( \text{MIN} \) functions to select a case for cover, gearing and NPV.

Inputs_1 sheet is set out in columns to mirror the first page of the Control sheet whereas Inputs_2 sheet is in rows to accommodate the extra expenditure during the operating period (see Figure 4.13).
SENSITIVITY AND COST OF CAPITAL

The Sensitivity schedule calculates a weighted average cost of capital (WACC) for the project using the Capital Asset Pricing Model (CAPM). The procedure is as follows:

- input for the risk-free rate, risk premium, historic equity beta, historic debt equity ratio, any extra hurdle rate premium, tax rate and predicted debt equity ratio;
- the model un-leverages the equity beta by multiplying the beta by \((1 - \text{debt/equity ratio})\);
- the resulting asset beta is divided by \((1 - \text{forecast debt/equity ratio})\);
- the cost of equity can then be calculated from extra hurdle rate + risk free rate + risk premium * equity beta;
- the cost of debt is the cost multiplied by \((1 - \text{tax rate})\);
- the WACC is then the cost of equity multiplied by its weighting plus the cost of debt multiplied by its weighting;
- there is also the option of including inflation in the calculation using the Fisher formula: \([\frac{\text{(1 + interest rate)} \times (\text{1 + inflation})}{\text{(1 + interest rate)} + \text{(1 + inflation)}}] - 1\).

In this example, the cost of capital is 17.60 per cent to reflect the risk on the organization in the beta; leverage in the debt/equity ratio, inflation and a hurdle premium to incorporate the extra risk in the project relative to the organization (see Figure 4.14).

![Figure 4.14](image)

**Cost of capital inputs**
The slider control updates the forecast debt/equity ratio and is linked to a macro to update the inputs for the data tables shown in Figure 4.15. This is an alternative to the button at the top of the page since the outputs below are axes for the data tables further down the sheet:

- equity beta
- project debt/equity ratio
- inflation adjusted WACC percentage.

The other tables display the sensitivity of the WACC to the project debt/equity ratio and the beta together with the effect on the NPV of the WACC.

**CONSTRUCTION, BORROWING AND OUTPUT**

The construction amounts, borrowings capacity and output are laid out in the Control schedule. These sheets show the workings on a periodic basis where the phasing of the construction affects the requirement for borrowings. After construction, there is also some new minor expenditure for repairs, maintenance and additions.

The depreciation per annum is an input cell on the Control schedule and the total capital for the period is depreciated at the rate. In the example, the rate used is 10 per cent per annum since the equipment life is 10 years (see Figure 4.16).
The borrowings and equity ratio are fixed so that the construction determines the capital requirement. Interest during construction is capitalized on the Loan sheet to form the total requirement. The debt percentage is subject to a loan over 10 years. The objective is to allow the debt requirement and equity to cascade through the model based on the construction costs. The model uses equity first and then loans, but a model could be made more complex with different loan facilities offering varied expiry dates and interest rates. Other methods of equity injection could include:

- percentage of total capital (debt and equity);
- equity injected into the capital as required;
- equity paid at certain times such as completing milestones or key stages;
- percentage of construction costs after escalation and contingencies.

In the extract from the Loan funding schedule, the debt/equity split of 50 per cent is maintained and repayments are scheduled on a cash or annuity basis (see Figure 4.17). The interest rates come from the Control sheet so that the schedule calculates the key information:

- interest payable both pre- and post-completion;
- principal repayment;
- cash flow available to repay interest and principal;
- balance carried forward to the next period.
This model is limited to two products denoted on the Control schedule. The purpose of this sheet is to provide a link between the initial inputs and the accounting sheets. The figures are presented without escalators to show an excess or deficit from the basic revenue and costs. The revenue is simply the number multiplied by the price per unit. At the bottom, the costs are escalated based on the increases in the Control sheet and the period number (see Figure 4.18).

**ACCOUNTING SCHEDULES**

All the schedules so far provide the data for the accounting schedules for presenting the likely profitability, net worth, cash flow and financial analysis. These schedules use standard layouts which could also be incorporated into budget, loan analysis, equity valuation, management buy-out and other models involving forecasts and accounting statements, such as:

- income statement
- balance sheet
- ratios
- cash flow.
Each of the lines is labelled with its source and uses data from loan and cost schedules. The result from the income statement is the accounting profit in each of the periods (see Figure 4.19). Workings at the bottom show the calculation of tax for both the income and cash flow schedules.
The balance sheet self-checks at the bottom and demonstrates the accounting valuation for the project at each period end (see Figure 4.20). The income statement and balance sheet are linked since increased loans feed through to higher interest payment in the income statement, less profit to pay dividends and therefore less cash and net worth in the balance sheet.

There are two cash flow statements. The first restates the income statement and balance sheet in the standard annual accounts format. This divides trading from non-trading cash and displays totals for the net operating cash flow and the cash inflow or outflow before financing. New capital as debt or equity is isolated and the statement reconciles back to the change in cash on the balance sheet. The second cash statement calculates the cash available for paying dividends, which is set in the Control schedule as 50 per cent of the cash available. The elements are shown in Figure 4.21. Again, the schedule self-checks to the change in bank on the balance sheet.
The equity and debt providers need the financial analysis of the project. The equity providers need to know the returns relative to the risk. In particular, the key areas are:

- profitability and return such as return on equity, profit margin and return on assets;
- financial structure such as gearing, interest coverage and solvency;
- operating cycle such as working capital, debtors, creditors and inventory days;
- cash flow such as net operating cash flow to sales.

The model provides the standard ratios grouped around the core ratios. Again, all the derivations of the ratios are shown on the schedule (see Figure 4.22). The return ratios are calculated on a pre- and post-tax basis.
Debt providers may be more interested in cover ratios. The financial model needs to derive the maximum amount of debt that the project cash flow could safely support. The important ratios here are:

- Gross gearing (%) \( \frac{(B20 + B25)}{B30} \)
- Net gearing (%) \( \frac{(B20 + B25 - B9)}{B30} \)
- Gearing – debt to equity ratio \( \frac{B25}{B25 + B30} \)
- Solvency (interest coverage) \( \frac{P25}{P27} \)
- Debt service ratio \( \frac{(P25 + C10 - P30)}{(C17 + C26)} \)

There are variants of these ratios. For example, earnings before interest, taxation, depreciation and amortization (EBITDA) or net operating cash flow could be used instead of operating profit for interest coverage. The project must be able to demonstrate both quantity and quality of cash flow and therefore in its simplest form must cover the interest payments. Debt providers also require repayment of principal, and the debt service ratio includes both interest and debt in the formula:

\[
\frac{(Operating\ profit + Depreciation + Amortization - Dividends)}{(Interest + Principal\ repayment)}
\]
An alternative formula is:

$$\frac{EBITDA}{(Interest + (Principal/(1-Tax\ rate)))}$$

Where any of these ratios fall below one, the project is not generating sufficient cash to service its debts. A good model should survey the data and include decision making. The extract from the Control sheet shown in Figure 4.23 includes individual coverage tests to ensure that the model 'passes' at each stage. The minimum or maximum is extracted using the functions $\text{MIN}$ and $\text{MAX}$ to highlight the periods where coverage is at a minimum. Since forecasts notoriously become less accurate the further into the future you project, it is obviously important to critically review the coverage and returns from the later periods. The model therefore assists in demonstrating the key ratios for the client, advisers, debt and equity providers. This extract is on the Control sheet.

**Figure 4.23**

**Return ratios**

<table>
<thead>
<tr>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
<th>J</th>
<th>K</th>
<th>L</th>
<th>M</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Div before Tax</td>
<td>R61</td>
<td>182.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity after Tax</td>
<td>R52</td>
<td>26.4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project After Tax</td>
<td>R63</td>
<td>19.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Project before Tax</td>
<td>R54</td>
<td>24.4%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>WACC</td>
<td>17.8%</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Net Present Value</td>
<td>25.2%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Management Tests</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Min Interest Cover Ratio</td>
<td>1.00</td>
<td>1.33</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Minimum NPV at 17.6%</td>
<td>28.06</td>
<td>26.28</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Maximum Gearing</td>
<td>15.00</td>
<td>15.54</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Min After Tax Equity Return</td>
<td>22.67</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
</tbody>
</table>

**MANAGEMENT ANALYSIS AND SUMMARIES**

The complete model is included in this chapter to demonstrate the number of variables, possible inputs and therefore the level of risk to be borne by each party. On account of the detail, the model needs schedules to summarize and report on the findings. These schedules are called:

- Management Summary
- Annual Summary
- Management Analysis.
The Management Summary brings together the internal rates of return from the Control schedule together with the components of the weighted average cost of capital from the Sensitivity sheet (see Figure 4.24). The table of management tests is repeated to demonstrate the acceptability of the cash flows.

![Management Summary](image)

Figure 4.25 is a summary of the capital costs and the loans and equity mix. The construction requirements are matched by an equal amount of debt and equity.

The Sensitivity chart illustrates how the NPV of the project changes as the cost of capital increases or declines (see Figure 4.26). The slope of the lines gives a good indication of the responses since the NPV rises by 20 to around 50 if the cost of capital is reduced to 15 per cent. If the WACC rises above 21.5 per cent, then the project attains a negative NPV.

The Annual Summary picks key lines from the other schedules to summarize output, revenue, cash and ratios on a periodic basis (see Figure 4.27). This is a single-page report for showing exactly how the cash flows and how this affects the cover and return ratios.
Figure 4.25  
Capital Costs and Loan

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, Plant &amp; Equipment</td>
<td>50.63</td>
</tr>
<tr>
<td>Construction Costs</td>
<td>25.31</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>10.13</td>
</tr>
<tr>
<td>Legal Costs</td>
<td>0.51</td>
</tr>
<tr>
<td>Establishment Costs</td>
<td>0.51</td>
</tr>
<tr>
<td>Management &amp; Contingency</td>
<td>4.35</td>
</tr>
<tr>
<td>Interim Interest</td>
<td>11.34</td>
</tr>
<tr>
<td>Increase in Working Capital</td>
<td>9.98</td>
</tr>
<tr>
<td><strong>Total Required</strong></td>
<td><strong>112.75</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Method</th>
<th>Cash 50.0%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Loan</strong></td>
<td>56.37</td>
</tr>
<tr>
<td><strong>Loan Cost</strong></td>
<td>10.00</td>
</tr>
<tr>
<td><strong>Total Funding</strong></td>
<td><strong>112.75</strong></td>
</tr>
</tbody>
</table>

Figure 4.26  
Sensitivity

NPV Sensitivity to WACC at 17.89%
Schedules of figures are difficult to understand and therefore the model provides an additional method of reporting using a dynamic chart. The objective is to copy any sheet to the Schedule sheet and then look up these values on the Management Analysis sheet (see Figure 4.28). This saves producing multiple charts and provides the user with the flexibility of examining almost any line in the model.

The first stage is to choose a schedule using the control box and this updates the cell link at D61. There is a macro assigned to the control called CopyDataSheet. This performs the following:

- selects Management Analysis sheet;
- updates the sheet names at B50 on the Menu sheet;
- selects the sheet number selected by the control;
- copies rows 9 to 75 (since row 75 is the maximum row of any schedule);
- goes to the Schedule sheet and paste specials the values;
- pastes to A9 the name of the sheet that has been copied and pasted.
The full text of the macro is as follows:

```vba
Sub CopyDataSheet()
    ' CopyDataSheet Macro
    ' Macro developed by Alastair L Day
    ' Excel uses index numbers for sheets so this macro copies a sheet number given by the control and paste specials the values into the Schedule sheet
    ' The second control then selects a row on the Schedule sheet for a chart
    Dim Sheet_Selection
    Dim Number, Counter, SheetName(25)
    Application.ScreenUpdating = False
    Sheet_Selection = Range("Management_Analysis!d61")
    'Select Management Analysis sheet
```
'Update the sheet names at B50 on the Menu sheet
Worksheets(1).Select
'Update list of schedules on menu sheet
Range("B50").Select
Number = ActiveWorkbook.Sheets.Count
For Counter 1 To Number
SheetName(Counter) = Worksheets(Counter).Name
ActiveCell.Offset(1, 0).Range("A1").Select
ActiveCell.FormulaR1C1 = Worksheets(Counter).Name
Next Counter
'Select the sheet selected by the control
Application.Worksheets(Sheet_Selection).Select
'Copy rows 9 to 75
Rows("9:75").Select
Application.CutCopyMode = False
Selection.Copy
'Go to the Schedule sheet and paste special the values
Range("b9").Select
Sheets("Schedule").Select
Range("A9").Select
Selection.PasteSpecial Paste: = xlValues, Operation: = xlNone,
SkipBlanks: = False, Transpose: = False
Range("A9").Select
Application.CutCopyMode = False
Range("b2") =
Application.Worksheets(Sheet_Selection).Name
'Paste to A9 the name of the sheet you just copied and pasted
Sheets("Management_Analysis").Select
Range("A9").Select
Application.StatusBar = False
Application.ScreenUpdating = True
Application.Calculation = xlAutomatic
End Sub
The second control then selects a line number on the Schedule sheet using a simple OFFSET formula based on the cell link at cell D63 (see Figure 4.29). Again, the user sees the actual line text and can decide easily which line is needed. This is the formula in cell G15:

$$= IF(ISERROR(OFFSET(Schedule!G8,$D$63,0)),0,OFFSET(Schedule!G8,$D$63,0))$$

The data is changed on row 15, and row 16 includes a factor analysis. The first data point defaults to 100 and all subsequent points are restated as a factor. Minus 20 per cent would be 80 and plus 25 per cent would be 125. This is often a better way of presenting percentage changes than using just the percentage difference.

The finished Management Analysis chart shows the net operating cash flow from the cash flow schedule (see Figure 4.30). Here you can see the trend of the forecast results and examine the changes using multiple scenarios updated from the Control sheet.

You can select other schedules, and the text in the second control will automatically update if calculation is set to automatic. Since the macro suppresses the screen updates, you do not notice the macro running. Figure 4.31 shows the return on sales from the Ratios schedule.
### Management Analysis chart

![Management Analysis chart](image1)

### Ratio analysis

![Ratio analysis](image2)
The Schedule sheet merely contains values correct to 13 decimal places, and the sheet always remains unprotected since the macro needs access to the sheet to update the values (see Figure 4.32).

**Figure 4.32**

**Schedule values**

---

**SUMMARY**

Project finance and its basic methodology allow risk to be shared amongst participants. The financial model sets out all the model sections together with the extra variables and contingencies to explore the potential cost overruns and other variables. Rather than just producing basic cover ratios, the model provides much more flexibility for examining up to 10 scenarios in the Control and Inputs schedules, and the variables cascade through the model. The Management Analysis and summaries provide the user with a means of extending the understanding of the risk inherent in the project. Macros and controls allow you to review multiple lines on all the schedules to demonstrate the potential downsides of the project.
5

Simulation

---

Introduction

Building blocks

Procedure

Real estate example

Summary

File: MRM2_05_01 and MRM2_05_02
INTRODUCTION

The project finance model in the previous chapter introduced a single-point model and then layered on scenarios and other risk techniques. Whilst you can add scenarios and multiply the answers by the assumed probability to derive a weighted outcome, there comes a point when it is inefficient to add more and more manual scenarios. The solution is to explicitly model uncertainty and build it into the model. The project model contained inputs for sales growth and demand as single points as a best guess. In the real world, you may be less certain about an exact figure, and the desired input could be a range or a distribution. The simulation on the Monte Carlo simulation model accepts distributions as inputs, runs the model through large numbers of theoretical scenarios and produces an output also as a distribution.

On the one hand, the single-point model produces answers such as the net present value (NPV) or the return to investors. On the other hand, the simulation model answers questions such as ‘How likely is the company to achieve cash flow covers on loan repayments of three times?’ or ‘What percentage chance is there that the unit will make a profit?’ This could be a great benefit since you do not have to build the physical system to understand the possible outcomes. The programming is often simpler than trying to model a number of discrete scenarios.

Uncertainty usually grows with time and estimating the interplay between variables using single-point models fails to take into account the potential forecasting errors. Potential errors normally increase with time as shown by the error bars. Figure 5.1 shows errors bars increasing with time. Similarly with time, factors may increase in importance or factors arise which have not been modelled. Therefore, a model which incorporates the uncertainty to be found in empirical situations may provide more management information about potential risks.

The structure of a simulation model is very similar to a single-point model and it is usual to build in simulation as an extra layer on the existing model. Most of the calculations and variables remain the same except that certain variables will now be represented by probability distributions instead of a single value.

Probability modelling is not a new concept. The mathematics behind Monte Carlo came out of the Manhattan Project to build the atomic bomb during the Second World War. The work is largely credited to Stanislaw Ulam, an Austrian-born mathematician, along with computer pioneer and scientist John von Neumann. Simulation models offered a way of arriving at approximate solutions to complex problems associated with the random neutron diffusion in nuclear weapons material. One report says that Ulam named the method ‘Monte Carlo’ after a relative fond of sneaking off to Monaco’s casinos. Nevertheless, the name does underline the fact that this is a probability and not a certainty model.
This chapter deals with simulation methods within Excel; however, there are a number of commercial add-ons to Excel for automating the process listed at www.financial-models.com, for example:

- @RISK at www.palisade.com
- Crystal Ball at www.crystalball.com

**BUILDING BLOCKS**

There are several building blocks to simulation models consisting of random numbers and probability distributions. The golden rule is that all iterations generated by the model must be possible so that the model replicates possible events that could feasibly occur in the real world. The validity of the inputs is therefore essential. If you follow this rule, you will have a greater chance of producing a model that is both accurate and realistic. For example, a very common mistake is to produce a model that inadvertently calculates the mean of the answer, rather than developing a model that produces a large number of scenarios, from which the spreadsheet calculates the mean. For a simple illustration, consider the modelling of a variable (X) that has a 50 per cent chance of being Normal(100,33) and a 50 per cent chance of being Normal(70,5). A normal distribution can be described by its mean and standard deviation so that in the example above the mean is 100 and the standard deviation 33. This could be incorrectly modelled as follows:
\[ X = \text{Normal}(100,3) \times 0.5 + \text{Normal}(70,5) \times 0.5 \]

or correctly as a discrete distribution:

\[ X = \text{Discrete} \left\{ (\text{Normal}(100,3), \text{normal}(70,5)), (0.5, 0.5) \right\} \]

The first formula is wrong because it generates values that could not occur and does not generate a lot of those that would occur. There is a 50 per cent chance of each discrete set of events with a different mean and standard deviation.

**Random numbers**

Excel is capable of generating random numbers between 0 and 1 using the RAND function. Alternatively, the RANDBETWEEN allows you to produce discrete numbers between a high and low figure. Note that the Analysis Toolpak should be installed as an add-in to use this function. Each time you press F9, the sheet updates with new values. With RAND, approximately 10 per cent of the numbers will be between 0 and 0.1 eventually, although smaller samples will give anomalies. More numbers will be generated in certain bins and you need larger samples to generate truer randomness. Two statistical theories underline the methodology in simulation.

**Strong law of large numbers**

This states that the larger the sample size the closer the distribution to the theoretical distribution. As you run more trials, then the randomness starts to disappear and the outliers become less important. The distribution starts to attain a much more concise shape.

**Central limit theorem**

This states that a mean of set of variables drawn independently from same distribution will be normally distributed. Based on the Strong law above, it means that if you take variables at random from a non-normal distribution, the selected values will be approximately normally distributed.

This can be expressed as formula where the mean of \( n \) variables (\( n \) should be large), with same distribution \( f(x) \), will be normally distributed:

\[ \bar{x} = \text{Normal}(\mu \sigma / \sqrt{n}) \]

where \( \mu \) = mean and \( \sigma \) standard deviation of the \( f(x) \) distribution from which the \( n \) samples are drawn. If you multiply both sides by \( n \), then the
sum of \( n \) variables drawn independently from the same distribution is given by:

\[
\Sigma = n\bar{x} = \text{Normal}(n\mu, \sqrt{n}\sigma)
\]

The file, MRM2_05_01.xls contains a sheet called Dice which reproduces throwing two dice up to 2000 times. The data are on the sheet called Dice_Data (see Figure 5.2). The combinations of scores range from 2 to 12, but numbers such as 7 are easier to attain since there are more combinations of dice that produce this result.

If you only create 50 trials, there are not enough trials to create the theoretical distribution under the two theorems above. Each time you press F9, you will obtain a different set of values. Figure 5.3 shows excess scores at the upper end of the scale. Further trials would improve the shape of the distribution since there should be a peak at seven as this is the most likely combination.

As you increase the number of trials the shape of the histogram changes until with 2000 trials the shape is closer to a normal bell curve. The histograms for 2000, 1000 and 50 trials are shown together represented as percentages of the total sample (see Figure 5.4). The larger sample clearly results in a more normal distribution and this is confirmed by the variance chart showing the difference of 50 and 1000 trials to 2000 trials (see Figure 5.5).
Figure 5.6 contains all the data for the histograms. The Dice_Data sheet produces the random numbers and scores which have to be counted and presented as frequency plots. There is also a requirement to show scores of less than 2000 to demonstrate how the distribution changes with more trials. Cell E7 contains an input for the row number. This is used in cell E10 to create an offset number for an average function. This means that you can look at any combination between 1 and 2000.
E10 = AVERAGE(Dice_Data!E7:OFFSET(Dice_Data!E$7, Dice!E$9-1,0))

The same method is used to count the scores in the bins from 2 to 12 and create the data for the histograms.

E17 = FREQUENCY(Dice_Data!$E$7:OFFSET(Dice_Data!$E$7, Dice!$E$$9\cdot1$,0), $B$17:$B$27)
Figures 5.7 and 5.8 show how the mean and standard deviation develop during the 2000 trials. The initial variation disappears and the means and standard deviations move closer to their theoretical results.

**PROCEDURE**

The procedure is to decide on the structure of the model and the variables to be modelled. The example here is called Rental in the file.
MRM2_05_02.xls. This file shows a simple, single-point model looking at the margin from renting housing units (see Figure 5.9). The maximum number of units for rent is 25 and the minimum 22. The average selected is 22 at a rental of 2000 per month. The expenses are 40000 and the resulting margin 4000.

The Sensitivity table shows the risk from renting fewer properties or an increase in costs (see Figure 5.10). If occupancy is lower at 20 units, the margin becomes negative. The problem is to understand the level of risk involved based on the two key factors of occupancy and expenses.

The stages in layering a simulation on to the model are:

- Decide on the probability distributions, their attributes and possible inter-relationships through past data or other research.
- Use random numbers to generate large numbers of possible scenarios.
- Draw a scatter chart of the data output.
- Count results in bins (ranges).
- Calculate the descriptive statistics of the distribution.
- Draw a histogram of the results.

In this case, there appears to be no historic pattern of occupancy and therefore a uniform distribution is used between the high and low figures. This can be generated in Excel using a `RANDBETWEEN` function. The expenses appear to have a mean of 40,000 and to vary by 1000 a month. This appears, on past experience, to be a normal distribution which can be modelled using the function `RAND`. The workings for the data are at the bottom of the sheet in Figure 5.10. Since these functions randomize the answers, the results will change every time the workbook is recalculated (F9). Therefore the currency results will vary from the graphics below.

**Office 2007 – Formulas, Functions Library, Maths & Trig (Excel 2003 – Insert, Function)**

The revenue is a random number between 20 and 25 multiplied by the rental per month.

```
=RANDBETWEEN($D$6,$E$6)
```

Column D generates a random number between 0 and 1 using `RAND`, and the costs are derived using the `NORMINV` function (see Figure 5.11). This takes the arguments of probability, mean and standard deviation. The last two are inputs and the probability is the random number. The margin is therefore the revenue minus the costs. This is repeated 100 times down the page to gain a sample of 100 scenarios.
The next stage is to draw a scatter chart of the results using an XY scatter chart with a linear trend line through the data. This shows the relationship between increased occupancy and increased margin (see Figure 5.12). At each level of occupancy there is a spread of values reflecting the standard deviation of the costs.
Office 2007 – Insert, Charts, Scatter (Excel 2003 – Insert Chart, Chart Wizard)

The scatter chart only provides an idea of the results. The FREQUENCY function allows counting into bins. This chart shows a peak of margin between 5000 and 7000 which is higher than the single point answer (see Figure 5.13). This is because the input was 22 and the average of 20 to 25 is 22.50.

Other statistics are also available in Excel using functions shown in Table 5.1.

### Table 5.1

<table>
<thead>
<tr>
<th>Function</th>
<th>Result</th>
</tr>
</thead>
<tbody>
<tr>
<td>MIN</td>
<td>Minimum number in an array</td>
</tr>
<tr>
<td>MAX</td>
<td>Maximum number in an array</td>
</tr>
<tr>
<td>COUNTIF</td>
<td>Count if a condition is true – in this case less than zero to count the trials with no margin</td>
</tr>
<tr>
<td>AVERAGE</td>
<td>Arithmetic mean</td>
</tr>
<tr>
<td>MEDIAN</td>
<td>Middle result in an array</td>
</tr>
<tr>
<td>SKEW</td>
<td>Skew characterizes the degree of asymmetry of a distribution around its mean. Positive skew indicates a distribution with an asymmetric tail extending towards more positive values. Negative skew indicates a distribution with an asymmetric tail extending towards more negative values</td>
</tr>
<tr>
<td>KURT</td>
<td>Kurtosis of the distribution. Positive kurtosis indicates a relatively peaked distribution. Negative kurtosis indicates a relatively flat distribution.</td>
</tr>
<tr>
<td>SLOPE</td>
<td>Slope of the data using a linear trend line ($y = mx + b$)</td>
</tr>
<tr>
<td>RSQ</td>
<td>$r^2$ is the measure of fit between the linear regression line and the data. The $r^2$ value can be interpreted as the proportion of the variance in $y$ attributable to the variance in $x$.</td>
</tr>
</tbody>
</table>

Office 2007 – Formulas, Functions Library, Maths & Trig (Excel 2003 – Insert, Function)

The counted results can then be plotted with the bins as the $x$-axis and the number of results as the $y$-axis.

The histogram shows the results of the FREQUENCY function (see Figure 5.14). Based on the inputs for occupancy and costs, the margin may not be as firm as 4000 as there are a number of results at around zero. The histogram demonstrates that the overall margin should be higher; however, percentiles would also show the range of values.
The percentile takes the data array and the K value as its arguments. Figures 5.15 and 5.16 show that 50 per cent of the values fall below 4520.8.

=PERCENTILE($G$115:$G$214,K47)

The simulation model provides far more information than the single-point model about how the variables behave and therefore the inherent risk. Increasing the standard deviation of the costs will increase the range of possible outcomes. Similarly, increasing the lowest occupancy to 22 will reduce the range of revenue and therefore the spread of results.

**REAL ESTATE EXAMPLE**

This example revisits the real estate model in Chapter 3 to examine the factors voids and rental per month. The method uses a mean and a standard deviation for these two factors on the Simulation sheet which drive the inputs on the Model sheet. The random number generation is in Visual Basic code since models using tables become slower with more and more calculations. Here, the number of iterations is 1000 and it is sometimes easier to generate the data in code and then transfer it to Excel. The stages are:

- The model generates the numbers for a particular scenario.
- It transfers them to the Model sheet.
- It recalculates and then stores the numbers in an array.
5 · Simulation

Figure 5.15

Percentiles

<table>
<thead>
<tr>
<th>Interval</th>
<th>Percent</th>
<th>Percentile</th>
<th>Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.00%</td>
<td>0.05</td>
<td>199.23</td>
<td>1,035.62</td>
</tr>
<tr>
<td></td>
<td>0.10</td>
<td>343.85</td>
<td>543.09</td>
</tr>
<tr>
<td></td>
<td>0.15</td>
<td>1,082.88</td>
<td>719.02</td>
</tr>
<tr>
<td></td>
<td>0.20</td>
<td>1,534.67</td>
<td>471.73</td>
</tr>
<tr>
<td></td>
<td>0.25</td>
<td>1,831.30</td>
<td>236.63</td>
</tr>
<tr>
<td></td>
<td>0.30</td>
<td>2,372.21</td>
<td>540.91</td>
</tr>
<tr>
<td></td>
<td>0.35</td>
<td>3,081.95</td>
<td>709.74</td>
</tr>
<tr>
<td></td>
<td>0.40</td>
<td>3,933.84</td>
<td>851.89</td>
</tr>
<tr>
<td></td>
<td>0.45</td>
<td>4,412.72</td>
<td>478.88</td>
</tr>
<tr>
<td></td>
<td>0.50</td>
<td>4,951.05</td>
<td>536.32</td>
</tr>
<tr>
<td></td>
<td>0.55</td>
<td>5,307.26</td>
<td>356.24</td>
</tr>
<tr>
<td></td>
<td>0.60</td>
<td>5,961.71</td>
<td>654.43</td>
</tr>
<tr>
<td></td>
<td>0.65</td>
<td>6,461.46</td>
<td>499.75</td>
</tr>
<tr>
<td></td>
<td>0.70</td>
<td>7,031.31</td>
<td>559.85</td>
</tr>
<tr>
<td></td>
<td>0.75</td>
<td>7,818.59</td>
<td>785.28</td>
</tr>
<tr>
<td></td>
<td>0.80</td>
<td>8,344.74</td>
<td>528.15</td>
</tr>
<tr>
<td></td>
<td>0.85</td>
<td>8,702.82</td>
<td>358.08</td>
</tr>
<tr>
<td></td>
<td>0.90</td>
<td>9,583.38</td>
<td>880.57</td>
</tr>
<tr>
<td></td>
<td>0.95</td>
<td>10,418.43</td>
<td>835.95</td>
</tr>
<tr>
<td></td>
<td>1.00</td>
<td>11,814.04</td>
<td>1,395.61</td>
</tr>
</tbody>
</table>

Figure 5.16

Percentiles chart
- It loops 1000 times and then pastes the results in a two-dimensional range J5:Q1005 on the Simulation sheet.
- It produces a scatter chart, frequency table, statistics, percentiles and a histogram.

The inputs in Figure 5.17 use the Base Case scenario on the Model sheet with the standard deviation for the monthly rental at 50 and 10 per cent for the percentage voids. The income after capital growth on the Model sheet is 2600.49 and the net yield percentage 4.84 for this initial case. The simulation layer therefore seeks to show the possible spread in the answers when the ranges of inputs are taken into account.

The code below declares the values and sets highs and lows for each of the factors. It starts a For Next loop, derives the values based on random numbers and the normal probability distribution, and transfers the values for calculation to the Model sheet. When it gets to the end of the loops, the code has built an array or grid of variables that is 1000 cells down by 7 across. Seven items of data are saved per scenario and these are then pasted on to the sheet at the end.

```
Sub Simulation()

Dim Result(1000, 7) 'Set up an array variable 1000 down by 7 across
Dim RandomFactorA, RandomFactorB, Count, ExistingValue1, ExistingValue2
Dim FactorA, FactorAHigh, FactorALow, FactorAStd,
FactorB, FactorBHigh, FactorBLOW, FactorBStd
```
ExistingValue1 = Range("model!d15") 'Remember existing values
ExistingValue2 = Range("model!d17")
Range("Simulation_Results") = "" 'Zero existing results
Randomize

Application.Calculation = xlSemiautomatic 'Turn off calculation of tables

Range("model!d15") = Range("simulation!c15")
Range("model!d18") = Range("simulation!c18")

Range("simulation!B75") = 
(Int((Range("model!i10") * 10))) / 10 ' set centre of frequency table

FactorA = Range("simulation!c15") 'Rental
FactorB = Range("simulation!c18") 'Voids

FactorAHigh = FactorA + Range("simulation!c16") 'Range and StDev for A
FactorALow = FactorA - Range("simulation!c16")
FactorAStd = (FactorAHigh - FactorALow) / 4

FactorBHigh = FactorB + Range("simulation!c19") 'Range and StDev for B
FactorBLow = FactorB - Range("simulation!c19")
FactorBStd = (FactorBHigh - FactorBLow) / 4

For Count = 1 To 1000 'START OF LOOP
RandomFactorA = Rnd 'Find factor for A for this trial
Range("model!d15") = 
Application.NormInv(RandomFactorA, FactorA, FactorAStd)
randomfactorb = Rnd 'Find factor for B for this trial
Range("model!d17") = 
Application.NormInv(randomfactorb, FactorB, FactorBStd)
Result(Count, 0) = RandomFactorA
Random factor A
Result(Count, 1) = Range("model!d15") 'Rental per month
Result(Count, 2) = randomfactorb
Random factor B
Result(Count, 3) = Range("model!d17") 'Voids
Result(Count, 4) = Range("model!i29")
Mastering Risk Modelling

‘Gross margin
Result(Count, 5) = Range("model!c36") ‘Net margin with capital growth
Result(Count, 6) = Range("model!d34")
‘Gross yield
Result(Count, 7) = Range("model!d36") ‘Net yield
Range("Simulation!E7") Count
Next Count END OF LOOP
Application.Calculation = xlAutomatic
Range("Simulation_Results") = Result ‘Paste results
Range("model!d15") = ExistingValue1 ‘Put back existing inputs
Range("model!d17") = ExistingValue2
End Sub

The information saved is as shown in Figure 5.18.

The model then uses some of the code from the previous example to draw scatter charts and histograms (see Figure 5.19). As the percentage of voids rise, the overall yield declines. With 1000 trials there are still a number of data points outside the main concentration and running the model for more trials would increase the accuracy based on the Central Limit theorem.

The table uses FREQUENCY and other statistical functions to summarize and describe the distribution of results (see Figures 5.20 and 5.21). The majority of returns cluster between 4.3 and 5.8 per cent as shown in the left-hand table in Figure 5.20. The right-hand table in Figure 5.20 summarizes the input data for the monthly rental and the voids percentage, and then lists the mean and other statistics for the output distribution.
5 · Simulation

**Scatter chart**

![Scatter chart](image1)

**Figure 5.19**

**Frequency results**

![Frequency results](image2)

**Figure 5.20**

**Histogram**

![Histogram](image3)

**Figure 5.21**
Mastering Risk Modelling

Both the quartiles and percentiles are calculated so that you can see how many results provided low returns (see Figures 5.22 and 5.23). In this case, 25 per cent of the trials resulted in returns below 4.4 per cent and an income of 2381.52. Again, the simulation model provides more management information about the possible spread of answers. Several sets of scenarios could be run with differing distribution inputs to see the effect of flexing each of the variables.

**Figure 5.22**

### Frequency tables

<table>
<thead>
<tr>
<th>Quartiles</th>
<th>Yield %</th>
<th>Count</th>
<th>Total Income</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>2.766</td>
<td>1</td>
<td>1,458.39</td>
<td>1</td>
</tr>
<tr>
<td>1</td>
<td>4.415</td>
<td>249</td>
<td>2,361.52</td>
<td>249</td>
</tr>
<tr>
<td>2</td>
<td>5.844</td>
<td>250</td>
<td>2,605.47</td>
<td>250</td>
</tr>
<tr>
<td>3</td>
<td>5.209</td>
<td>250</td>
<td>2,500.00</td>
<td>250</td>
</tr>
<tr>
<td>4</td>
<td>7.883</td>
<td>250</td>
<td>3,812.56</td>
<td>250</td>
</tr>
<tr>
<td>Total Results</td>
<td></td>
<td>1,000</td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>Range</td>
<td></td>
<td>4.328</td>
<td>2,328.17</td>
<td></td>
</tr>
</tbody>
</table>

**Figure 5.23**

### Quartiles chart

**SUMMARY**

Simulation methods add another layer to financial models, allowing a range of inputs based on probability distributions. Running the model through a series of randomly generated possible scenarios provides an automated 'what
if? analysis. It should be stressed that the outputs are entirely dependent on the input distributions and therefore the model is a probability and not a certainty model. In the real world, there are always events that have not been foreseen by the modeller, which can affect the simulation outputs. Nevertheless, this form of modelling adds another dimension to the information produced by financial models.
Financial analysis

Introduction

Process

Environment

Industry

Financial statements

Profit and loss

Balance sheet

Operating efficiency

Profitability

Financial structure

Core ratios

Market ratios

Trend analysis

Cash flow
INTRODUCTION

Financial analysis seeks to outline the main areas of risk highlighted by an organization's annual report. Recent company failures and the consequent tightening of corporate governance as defined by the Sarbanes–Oxley Act in the US mean that it is important to highlight possible areas of weakness and read the reported data correctly. Since calculating ratios or deriving cash flows with a pocket calculator is time consuming, a risk model can be an important tool for understanding the accounts.

Performance measurement in the form of ‘what gets measured gets managed’ can be summarized as:

- economy – how well the company buys in the factors of production (labour, materials, knowledge);
- efficiency – how well the company turns the ‘raw material’ into goods and services for sale;
- effectiveness – how well the company rewards the key stakeholders, including shareholders;
- environment – the company’s responsibilities in the wider world;
- ethics – ethical goals such as corporate governance.

![Analysis framework](image)
Figure 6.1 categorizes the banking analysis. First, the historic position outlines the quality of past decision making and the ability of the management to make and implement strategic decisions leading to an increase in the value of the company. Measures of success will vary by industry: for example, the value added by employees can be important in a service company whereas sales per square metre can indicate increased efficiency in a supermarket chain. For most companies, these are significant indicators of past success.

Past performance is not a guarantee of future success and, in assessing loans or financial commitment, analysis needs to switch to the current and forecast position. There are factors within and extra to the organization’s control in driving it forward and therefore analysis needs to include some assessment of future performance.

This chapter reviews the analysis from a risk perspective and Figure 6.2 demonstrates the main sources of risk:

- process – limitations of financial statements;
- environment – factors beyond the organization’s control;
- industry – competitiveness of the industry and reliability in producing returns;
- financial factors – operating cycle, profitability and financial structure;
- cash flow produced by the interlocking financial factors;
- management competence and depth.

![Risk framework diagram](image-url)
PROCESS

The starting point is the annual report, which in the UK is drawn up based on the following four fundamental principles:

1. prudence means that doubtful revenues are not included while potential liabilities and losses are provided for;
2. consistency requires similar treatment from one accounting period to the next;
3. going concern assumes that the business will continue to operate;
4. matching or accruals means that costs should be matched as far as possible to applicable revenue in the same accounting period.

The above principles are augmented by financial reporting standards and conventions which seek to produce similarity in the way that organizations report their results. Internationally, the IAS standards provide a system of financial accounting standards and policies which result in Generally Accepted Accounting Principles (GAAP). Despite the rules on reporting, there are limitations to the financial information so that reports from different international companies are not always strictly comparable. For example, there are a number of methods for enhancing earnings which usually involve shifting cost from the income statement to the balance sheet. This could be achieved by adopting a longer depreciation period for fixed assets, capitalization of interest or research and development expenses. The intention here is not to provide a listing of the limitation of accounts but merely to point out that there is a risk in taking the figures as absolute values.

Other distortions could be created by the choice of year end or changes in the composition of group operations. Highly acquisitive companies are difficult to analyse since the figures are not always comparable across year ends. Similarly, changing year ends reduces the comparability of the figures to the point where trend analysis becomes more difficult.

ENVIRONMENT

The STEEPV model was outlined in Chapter 4 and is applicable here. Any analysis should begin with an assessment of the non-financial factors. These are factors beyond the organization’s influence and any analysis should include an understanding of the forces operating on the environment, such as the following:

- Economic – economic cycles, interest and exchange rates, inflation both domestic and foreign. In the global economy, economic risks are always present whether an organization is an exporter or domestic service supplier.
Demographics and demand in different age groups – Western Europe is an ageing population and this affects the demand for a wide range of products from care homes to nappies.

Social – trends that have a medium- and long-term effect on demand.

Technology – each industry is affected differently: some may benefit while others may not be able to change rapidly enough to remain competitive. For example, Psion pioneered the personal digital assistant (PDA) market but withdrew from the market owing to increased competition and falling prices.

Government changes can change competitiveness. For example, the government has reduced the attractiveness of UK finance leases since 1997 by curtailing the tax depreciation benefits relative to operating leases and fixed-term rentals. Changes in the way that government acquires goods and services can also change the landscape such as with the private financing initiatives for the acquisitions of schools and hospitals.

Ecology – this factor has assumed more importance with the rise of lobby groups and non-governmental organizations such as Greenpeace. Companies are judged on their ‘green’ credentials and those such as Shell and Norsk Hydro have been forced to change their policies.

If an environment appears to be stable, then predictions can be made on the basis of the past, but there can be unexpected changes (see Figure 6.3). Where there appears to be dynamic change, then projections of the future are likely to be useful in determining the key success factors and their sensitivity. Where change is both dynamic and complex, then the management ability assumes importance because of the requirement for a market-driven response to change.
INDUSTRY

The Michael Porter ‘five forces’ model (see Figure 6.4) provides a framework for understanding a company’s competitive position within an industry. As part of the qualitative analysis, an assessment is made of each of these factors and the impact on competition. Since the management and financial strategy should be coordinated, it follows that the industry characteristics influence the type of strategy adopted. The purpose is to try and achieve a ‘sustainable competitive advantage’ over the short and medium term. In analysis terms, this should mean a non-volatile cash flow and the ability to meet debts comfortably as they arise.

In the European airline industry, the threat of potential entrants is kept to a minimum by the high capital requirements and the difficulty of accessing new landing slots. National full-cost airlines typically have control over the hub and spoke networks used for intercontinental travel and appear to use their economies of scale to keep out competitors. There are few substitutes to using aircraft travel over longer distances, but other forms of travel such as car and rail, most notably the Channel Tunnel and high-speed rail networks, can offer equal benefits. The power of suppliers is great especially in the market for large jets. Lower down, there is a duopoly between Boeing and Airbus Industrie which limits airlines’ ability to choose. The power of buyers has been increased through deregulation and the rise of low-cost carriers based on the South Western Airlines model in the US. The ‘no frills’ package has been developed in Europe by Ryanair and easyJet to such an extent that the current market capitalization of Ryanair is greater than British Airways. AirAsia has also seen rapid growth in Asia. Therefore, the market has become more competitive and the airlines in Europe have a lesser grip, leading to reduced profits and prospects.
An alternative method would be to analyse the sources of value, and one model uses value chains to assess how a business unit adds value (see Figure 6.5). The key activities are inbound logistics, operations, outbound logistics, marketing and sales, and after service. These areas are supported by the infrastructure, human resources management, technology development and procurement. Business units can be compared to a peer group to assess the degree of success in these areas. The qualitative analysis leads to the modelling and an assessment of risk in the financial reports, and this initial review should provide questions for further considerations when the accounts are standardized as schedules.

**FINANCIAL STATEMENTS**

After consideration of the macro and industrial context, the model provides a standard method for reviewing companies and identifying trends. The basic question is whether risk is increasing or decreasing in the company. Trade credit tends to be fairly short term while bank loans usually entail a commitment over several years. Bear in mind also the time it takes after the year end to publish accounts. The model spreads the accounts into standard schedules and produces ratios and cash flows to assist with isolating weaknesses and identifying trends:

- ratios vary widely between different sectors such as retailers, manufacturers and service companies;
- trends need to be considered against the environment and industry sector;
- the absolute numbers are not relevant;
- ratios are backward looking and it usually takes companies some months to report and file accounts;
analysis against a peer group or sector can highlight areas where the company is more or less efficient.

Most institutions have their own rules about how to treat intangibles or assets under constructions, and the spread format introduces a clear and concise method of combining the reported statements together with their notes. The three main areas of risk are:

1. operating efficiency – the operating cycle;
2. performance – profitability;
3. financial – financial structure and leverage.

In reviewing the above three risk sources, the model needs to address:

- sales growth and its impact on working capital and cash;
- working capital and the availability of resources;
- cash flow performance, in particular the trading cash flow;
- profitability and the distribution of cost;
- return on capital for shareholders as their return for the risk of investing in the company;
- requirement for capital expenditure to fuel further growth in forecast periods;
- gearing and the proportion of the company funded by outside debt;
- debt repayment ability.

The model conforms to the structure shown in Figure 6.6 and is based on the standard Systematic application template. It is important that each schedule layout is consistent. The income statement and balance sheet are input schedules and these provide the information for the cash flow and ratio schedules. The forecast sheet uses key performance drivers to redraw the forecast schedules and these act as a basis for the next chapter. Here the emphasis switches to loan cover, sustainable growth and bankruptcy prediction models.

**PROFIT AND LOSS**

The structure of the profit and loss or income statement follows traditional lines (see Figure 6.7). This is simplified for ease of understanding, but more lines could be added to subdivide the categories to display an increased level of detail.
The input cells in Excel are marked blue and the totals are in bold green on the screen. The latter cells only add up the cells above, which all adhere to the cash flow rule. Cash received is positive, while cash outflows are entered as negative numbers. Numbers are formatted so that zeros display as a ‘-’ to make the schedule easier to understand.

Excel does not allow you to ‘drill down’ to the answers from one schedule to another. It can be a problem understanding the source of the cell results. The model uses a numbering system, for example ‘P’ for profit and loss or ‘B’ for balance sheet, when referring to this data in the calculation schedules. The format for the numbering is:

```
"P"&TEXT(ROW(A10),"00")
```
The levels of profit are clearly marked and Table 6.1 shows the alternative descriptions.

For completeness, the common size analysis is calculated on the right-hand side (see Figure 6.8). This acts as a first step to ratios and shows each of the cost and profit lines as a percentage of sales. Figure 6.8 shows the declining gross margin and profits coupled with an increasing dividend payout ratio.

### BALANCE SHEET

The balance sheet shows the book value of assets and liabilities of the company at each year end. The format corresponds to international notation and is split into current and fixed assets followed by current liabilities, long-term debt and shareholders’ funds, which is split into shares and retained profit and loss. The number of categories is again limited but could be expanded, for example to include other share categories.
The total assets are given for each year and there is again a percentage split (see Figure 6.9). This is an input sheet and therefore no ‘work’ is done here. Rather, the data is standardized for further analysis in the cash flow and ratios sheets. The schedule includes a ‘CheckSum’ to check that assets equal liabilities (see Figure 6.10). If they do not, then cell E43 displays a warning message:

```
=IF(SUM(I43:M43)<>0,"Errors","No Errors")
```
Together the income statement and balance sheet constitute the basic inputs to the model. In this form, you can look along the rows and try to pick out trends. The common size views assist with a cursory view of trends, but eventually you need to look more closely by calculating ratios and discerning trends.

**OPERATING EFFICIENCY**

The three areas of risk determine the quality and quantity generated by the organization. The decisions of what and how much to produce are underpinned by the management. In turn, the efficiency in the business cycle (see Figure 6.11) underlines the control exerted by the management in the use of resources.

Cash is used to purchase raw materials, which move through the production process into finished goods. The company delivers the goods, invoices its clients and has to wait for the customer to pay. It is a measure of management ability as to how fast it can ‘turn’ this cycle. If it cannot sell its finished goods, then they will remain in a warehouse and have to be funded from cash in the operating cycle, bank finance or new equity. More borrowings will increase the company’s costs and reduce profits through an increased interest burden. This is termed ‘business risk’.

---

**Figure 6.10**

<table>
<thead>
<tr>
<th>Liabilities</th>
<th>USE/MIL (L/O)</th>
<th>Dec-08</th>
<th>Dec-09</th>
<th>Dec-07</th>
<th>Dec-06</th>
<th>Dec-05</th>
</tr>
</thead>
<tbody>
<tr>
<td>26.00</td>
<td>Short Term Bank Loans</td>
<td>91.6</td>
<td>4,797.0</td>
<td>5,216.0</td>
<td>7,645.0</td>
<td>795.0</td>
</tr>
<tr>
<td>28.00</td>
<td>Trade Creditors (Payables)</td>
<td>740.0</td>
<td>1,771.0</td>
<td>6,909.0</td>
<td>8,020.0</td>
<td>4,846.0</td>
</tr>
<tr>
<td>30.00</td>
<td>Other Creditors</td>
<td>116.0</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>31.00</td>
<td>Other Current Liabilities</td>
<td>1,274.0</td>
<td>3,602.0</td>
<td>5,825.0</td>
<td>4,095.0</td>
<td>3,578.0</td>
</tr>
<tr>
<td>32.00</td>
<td>Current Liabilities</td>
<td>8,674.0</td>
<td>16,960.0</td>
<td>17,254.0</td>
<td>17,073.0</td>
<td>9,376.0</td>
</tr>
<tr>
<td>33.00</td>
<td>Long Term Bank Loans</td>
<td>7,413.0</td>
<td>16,448.0</td>
<td>17,328.0</td>
<td>17,989.0</td>
<td>38,036.0</td>
</tr>
<tr>
<td>34.00</td>
<td>Long Term Liabilities</td>
<td>7,413.0</td>
<td>16,448.0</td>
<td>17,328.0</td>
<td>17,989.0</td>
<td>38,036.0</td>
</tr>
<tr>
<td>37.00</td>
<td>TaxDeferted Taxation</td>
<td>900.0</td>
<td>3,923.0</td>
<td>8,236.0</td>
<td>5,520.0</td>
<td>6,933.0</td>
</tr>
<tr>
<td>38.00</td>
<td>Long Term Liabilities and Promissory Notes</td>
<td>7,724.0</td>
<td>14,891.0</td>
<td>26,698.0</td>
<td>23,720.0</td>
<td>50,075.0</td>
</tr>
<tr>
<td>39.00</td>
<td>Ordinary Shares (Common Stock)</td>
<td>15,440.0</td>
<td>58,210.0</td>
<td>52,139.0</td>
<td>52,316.0</td>
<td>54,325.0</td>
</tr>
<tr>
<td>39.10</td>
<td>Profit and Loss Reserve (Retained Earnings)</td>
<td>1,272.0</td>
<td>4,589.0</td>
<td>4,431.0</td>
<td>2,815.0</td>
<td>3,649.0</td>
</tr>
<tr>
<td>40.00</td>
<td>Shareholders’ Funds</td>
<td>13,694.8</td>
<td>46,244.0</td>
<td>50,258.0</td>
<td>54,851.0</td>
<td>57,976.0</td>
</tr>
<tr>
<td>44.00</td>
<td>Unearned/Deferred Revenues</td>
<td>-</td>
<td>3,752.0</td>
<td>2,359.0</td>
<td>2,569.0</td>
<td>181.0</td>
</tr>
<tr>
<td>45.00</td>
<td>Total Liabilities and Equity</td>
<td>23,096.0</td>
<td>67,092.0</td>
<td>71,572.0</td>
<td>68,036.0</td>
<td>101,314.0</td>
</tr>
<tr>
<td>46.00</td>
<td>Market Debt</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>47.00</td>
<td>Number of Shares Issued &amp; Outstanding</td>
<td>961,610.0</td>
<td>2,776,726.0</td>
<td>2,485,544.0</td>
<td>2,887,960.0</td>
<td>2,953,000.0</td>
</tr>
<tr>
<td>48.00</td>
<td>Current Share Price</td>
<td>28.00</td>
<td>45.00</td>
<td>50.00</td>
<td>18.00</td>
<td>13.40</td>
</tr>
</tbody>
</table>
Liquidity is the ability of management to turn operating assets into cash. Here it is necessary to question the valuation of the current assets. Questions could relate to the saleability of the stock or the composition of the debtors where cash can safely be expected. For example, a leasing company could fail to terminate slow payers and thereby delay booking a loss because of a client’s insolvency. The effect would overstate debtors and profits by including non-viable debts.

Solvency requires that the organization can meet cash demands as they fall due. Bankers require cash payment both of capital and interest. Here the accounts should demonstrate the margin of safety should sales decline. Stocks are of particular interest, especially in industries such as retailing where the number of days stock could hide other more fundamental problems.

The balance sheet structure is shown in Figure 6.12. The model calculates ratios such as:

- **Stock days** – this is the number of stock days on hand. A rising number of stock days could demonstrate the company’s inability to shift old or out-of-date stock. This could be further sub-divided into raw materials, work in progress and finished goods.

- **Creditor days** – this is the number of days taken to pay creditors. A high or rising ratio could indicate that the company was overtrading and using supplier cash.

- **Debtor days** indicate the accounts receivable days or collection period. The attitude towards credit policy and collection can illustrate the management’s abilities or problems with sub-standard or returned products.

- **Funding gap or cash conversion cycle**. This is the debtor days plus stock days minus creditor days. A longer cycle means more risk since the company has to wait longer to turn debtors and stock back into cash.

- **Working capital turnover**. This is sales/(stocks + debtors – creditors) and represents the number of times in a year that the company turns the working capital. Again, different companies and industries require differing...
levels for efficient operation. The ratio may also indicate overtrading where the ratio is high and growing quickly. The level of growth may be too high for the financial resources of the company. In the short term, overtrading may be a source of low-cost financing, but in the longer term the risk of insolvency increases. Other symptoms are:

- decreasing liquidity;
- high stock turnover;
- increasing interest costs;
- high working capital turnover;
- capital expenditure or increased investment in intangibles.

The model uses functions to determine if last year is better than the two previous years ('Better'), ahead of one year ('OK') or worse than both years ('Worse'). This directs the user at the lines that need investigation or further attention. The cell formula in cell M11 on the ratios sheet is:

```
=IF(K11=0,"N/A",IF(J11=0,"N/A",IF(AND(L11>K11,L11>J11),"Better",IF(OR(L11>K11,L11>J11),"OK","Worse")))))
```

Gearing and inventory together with the funding gap use opposite logic. If the number of days or the gap increases, this means that the company has to find more resources to fund the cycle. The funding gap increases in the two previous periods and so the cell formula returns 'Worse'.

In each formula, the possibility of an error caused by a zero number is handled by an IF statement. This is Ratios cell L11:

```
=IF(Income!M10<>0, (Income!M24/Income!M10)*100, 0)
```
An alternative would be to use `ISERROR` or `ERROR.TYPE` to force zero if Excel cannot calculate a valid answer. The answer is multiplied by 100 since the application standardizes on numbers rather than a mixture of numbers and percentages.

\[
=IF(ISERROR(Income!M24/Income!M10),0,(Income!M24/Income!M10)\times100)
\]

Figure 6.13 shows an improved position in receivables, where the number of days is declining, and a worsening position for creditors. Working capital turnover is increasing because of the reduced sales, debtors and creditors. Overall the operating efficiency is increasing against a background of falling sales.

### PROFITABILITY

Profitability is supposed to be the goal of companies to reward the shareholders for risking their investment in the company. Financial reporting standards set out the general rules, but there are always different interpretations of the rules by operating officers. Furthermore, there are several profit
Financial analysis

and return measures which may provide differing results. If a company is profitable, then one would expect to see the returns revealed in cash flow, but this is not always the case. Therefore, profitability should not be reviewed to the exclusion of operating efficiency, financial structure and cash flow.

Where you have profits, but no cash flow, then you may need to examine the accounting methods and standards. For example, the company in the model has increased sharply the amounts in intangible assets to the point where this is almost as great as the shareholders’ funds. This could hide costs that are being ‘parked’ in the balance sheet in order to bolster profits.

The ratios in this section are:

- gross profit/sales as the percentage gross margin;
- net operating profit/sales as a percentage return on trading;
- profit before tax/sales as the profit margin after interest costs;
- return on capital employed (ROCE) as net operating profit divided by long-term debt plus shareholders’ funds;
- return on invested capital (ROIC) as net operating profit multiplied by \((1 – \text{tax})\) divided by long- and short-term debt plus shareholders’ funds;
- return on assets as the net operating profit divided by total assets.

Figure 6.14 show a volatile position with returns worse in the last period for all ratios. The income statement profit ratios have all halved, and balance sheet measures such as the return on assets have sunk to levels lower than the cost of capital.

**FINANCIAL STRUCTURE**

Financial risk is concerned with the structure of the balance sheet together with the sources of finance to the company. Bankers are concerned with the liabilities taken on by companies and their ability to service debt. Prospects are often more volatile than originally anticipated and therefore the model needs to provide information about the financial strength. The company needs to manage debt and equity efficiently in order to reduce the cost of capital but also not take on obligations which cannot be paid back. In general terms, the cost of capital falls with an increasing debt percentage on the balance sheet, but the financial risk increases because of the interest burden.

The ratios calculated by the model are:
Current ratio – basic measure of liquidity as the ratio of current assets to liabilities. The working capital requirement varies across industries so the absolute value is less important than the trend.

Quick ratio – this excludes stock from the current ratio. The rationale is that stock is often difficult to sell at book prices and may not be as realizable in the short term.

Working capital as current assets minus current liabilities.

Gross gearing (leverage) as short- plus long-term debt divided by shareholders’ funds.

Net gearing (leverage) as gross gearing debt less cash and marketable securities.

Solvency or time interest earned measures the number of times profit before interest and tax covers the interest payment.

Total equity/total assets is a measure of financial strength or who owns the company. Companies with a high ratio are financially more resilient.

Figure 6.15 shows increasing gearing and reduced solvency as returns only cover the interest payment twice over. The findings are in line with operating efficiency and profitability, both of which have declined in the last year.

CORE RATIOS

One method of calculating ratios from key areas is to use Du Pont or core ratios and calculate the components of the return on equity. Return on
equity defines the return the shareholders receive from the enterprise. As a shortcut, the method also provides a ratio from each of the risk areas discussed above.

The return on equity is net profit after tax/shareholders’ equity and this can be subdivided into:

<table>
<thead>
<tr>
<th>Ratio</th>
<th>Formula</th>
<th>Sub-ration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Sales</td>
<td>NPAT/Sales</td>
<td>Profitability P24/P10</td>
</tr>
<tr>
<td>Asset Turnover</td>
<td>Sales/Total Assets</td>
<td>Operating Efficiency P10/B24</td>
</tr>
<tr>
<td>Asset Leverage</td>
<td>Total Assets/Equity</td>
<td>Financial Structure B23/B39</td>
</tr>
</tbody>
</table>

These three ratios, when multiplied together, equal the return on equity.

\[
\frac{NPAT}{Equity} = \frac{Sales}{Total\ assets} \times \frac{Total\ assets}{Equity} \times \frac{NPAT}{Sales}
\]

The ratios in this section (see Figure 6.16) are multiplied out to show the composition of the return on equity (see Figure 6.17). This has declined over the period and underlines the worsening performance. Faced with the weaker areas, the analysis can then proceed to review these areas in more detail.

The ratios demonstrate the levers that management can use to extract performance from the business:

- earnings from each $1 of sales – profit margin (income statement)
- sales for each $1 of assets – asset turnover (asset side of balance sheet)
- equity used to finance each $1 of assets – financial or asset leverage (liabilities side of balance sheet).

Return on equity is often considered to be the most important return measure, but it has limitations:

- The return on equity (ROE) is historic and may not be a good indicator for the future.
- The calculation does not include a measure of the risk profile of the industry and company. More risk should demand a greater return to shareholders.
The ROE is an accounting measure and is based on book values. The value of equity may be better presented by the market value of debt and the market value of equity (enterprise value).

Asset turnover depends on the sector and the assets needed in the business. Knowledge-based companies invest in people and information as major assets in developing competitive advantage as opposed to high levels of plant and equipment. These values are not recorded on the balance sheet.

Asset leverage depends on the uncertainty of cash flows. In a risky or volatile business, such as pharmaceuticals, shareholders are normally expected to fund research and development. There may be pressure to advance revenues and capitalize costs which can distort the asset leverage.

MARKET RATIOS

The model includes a number of market ratios (see Figure 6.18). The market capitalization is reducing because of a reduced share price. The earnings per share has declined and the P/E ratio increases because of the reduction in share price. The dividend per share has increased, reflecting management’s desire to maintain the dividends despite falling profits. The market to book ratio is below one and therefore the stock market does not rate the prospects for the company or have faith in the management.

TREND ANALYSIS

The Historic_Mgt_Analysis sheet provides a dynamic chart for reviewing all the rows in the income statement, balance sheet and ratios. See Chapter
2 for an explanation of the method. It can often ‘see’ the trends when faced with the schedules of numbers produced by Excel. On the basis that different audiences needs varying levels of detail, the chart allows you to look at individual lines.

### Market ratios

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Component</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>combo box</td>
<td>with the labels as inputs and cell J13 as the link;</td>
</tr>
<tr>
<td>OFFSET</td>
<td>function looking at the block of data below and using the cell link as the row number;</td>
</tr>
<tr>
<td>chart</td>
<td>of the single series.</td>
</tr>
</tbody>
</table>

### Office 2007 – Developer, Controls, Insert, Form Controls (Excel 2003 – View, Toolbars, Forms)

Figure 6.19 shows the return on assets where the components are:

- combo box with the labels as inputs and cell J13 as the link;
- OFFSET function looking at the block of data below and using the cell link as the row number;
- chart of the single series.
Figure 6.20 provides a relative result where the first year is a factor of 100 and the next years the percentage movement. Thus factor 80 would be a 20 per cent reduction.

**Figure 6.20**

**Factor chart**

The ratio analysis shows a worsening financial position so the next stage is to examine the cash flow produced by operations and consumed by the company. Since cash flow should not be affected by accounting standards and conventions, this analysis may reveal more about the financial prospects. Similarly, as bankers seek a steady and non-volatile cash flow to repay debts, cash flow analysis should provide further information on financial health.

The model includes a sheet called Cashflow which reconciles the income statement and balance sheet back to change in cash.

- Starting cash balance
- Cash generated from operations and other sources
- Cash used to fund operations, investment, research, etc.
- Ending cash balance.

The model uses a layout which calculates the trading cash or net operating cash flow (NOCF) and then the uses of the cash together with the new capital introduced into the business to reconcile back to bank. The key objective is to split the cash generated through trading operations, one-off sources of cash, uses of cash and new capital introduced into the business. Provided the model is correct, the remaining balance should reconcile back to the change in cash on the balance sheet.
The important lines are:

- **EBITDA** – net operating profit adding back non-cash items such as depreciation of fixed assets and amortization of goodwill as a simplistic proxy for cash flow;
- **net operating cash flow** – trading cash produced from the trading of the company;
- **cash flow before financing** – cash before new capital.

Figure 6.21 illustrates the derivation of the lines in the cash flow. This is particularly useful where the information is derived from the change in balance from the beginning to the end of the year in the balance sheet and the amounts passed through the income statement.

### Cash flow method

<table>
<thead>
<tr>
<th>Item</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Operating Profit (NOP)</td>
<td>Income statement</td>
</tr>
<tr>
<td>Depreciation/Amortisation</td>
<td></td>
</tr>
<tr>
<td>Non-cash items</td>
<td></td>
</tr>
<tr>
<td>Earnings before Interest, Tax, Depreciation and Amortization (EBITDA)</td>
<td></td>
</tr>
<tr>
<td>Operating items</td>
<td></td>
</tr>
<tr>
<td>(+) Current Assets</td>
<td>Inc., negative, Dec., positive</td>
</tr>
<tr>
<td>(−) Current Liabilities</td>
<td>Inc., Positive, Dec., negative</td>
</tr>
<tr>
<td>Net Operating Cash Flow (NOCF)</td>
<td>EBITDA + change in working capital</td>
</tr>
<tr>
<td>Returns on investment and servicing of Finance</td>
<td></td>
</tr>
<tr>
<td>Interest Received</td>
<td>Income statement</td>
</tr>
<tr>
<td>Interest Paid</td>
<td>Income statement</td>
</tr>
<tr>
<td>Dividends</td>
<td>Income statement</td>
</tr>
<tr>
<td>Net Cash Outflow from Returns on Investments and Servicing of Finance</td>
<td></td>
</tr>
<tr>
<td>Taxation</td>
<td>Income statement</td>
</tr>
<tr>
<td>Taxes Paid</td>
<td>Income statement</td>
</tr>
<tr>
<td>Defined Tax</td>
<td>Change in balance sheet</td>
</tr>
<tr>
<td>Net Cash Outflow for Taxation</td>
<td></td>
</tr>
<tr>
<td>Investing Activities</td>
<td></td>
</tr>
<tr>
<td>Expenditure on Property, Plant and Equipment</td>
<td>Change in balance sheet + depreciation in P&amp;L</td>
</tr>
<tr>
<td>Expenditure on Investment &amp; Intangibles</td>
<td>Change in balance sheet</td>
</tr>
<tr>
<td>Marketable Securities</td>
<td>Change in balance sheet</td>
</tr>
<tr>
<td>Net Cash Outflow for Capital Expenditure and Financial Investment</td>
<td></td>
</tr>
<tr>
<td>Exceptional and Minority Items</td>
<td>Income statement and balance sheet (if applicable)</td>
</tr>
<tr>
<td>Net Cash Outflow from Exceptional and Minority Items</td>
<td></td>
</tr>
<tr>
<td>Reconciliation</td>
<td>Difference between FE or P&amp;L and balance sheet</td>
</tr>
<tr>
<td>Total Cash (Outflow/Inflow) before Financing</td>
<td>Add or Subtract</td>
</tr>
<tr>
<td>Financing</td>
<td></td>
</tr>
<tr>
<td>Share Capital and Reserves</td>
<td>Change in balance sheet</td>
</tr>
<tr>
<td>Short Term Debt and Provisions</td>
<td>Change in balance sheet</td>
</tr>
<tr>
<td>Long Term Debt and Provisions</td>
<td>Change in balance sheet</td>
</tr>
<tr>
<td>Net Cash Inflow/Outflow from Financing</td>
<td></td>
</tr>
<tr>
<td>Increase (Decrease) in Cash</td>
<td>Add or Subtract</td>
</tr>
</tbody>
</table>

The method is summarized in Figure 6.21 where the statement starts with the net operating profit and adds back non-cash items resulting in
earnings before interest, tax, depreciation and amortization (EBITDA). The changes in working capital are subtracted to form the net operating cash flow. An increase in current assets results in a reduction of cash, while an increase in current liabilities results in an increase of cash.

The net operating cash flow is usually the first line of a reported cash flow statement and the lines above are shown as a note. Below the net operating cash flow, there are categories for returns on investment and servicing of finance, taxation, investing activities, exceptional and minority items.

**Figure 6.22**

<table>
<thead>
<tr>
<th>Line</th>
<th>Item Description</th>
<th>USD (000)</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>Net Operating Profit (NOPF)</td>
<td>$442.0</td>
<td>1,088.0</td>
</tr>
<tr>
<td>11</td>
<td>Earnings before Interest, Tax, Depreciation and Amortization (EBITDA)</td>
<td>$442.0</td>
<td>1,088.0</td>
</tr>
<tr>
<td>12</td>
<td>Operating Items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>(a) Current Assets</td>
<td>$505.0</td>
<td>(240.0)</td>
</tr>
<tr>
<td>16</td>
<td>(b) Current Liabilities</td>
<td>$505.0</td>
<td>(240.0)</td>
</tr>
<tr>
<td>17</td>
<td>Net Operating Cash Flow (NOCF)</td>
<td>1,088.0</td>
<td>0,792.0</td>
</tr>
<tr>
<td>18</td>
<td>Returns on Investment and Servicing of Finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>InterestsReceived</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>InterestPaid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Dividends</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Net Cash Outflow from Interest, Tax, and Servicing of Finance</td>
<td>(734.0)</td>
<td>(1,030.0)</td>
</tr>
<tr>
<td>26</td>
<td>Taxation</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>InvestmentActivities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>CapitalExpenditure and Equity Finance (Net)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Equity Finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Net Cash Outflow for CapitalExpenditure and Equity Finance</td>
<td>(4,380.0)</td>
<td>(4,380.0)</td>
</tr>
<tr>
<td>36</td>
<td>Exceptional and Minority Items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>ExceptionalIncome and Expenditure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>38</td>
<td>Net Cash Outflow from Exceptional and Minority Items</td>
<td>(1,377.0)</td>
<td>(1,377.0)</td>
</tr>
<tr>
<td>52</td>
<td>Total Cash Outflow before Financing</td>
<td>(5,770.0)</td>
<td>(5,770.0)</td>
</tr>
<tr>
<td>53</td>
<td>Financier</td>
<td></td>
<td></td>
</tr>
<tr>
<td>54</td>
<td>Increase (Decrease) in Cash</td>
<td>1,972.0</td>
<td>(551.0)</td>
</tr>
</tbody>
</table>

The reconciliation items catch any differences between the retained earnings in the income statement and the amount actually added to the reserves in the balance sheet. These could consist of:

- prior year P&L adjustment;
- shares issued or repurchased;
- preference shares issued;
- goodwill written off or written back;
- foreign exchange translation;
- revaluation for the year;
- transfer to/from reserves.

The balance at the bottom should agree with the change in cash on the balance sheet and there is a CheckSum to ensure that any errors are reported visually on the schedule (see Figure 6.22).

Cell E55: =IF(ROUND(SUM(J55:M55),0)=0,"No Errors","Errors")

**Net operating cash flow (NOCF)**

Figure 6.23 illustrates the variability in the underlying cash flow over the four periods. The operating cash flow has declined in the last three periods.

![Figure 6.23](NOCF)

<table>
<thead>
<tr>
<th>Time</th>
<th>Flow</th>
<th>NOCF(2000-00)</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>(million)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>J55</td>
<td>M55</td>
</tr>
<tr>
<td>C1</td>
<td>C1</td>
<td>EBITDA</td>
<td>D11</td>
</tr>
<tr>
<td>D1</td>
<td>D1</td>
<td>Operating Cash</td>
<td>D23</td>
</tr>
<tr>
<td>D2</td>
<td>D2</td>
<td>Net Operating Cash Flow (NOCF)</td>
<td>D26</td>
</tr>
</tbody>
</table>

The ratios schedule contains cash flow ratios at the bottom calculated by dividing different cash measures back into sales (see Figure 6.24). These again show a reduction in cash flow. Sales are used since this number should not be varied by international accounting conventions, but there are still variances on when revenues are recognized.

- EBITDA/sales (%)
- net operating cash flow/sales
- cash flow before financing/sales.

![Figure 6.24](Cash ratios)
Free cash flow

Free cash flow has a number of definitions and Figure 6.25 shows the difficulty of defining the elements that should be included or excluded. In simple terms, free cash flow is the cash flow available to pay debt providers and equity holders. It is defined here as:

- net operating profit (NOP)
+ depreciation/amortization/non-cash items
- earnings before interest, tax, depreciation and amortization (EBITDA)
+/- changes in net working assets
- net operating cash flow (NOCF)
- expenditure on property, plant and equipment, investment and proceeds of sale
- net cash outflow for taxation
operating free cash flow.

There is a schedule in the model called Free_Cash_Flows, which uses information from the cash flow schedule to derive free cash flow. This schedule includes expenditure on investments and shows a cash outflow when capital expenditure and investments are taken into account (see Figure 6.25).

FORECASTS

The financial analysis model has concentrated on the historic results whereas this section sets out the forecast method used in the file. Bankers need to forecast cash flows in order to ascertain the ability to repay future debts. Whilst statistical methods such as exponential smoothing or harmonic means could be applied, this method focuses on the key determinants of value creation.
The objective is to provide values for key drivers such as sales growth or capital expenditure and then to redraw the financial statements to provide both a historic and forecast perspective. This provides an income statement, balance sheet together with a cash flow, and ratios. The exact layouts are used for the forecast and historic schedules in order to minimize the errors. Similarly, management analysis can be enhanced with charts to show the anticipated changes.

The completed model should assist in answering management questions, for example:

- Does the company possess sufficient internal resources to fund the anticipated growth?
- Will the company's financial position strengthen or weaken?
- Is the risk of insolvency likely to increase?

Key drivers

This approach is sometimes called percent of sales forecasting. It involves:

- calculating profit and loss items as a percentage of sales;
- calculating balance sheet items as a percentage of sales;
- drawing the profit and loss;
- drawing the balance sheet;
- using cash or short-term overdraft as the ‘plug’ to make the balance sheet add up.

Figure 6.26 is an extract from the forecast sheet showing drivers and the historic percentages.

<table>
<thead>
<tr>
<th>Key drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Line</strong></td>
</tr>
<tr>
<td>---</td>
</tr>
<tr>
<td>11</td>
</tr>
<tr>
<td>12</td>
</tr>
<tr>
<td>13</td>
</tr>
<tr>
<td>14</td>
</tr>
<tr>
<td>15</td>
</tr>
<tr>
<td>16</td>
</tr>
<tr>
<td>17</td>
</tr>
<tr>
<td>18</td>
</tr>
<tr>
<td>19</td>
</tr>
</tbody>
</table>

Figure 6.26
Since most variables on the income statement are assumed to have a linear relationship to sales, the only items with links to the balance sheet are interest payments and receipts together with depreciation. These require information from the income statement and balance sheet as detailed in Figure 6.27. New equity, capital expenditure and investments are actual amounts rather than percentages. This matrix could be made more complex with more drivers and amounts rather than sales percentages.

Sales growth is usually the most important variable since it drives the company forward. The growth rate in cell G12 is based on this formula. In all cases, the model will display zero if there are no sales in the previous period, and it will suppress mathematical errors.

\[=\text{IF}(F11=0,0,(G11-F11)/F11)\]

Columns K to O are inputs for the five years of the forecast, and the user simply reviews the previous five-year period and after investigation can select a percentage for each of the variables. It is a good idea to establish a ‘Base Case’ and save it as a scenario using Data, Data Tools, What-if Analysis (Excel 2003 – Tools, Scenarios, Add). It is likely that you would want to test various views of the future and scenarios are a good way of recording the ‘audit trail’. For example, the case in the model

<table>
<thead>
<tr>
<th>Item</th>
<th>Reference</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forecast</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial sales</td>
<td>F10</td>
<td>Use last year as the basis</td>
</tr>
<tr>
<td>Sales growth</td>
<td>Change P10</td>
<td>Sales growth</td>
</tr>
<tr>
<td>Costs of goods sold/Sales</td>
<td>F11/P10</td>
<td>Percentage of sales</td>
</tr>
<tr>
<td>Depreciation rate</td>
<td>F13-P14-B19</td>
<td>Depreciation on previous year’s fixed assets in balance sheet</td>
</tr>
<tr>
<td>SG&amp;A/Sales</td>
<td>F15/P10</td>
<td>Percentage of sales</td>
</tr>
<tr>
<td>Interest paid on debt</td>
<td>F17BQ9+653</td>
<td>Interest paid on debt in balance sheet</td>
</tr>
<tr>
<td>Interest earned on cash</td>
<td>F1613D10.11</td>
<td>Interest received on marketable securities in balance sheet</td>
</tr>
<tr>
<td>Exceptionals/Sales</td>
<td>F21/F11</td>
<td>Percentage of sales</td>
</tr>
<tr>
<td>Marginal tax rate</td>
<td>F22/F22</td>
<td>Tax paid / Profit before tax</td>
</tr>
<tr>
<td>Dividend payout ratio</td>
<td>F23/F24</td>
<td>Dividends / Profit after tax</td>
</tr>
<tr>
<td>Net fixed assets/Sales</td>
<td>E19/F11</td>
<td></td>
</tr>
<tr>
<td>Intangibles/Sales</td>
<td>E20.21/F11</td>
<td></td>
</tr>
<tr>
<td>Current assets/Sales</td>
<td>E12.14/F11</td>
<td></td>
</tr>
<tr>
<td>Current liabilities/Sales</td>
<td>E32-E38/F11</td>
<td></td>
</tr>
<tr>
<td>Debt/Sales</td>
<td>E33-E20/F11</td>
<td></td>
</tr>
<tr>
<td>Deferred tax/Sales</td>
<td>E35/F11</td>
<td></td>
</tr>
<tr>
<td>New Equity</td>
<td>E37</td>
<td>Actual amount</td>
</tr>
</tbody>
</table>
is optimistic as it anticipates growth and a reduced cost of sales. Using figures for the previous year will not produce such a positive outcome.

The percentages are all shown as input cells in Figure 6.28. You can then develop the answers by changing individual years. There is no rule that sales growth or depreciation has to be the same each year although for simplicity the inputs have been restricted to the first two years.

The model provides the user with immediate feedback as each variable is changed. You do not want to have to select the forecast statement to see the answer every time you change an input cell. Below the main table, there is a table of results showing the net operating profit, shareholders’ funds, net operating cash flow and the return on equity (see Figure 6.29).

Figures 6.30 to 6.32 show a construction of the financial statements by line.

**Deriving financial statements**

The model produces the income statement (see Figure 6.33) and balance sheet by applying the ratio percentages to the enhanced sales. These are called FIncome and FBalance and follow exactly the framework of the historic sheets. The past results are repeated together with the future values.

---

**Forecast variables**

![Figure 6.28](image_url)
### Results

<table>
<thead>
<tr>
<th>Time</th>
<th>Items</th>
<th>USD '000,000</th>
<th>Dec-10</th>
<th>Dec-11</th>
<th>Dec-12</th>
<th>Dec-13</th>
<th>Dec-14</th>
</tr>
</thead>
<tbody>
<tr>
<td>22</td>
<td>22 Intangible increase</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
<td>4,000</td>
</tr>
<tr>
<td>23</td>
<td>23 Current assets/Sales</td>
<td>25.0%</td>
<td>25.0%</td>
<td>25.0%</td>
<td>25.0%</td>
<td>25.0%</td>
<td>25.0%</td>
</tr>
<tr>
<td>24</td>
<td>24 Current liabilities/Sales</td>
<td>24.0%</td>
<td>24.0%</td>
<td>24.0%</td>
<td>24.0%</td>
<td>24.0%</td>
<td>24.8%</td>
</tr>
<tr>
<td>25</td>
<td>25 Debt/Sales</td>
<td>85.0%</td>
<td>85.0%</td>
<td>88.0%</td>
<td>88.0%</td>
<td>55.0%</td>
<td>55.0%</td>
</tr>
<tr>
<td>26</td>
<td>26 Deferred tax/Sales</td>
<td>19.0%</td>
<td>19.0%</td>
<td>19.0%</td>
<td>19.0%</td>
<td>19.0%</td>
<td>19.0%</td>
</tr>
<tr>
<td>27</td>
<td>27 New Equity</td>
<td>13.0%</td>
<td>13.0%</td>
<td>12.6%</td>
<td>12.0%</td>
<td>12.0%</td>
<td>12.0%</td>
</tr>
</tbody>
</table>

### Income statement

<table>
<thead>
<tr>
<th>No</th>
<th>Item</th>
<th>USD '000,000</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>P10</td>
<td>Sales</td>
<td></td>
<td>Calculate using sales growth</td>
</tr>
<tr>
<td>P11</td>
<td>Cost of Goods Sold</td>
<td></td>
<td>Calculate using gross profit margin</td>
</tr>
<tr>
<td>P12</td>
<td>Gross Margin</td>
<td></td>
<td>Manufacturer</td>
</tr>
<tr>
<td>P13</td>
<td>Depreciation</td>
<td></td>
<td>Use Depm / (average) FA ratio</td>
</tr>
<tr>
<td>P14</td>
<td>Amortization/Other</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P15</td>
<td>Sales, General &amp; Administration Overheads</td>
<td></td>
<td>SOA / Sales</td>
</tr>
<tr>
<td>P16</td>
<td>Net Operating Profit (NOP)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P17</td>
<td>Interest Expense</td>
<td></td>
<td>Use interest % on (average) debt</td>
</tr>
<tr>
<td>P18</td>
<td>Interest Income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P19</td>
<td>Other Financial income</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P20</td>
<td>Profit after Financial items</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P21</td>
<td>Exceptional Expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P22</td>
<td>Profit before Tax</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P23</td>
<td>Tax</td>
<td></td>
<td>Use tax payout ratio</td>
</tr>
<tr>
<td>P24</td>
<td>Net Profit after Tax (NPAT)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>P25</td>
<td>Minority Interest</td>
<td></td>
<td>Retain at same rate</td>
</tr>
<tr>
<td>P26</td>
<td>Dividends</td>
<td></td>
<td>Use dividend payout ratio</td>
</tr>
<tr>
<td>P27</td>
<td>Retained Profit for the Year</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Assets

<table>
<thead>
<tr>
<th>No</th>
<th>Assets</th>
<th>USD '000,000</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>B10</td>
<td>Cash and Deposits</td>
<td></td>
<td>Balance</td>
</tr>
<tr>
<td>B11</td>
<td>Marketable Securities</td>
<td></td>
<td>Balance</td>
</tr>
<tr>
<td>B12</td>
<td>Trade Debtors (Receivables)</td>
<td></td>
<td>Current assets / Sales</td>
</tr>
<tr>
<td>B13</td>
<td>Inventory</td>
<td></td>
<td>Current assets / Sales</td>
</tr>
<tr>
<td>B14</td>
<td>Sundry Current Assets</td>
<td></td>
<td>Current assets / Sales</td>
</tr>
<tr>
<td>B15</td>
<td>Current Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B16</td>
<td>Land and Buildings</td>
<td></td>
<td>Actual increase / (decrease)</td>
</tr>
<tr>
<td>B17</td>
<td>Plant and Machinery</td>
<td></td>
<td>Actual increase / (decrease)</td>
</tr>
<tr>
<td>B18</td>
<td>Depreciation</td>
<td></td>
<td>Balance + P&amp;L Depn</td>
</tr>
<tr>
<td>B19</td>
<td>Net Property, Plant and Equipment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B20</td>
<td>Other Investments</td>
<td></td>
<td>Actual increase / (decrease)</td>
</tr>
<tr>
<td>B21</td>
<td>Intangibles/Goodwill</td>
<td></td>
<td>Actual increase / (decrease)</td>
</tr>
<tr>
<td>B22</td>
<td>Non Current and Fixed Assets</td>
<td></td>
<td></td>
</tr>
<tr>
<td>B23</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>E24</td>
<td>Total Assets</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Colour coding in the form of shaded cells is also used to highlight the forecast. The method used to create the sheets was as follows:

- copy the historic sheet by right clicking the tab or using Home, Cells, Format, Move or Copy Sheet (Excel 2003 – Edit, Move, Create a Copy);
- change the name to 'F' (e.g. FIncome);
- code the labels in columns B to G to look up the historic sheet (this means that if you change anything on the Income sheet, it will update on the forecast);
insert the formulas in the historic cells to look up the values in the historic sheet;
insert the formulas by multiplying out from the Forecast sheet;
check the results including the signs (negative or positive).

The formulas use the forecast sheet to derive the new values as with the detail for column N below. In rows 17 and 18, the logic checks if cash is positive or negative and only applies funding interest on negative balances. The cash rules are followed and costs are all negative. (See Figure 6.34.)

The balance sheet follows the same pattern using the drivers from the Forecasting sheet. Where necessary, the model apportions the forecast percentage between different rows. The current assets percentage is 40 per cent and this is split between debtors, inventory and sundry current assets in rows 12 to 14.

\[ (\text{Forecast!K$11} \times \text{Forecast!K$23}) \times (\text{M12}/\text{SUM(M$12:M$14)}) \]

Cash and short-term debt are used to balance the assets and liabilities as the model's 'plug' (see Figures 6.34 and 6.35). The model includes workings at row 47 on the forecast balance sheet, which compare the assets without cash to the liabilities without short-term debt. If the assets are greater than liabilities, the model assumes there is a requirement for loans. In the event that liabilities are greater than assets, the model adds the balance to cash.
The balance sheet self-checks and there are no errors at the bottom in row 43 (see Figure 6.35). If there are errors of addition, an error message is displayed.

With the completed financial statements, you can review the figures for obvious logic and formula errors and then examine the trends in the figures. The sales growth has to be financed and therefore you would expect to see changes in the structure of the balance sheet:

- fixed assets – new and replacement assets;
- requirement for new debt and consequent changes in gearing;
- debtors + inventory – creditors = funding gap;
- discretionary funding = new loans and equity.

New funding requirement, expressed simply in this model as cash, is either positive or negative and makes the balance sheet assets equal liabilities. This is shown in cash or short-term debt.

The second stage of the forecast is to copy forward to cash flow and ratios information to new worksheets. You can then update the cell formulas to point at FIncome and FBalance. Since the logic on the cash flow worked with the historic sheet, it must also work when using data from the forecast (see Figure 6.36).

The formula in cell N15, change in current assets, calculates the difference between the two balance sheet dates:

\[=\text{SUM}(\text{FBalance!M12:FBalance!M14}) - \text{SUM} (\text{FBalance!N12 : FBalance!N14})\]
The other cells all follow exactly the logic in the Cashflow sheet. The advantage is now a longer period to view:

- EBITDA;
- net operating cash flow (NOCF);
- cash flow before financing;
- cash movement.

The ratios are forecast using the same method in FRatios, by copying forward and then using Home, Editing, Find & Replace (Excel 2003 – Edit, Replace) to update the cells and then copy to the right (see Figure 6.37).

The text on the right refers to the last two years actual and the first year of the forecast to provide some information on the direction of the ratios. If
the forecast is better than the last two years’, the cell displays ‘Better’ and if there is an improvement over one of two years, displays ‘OK’. If the ratio has deteriorated, the cell reads ‘Worse’. The formula in cell R11 reads:

```
=IF(P11=0, "N/A", IF(O11=0, "N/A", IF(AND(Q11>P11, Q11>O11), "Better", IF(OR(Q11>P11, Q11>O11), "OK", "Worse"))))
```

**FINANCIAL ANALYSIS**

The qualitative analysis shows an improving financial position with solid cash flow over the forecast period. Such a scenario may or may not be achievable by the management team, but were it to achieve these figures then cash flow and return ratios certainly improve as per the summary shown in Figure 6.38.

Two more schedules in the application assist with analysis: they are called Management_Summary and Management_Analysis. The first looks up important lines in the other schedules and puts together the summary of
the income statement, balance sheet, cash flow and ratios. The tests on the right try to assist with pinpointing the rows for management attention in the first year of the forecast.

The Management Analysis looks up each line from the four forecast schedules in rows 79 to 224 and uses a control and an OFFSET function to form a dynamic graph. This enables you to analyse a line on three graphs:

- line graph with three series, historic, forecast and historic trend line, extrapolated by five years;
- block graph of the historic and forecast figures;
- block graph of the factors where the first period is equal to 100.

An example of the historic and forecast net operating cash flow is shown in Figure 6.39. This method illustrates clearly the reduction in cash flow in the most recent period. The forecast is rising according to expectations, and this merits further investigation.

The advantage of this method is that you can view each line, because none of the lines is hard coded and you can see immediately the link between the past and the future. You can change the inputs on the Forecast sheet to see the result on the ratios or cash flow. In this example, net operating cash flow is variable and therefore the next stage would be to review the operating cycle ratios, such as debtor or creditor days, and then the requirement for new funding and the borrowing ratios.
The second set of block graphs (see Figure 6.40) contains one series, but the individual points are formatted differently. The pattern on the forecast was produced by selecting the individual data point, right clicking it, and then formatting patterns.
The forecast has shown a favourable position, but the company would exhibit worse prospects if the same pattern as for the previous year were to be repeated. The sales decline, and the cost of goods sold remains high. This squeezes profits and cash flow, and cash is still expended on capital expenditure and investments. Debt increases to fund the outgoings (see Figure 6.41).

The accounts become weaker in the key areas of operating efficiency, profitability and financial structure as borrowings rise and solvency ratios fall (see Figures 6.42 and 6.43). Profitability remains static at the previous period’s levels, but the return on capital and asset falls. This would be an unacceptable position for bankers and shareholders.
Revised ratios

Figure 6.42

<table>
<thead>
<tr>
<th>Line</th>
<th>Item</th>
<th>USD/1000,000</th>
<th>Reference</th>
<th>Dec-06</th>
<th>Dec-10</th>
<th>Dec-11</th>
</tr>
</thead>
<tbody>
<tr>
<td>8</td>
<td>Core Ratios</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>Return on Equity (NIPAT/Stock %)</td>
<td>P24/B10</td>
<td>4.17</td>
<td>4.82</td>
<td>4.54</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>Asset Turnover (Sales/Total Assets)</td>
<td>P10/B24</td>
<td>0.34</td>
<td>0.30</td>
<td>0.26</td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>Asset Leverage (Total Assets/Equity)</td>
<td>P24/B30</td>
<td>1.78</td>
<td>1.60</td>
<td>1.88</td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>Return on Equity (NIPAT/Equity %)</td>
<td>P24/B30</td>
<td>2.59</td>
<td>2.67</td>
<td>1.90</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>Profitability</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>Profit before Tax / Sales (%)</td>
<td>P22/B10</td>
<td>6.80</td>
<td>7.07</td>
<td>6.59</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>Return on Capital Employed (ROCE)</td>
<td>P18/B33+B33</td>
<td>3.99</td>
<td>3.83</td>
<td>3.33</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>Return on Invested Capital (ROI)</td>
<td>P10/(P+T)/(B33+B33+B39)</td>
<td>0.48</td>
<td>0.70</td>
<td>0.37</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>Return on Assets (ROA)</td>
<td>P18/B24</td>
<td>3.38</td>
<td>3.08</td>
<td>2.58</td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>Operating Efficiency</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>Inventory Days</td>
<td>B15/F11</td>
<td>55.07</td>
<td>55.07</td>
<td>55.07</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>Trade Receivables (Gross) Days</td>
<td>B15/B10</td>
<td>55.64</td>
<td>55.74</td>
<td>55.84</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>Operating Days</td>
<td>B59/F11</td>
<td>55.64</td>
<td>55.74</td>
<td>55.84</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>Funding Gap Debtors-Inventory-Creators</td>
<td>R25+R26-R27</td>
<td>(1.76)</td>
<td>(1.76)</td>
<td>(1.76)</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>Working Capital Turnover</td>
<td>P10/B12+15+B23</td>
<td>75.82</td>
<td>75.02</td>
<td>75.62</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>Financial Structure</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>Current Ratio</td>
<td>B15/B32</td>
<td>1.00</td>
<td>0.51</td>
<td>0.50</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>Quick Ratio (Acid Test)</td>
<td>B15-B10/B32</td>
<td>1.00</td>
<td>0.51</td>
<td>0.30</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>Working Capital (Pause)</td>
<td>B15-B32</td>
<td>0.51</td>
<td>(0.51)</td>
<td>(0.51)</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>Gross Debit (%</td>
<td>B26+B33+B33+B38</td>
<td>53.22</td>
<td>57.01</td>
<td>64.56</td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>Net Gearing (%)</td>
<td>B26-B33-B10-B11+B30</td>
<td>50.77</td>
<td>57.31</td>
<td>64.56</td>
<td></td>
</tr>
<tr>
<td>32</td>
<td>Solvency (Times Interest Earnings)</td>
<td>P10/P17</td>
<td>2.29</td>
<td>2.12</td>
<td>2.08</td>
<td></td>
</tr>
<tr>
<td>33</td>
<td>Total Equity/Total Assets</td>
<td>B59/B24</td>
<td>56.75</td>
<td>56.48</td>
<td>54.14</td>
<td></td>
</tr>
<tr>
<td>34</td>
<td>Cashflow Ratios</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>35</td>
<td>EBITDA / Sales</td>
<td>C10/P10</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>36</td>
<td>Net Operating Cash Flow/Sales</td>
<td>C10/P10</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>37</td>
<td>Cash Flow / Cash Flow (before Financing/Sales)</td>
<td>C10/P10</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td></td>
</tr>
</tbody>
</table>

Revised net operating cash flow

Figure 6.43
SUMMARY

The financial analysis model can be built up from the templates for the income statement and balance sheet. Ratios and cash flows are derived to examine the key areas of risk which affect the operating cash flow. The model supports other non-financial data about a company and should show the risk inherent as evidenced in the accounts.

Forecasts are useful for understanding the performance or key drivers producing value. In particular, forecasts can reveal the requirement for capital expenditure or new debt. Alternatively, they can be used to check client forecasts. The model has shown that the example cash flows are volatile and that the trading position is worsening. Using a different forecast illustrates the uncertainty of future trading, and the next stage is to introduce methods for examining loan cover and models for bankruptcy analysis.
INTRODUCTION

The previous chapter reviewed a financial analysis model in terms of the sources of risk inherent in the financial statements and forecasts. This chapter extends the model to include credit risk models to show the ability of a company to repay debt or to remain solvent during a forecast period. The existing forecast model provides forecast cash flow and ratios schedules. However, the analysis needs to reveal any inherent weaknesses with the company. If a bank grants credit and the client becomes insolvent and is unable to repay, the potential losses usually outweigh the potential margin many times. Not only are there capital losses but also increased costs in terms of administration, legal and other costs. Therefore it would improve the analysis if the credit model could look for signs of financial weakness.

There are many reasons for financial weakness, but here are some of the main ones:

- cyclical decline in demand and failure to react to a changing environment;
- weak management with a lack of a coherent strategy or conflict at board level;
- lack of centralized financial control and direction;
- poor acquisitions or lack of integration strategy;
- inappropriate product, market strategy or an inward-looking product mentality;
- wrong financial policy, poor working capital management or a failure to control overheads;
- problems with new projects or products.

Risk increases with each of the above and a marked deterioration in ratios is often evident. The signs could be:

- liquidity – reduced working capital, reduced creditor days and increased stock and debtor days;
- profitability – reduced profits and return on assets and capital: reduced profits will mean a falling interest cover;
- financial structure – increased loans and gearing, which will lead to increased interest charges and lower profits in the future;
- cash flow – reduced cash flow perhaps augmented by one-off sales of assets or subsidiaries to reduce debts;
- market – falling share price, earnings per share and market to book ratio.
CASH FLOW

For any lender the levels of cash flow confirm the cash available to meet further commitments (see Figure 7.1). The Loan Cover sheet sets out the categories:

- earnings before interest, taxation, depreciation and amortization (EBITDA) as the net operating profit plus the non-cash items such as depreciation and amortization;
- net operating cash flow (NOCF) as the EBITDA less changes in working capital such as debtors, creditors, stock, prepayments and accruals – this is the primary cash from trading operations;
- operating free cash flow as the net operating cash flow less expenditure on fixed assets and investments and taxation.

There are several definitions of free cash flow to define the cash available to specific stakeholder groups. This is the cash available to pay dividends to shareholders and interest and principal to debt providers. Adjustments may be required for off balance sheet debt and contingencies. An alternative definition would deduct dividends to form the cash flow available to debt providers. Nevertheless, the method provides a meaningful measure of cash flow.

COVER RATIOS

The Loan Cover sheet includes a calculator for estimating the amount of cash required on a new loan. An annual rental is calculated based on a period, nominal interest rate, capital value and terminal or future value. The model computes the annual rental and then the level of cover created by the different cash flow lines. This is simply the cash that has to be found rather than loan amortization plus interest. For example, solvency ratios concentrate on the times interest is earned rather than cash whereas this is an estimate of cash covers.
Here a loan of 10 million is derived over a five-year period at a rate of 10 per cent nominal (see Figure 7.2). This is a time value of money problem and can be solved using the PMT function. Cell E18 calculates the annual payment using the function. There is an IF condition to ensure that all entries are present before a rental is calculated.

\[
\text{=IF(SUM(E12:E15)<>0, PMT(E13, E12, -ABS(E14), E15, D71), 0)}
\]

The annual rental can then be used to derive covers against the cash flow lines. The cash flow is volatile and whilst the covers increase against operating profit and EBITDA, the cover at the NOCF level is declining. The level is also lower in the forecast period based on the forecast in the previous chapter. When capital expenditure, investments and taxation are taken into account, the covers are negative since the trading cash is being absorbed by investment (see Figure 7.3). If the cash flow is negative, the proposed loan can only be covered by new loans or share capital. In the example, net loans have increased by 6 billion dollars in the last year and share capital by 1.4 billion.

The dynamic chart (see Figure 7.4) shows clearly the variance in the net operating cash flow and the risk to any lender in advancing more funds to
the company. The forecast appears to rise and therefore an analyst can question the reality of the projection and the management’s ability to deliver the cash flow.

**Sensitivity**

With the initial model in place, one key area of risk is the sales growth. The forecast shows a 7 per cent growth, but one could question what happens to the covers if the sales growth is lower or higher. Sales growth is important since it drives costs and investment.

There is a sheet called Loan Cover Sensitivity, which looks up information from a data table at the bottom of the Forecast sheet (see Figure 7.5). You cannot look up information on a data table on another sheet and therefore the solution is to locate the table in workings on the forecast sheet and then look up the information on a reporting sheet.

**Figure 7.4**

![Net operating cash flow times cover](image)

**Figure 7.5**

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
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<td>46</td>
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<td>50</td>
<td>51</td>
<td>52</td>
<td>53</td>
<td>54</td>
</tr>
<tr>
<td>F41</td>
<td>Operating Profit (NOP)</td>
<td>3,705.8</td>
<td>3,474.6</td>
<td>3,604.2</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F42</td>
<td>Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA)</td>
<td>1,040.5</td>
<td>1,040.5</td>
<td>1,040.5</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F43</td>
<td>Net Operating Cash Flow (NOCF)</td>
<td>4,628.9</td>
<td>4,491.1</td>
<td>4,340.3</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F44</td>
<td>Expenditure on Property, Plant and Equipment (Preceded by Sale)</td>
<td>(5,553.0)</td>
<td>(5,553.0)</td>
<td>(5,553.0)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F45</td>
<td>Net Cash Outflow, for Taxation</td>
<td>(770.1)</td>
<td>(770.1)</td>
<td>(770.1)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F46</td>
<td>Operating Profit (NOP), Times Cover</td>
<td>1.59</td>
<td>1.48</td>
<td>1.50</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F47</td>
<td>Earnings before Interest, Tax, Depreciation and Amortisation (EBITDA), Times Cover</td>
<td>2.35</td>
<td>2.20</td>
<td>2.31</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F48</td>
<td>Net Operating Cash Flow (NOCF), Times Cover</td>
<td>1.65</td>
<td>1.57</td>
<td>1.60</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>F49</td>
<td>Operating Profit (NOP), Times Cover</td>
<td>0.97</td>
<td>0.86</td>
<td>0.95</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
The left column uses the function, MIN, to find the minimum along the forecast columns. Cell H41 obtains the minimum on the loan cover sheet since you want to know the low point in the forecast period. The function below returns 18,762.4 (see Figure 7.6).

\[ =\text{MIN(Loan}\_\text{Cover!J22:N22)} \]

Office 2007 – Data, Data Tools, What-if Analysis (Excel 2003 – Data, Table)

The data table is set up to use the sales growth on the forecast grid at cell Forecast!K12 as the input. The sales growth is along the top of the table and the elements down the left-hand side. This means that you can obtain the results for each of the cash flow lines and covers for differing levels of sales growth. With only one variable, you only need an input for the row input cell (see Figure 7.7).
On the Loan Cover Sensitivity sheet, you can see the results with a chart for each of the key lines (see Figure 7.8). This fits with the modularity of the model with a separate report for management purposes.

**Figure 7.8**

**Sensitivity charts**

![Sensitivity charts](image)

**SUSTAINABILITY**

Two areas of financial analysis can be difficult to ascertain from the figures: growth and decline. Figure 7.9 is the classic 1972 Greiner model showing the crises of growth for a young company. Organizations typically grow and pass through a number of stages with periods of rapid and slower growth. Particularly small companies are undercapitalized and show signs of over-trading. Mature companies become inefficient and start to decline. For these reasons, models of management competence often focus on these stages in company evolution as exhibiting a greater risk of insolvency.
The models in this section on the Growth sheet demonstrate methods for highlighting overtrading where a company's retained profits and existing resources are not sufficient to fund the actual growth percentages. There are a number which seek to show ratios of available resources and the degree of overtrading.

![Greiner growth model](image)

The model above seeks to show the ability to grow without restraining resources (see Figure 7.10). If there is capacity in fixed assets, then a 1 per
cent growth in sales will need a 1 per cent increase in net working assets. This is given by the first formula on line 22:

\[ g = \frac{(PATBD - D)}{NWA} - (PATBD - D) \]

where:

- \( g \) sustainable growth
- \( PATBD \) profit after tax before depreciation
- \( D \) dividend
- \( NWA \) net working assets.

The assumptions may be slightly unrealistic since a company also needs to invest in fixed assets as it grows. The formula can therefore be extended to include both net working and fixed assets.

\[ g = \frac{(PATBD - D)}{(NWA + FA) - (PATBD - D)} \]

If growth is in excess of the formula, then the company would have the choice of raising extra debt, issuing more shares or reducing the dividend payout. This model shows a sustainable growth below the equilibrium in the last two years after rapid growth in the first two periods. This is also reflected by the relatively unchanged turnover in the last periods.

The last model in this section attempts to ascertain the rate of sales growth that can be achieved while maintaining the same ratio of external liabilities to equity (see Figure 7.11). The formula is:

\[
g = \frac{[(PAT/S) \times (1 - (Dividend/PAT)) \times (1 + (Liabilities/Equity))] \times ((FA + CA)/S) - (PAT/S) \times (1 - (Dividend/PAT)) \times (1 + (Liabilities/Equity))]}{[(FA + CA)/S] - (PAT/S) \times (1 - (Dividend/PAT)) \times (1 + (Liabilities/Equity))}\]

where:

- \( PAT \) profit after tax
- \( S \) sales
- \( FA \) fixed assets
- \( CA \) current assets.

The sustainable rate keeping the liabilities/equity percentage constant is -0.84 per cent in the last year. The liabilities/equity ratio is 0.53 and this will remain the same with this growth rate.

The second model is based on two formulas:

\[
R = \frac{Retained\ earnings}{Sales} \quad T = \frac{Total\ assets}{Sales} \quad g = \frac{R}{T}
\]
This formula is then simplified as:

\[
\text{Retained earnings/Opening owners' funds}
\]

Growth in excess of this rate will require extra equity or will cause a weakening of the balance sheet.

The next model (PRAT) derives the sustainable growth by multiplying out the drivers detailed below:

- profit margin (P) as net operating profit/sales
- retained earnings (R) as retained earnings/sales
- asset turnover (A) as sales/total assets
- asset equity (T) as total assets/shareholders’ equity.

The sustainable growth is lower in the final periods as the balance sheet has weakened (see Figure 7.12). The reduction is from 7 per cent to 2 per cent, reflecting the same findings as the earlier models.

The last model of equilibrium growth uses the formula:

\[
g = \{R \times T\} \times \text{return on assets}
\]

\[
R = \text{retained earnings}
\]

\[
T = \text{asset equity}
\]

Again, this formula shows a declining equilibrium growth. Figure 7.13 summarizes the findings from the four methods where the high growth in the early periods was higher than could be sustained through retained earnings. The growth in the last two periods has been more restrained and below the maximums indicated by the model.

**BEAVER’S MODEL**

There are several ratio models for predicting bankruptcy and Beaver’s early work reviewed single ratios as important indicators of failure. He identified trends in three key ratios for predicting default (see Figure 7.14):
Mastering Risk Modelling

**Figure 7.12**

<table>
<thead>
<tr>
<th>Line</th>
<th>Item</th>
<th>US$000,000</th>
<th>Dec-09</th>
<th>Dec-10</th>
<th>Dec-11</th>
<th>Dec-12</th>
</tr>
</thead>
<tbody>
<tr>
<td>35</td>
<td>G36 Profit Margin (P)</td>
<td>0.04</td>
<td>0.05</td>
<td>0.05</td>
<td>0.05</td>
<td>0.05</td>
</tr>
<tr>
<td>37</td>
<td>G37 Return on Assets (ROA)</td>
<td>0.35</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
</tr>
<tr>
<td>38</td>
<td>G38 Asset Turnover (T)</td>
<td>0.04</td>
<td>0.04</td>
<td>0.04</td>
<td>0.04</td>
<td>0.04</td>
</tr>
<tr>
<td>39</td>
<td>G39 Asset Equity (E)</td>
<td>0.35</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
</tr>
<tr>
<td>40</td>
<td>G40 Sustainable Growth (PRAT)^2</td>
<td>1.50</td>
<td>1.51</td>
<td>1.51</td>
<td>1.51</td>
<td>1.51</td>
</tr>
<tr>
<td>41</td>
<td>G41 Variance Actual-Equilibrium</td>
<td>(1.00)</td>
<td>0.35</td>
<td>0.34</td>
<td>0.34</td>
<td>0.34</td>
</tr>
<tr>
<td>42</td>
<td>G42 Return on Equity (ROE)</td>
<td>0.35</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
</tr>
<tr>
<td>43</td>
<td>G43 Total debt/total assets</td>
<td>0.35</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
</tr>
<tr>
<td>44</td>
<td>G44 Net profit after tax/total debt</td>
<td>0.05</td>
<td>0.05</td>
<td>0.05</td>
<td>0.05</td>
<td>0.05</td>
</tr>
<tr>
<td>45</td>
<td>G45 Total debt/total assets</td>
<td>0.35</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
<td>0.36</td>
</tr>
</tbody>
</table>

**Figure 7.13**

Growth model summary

**Figure 7.14**

Beaver’s model

- operating free cash flow/total debt
- net profit after tax/total debt
- total debt/total assets.
BATHORY MODEL

Whilst single ratios provide part of the answer, it may be unsafe to depend on them. Researchers have studied combinations of ratios which provide some guidance on the tendency towards insolvency. These tend to be ratios of cash flow, debt structure and debt cover. The Bathory model does not try to weight a series of ratios, but instead picks ratios historically associated with company failure and multiplies them out equally (see Figure 7.15).

The factors are:

- X1 – Gross cash flow/Current debt;
- X2 – Pre-tax profit/Capital employed;
- X3 – Equity/Current liabilities;
- X4 – Tangible net worth/Total liabilities;
- X5 – Working capital/Total assets.

Gross cash flow is the profit after tax plus depreciation and amortization. Debt includes all sources of debt including leasing and hire purchase. Capital employed is composed of shareholders’ funds and loans over one year. Equity means the shareholders’ funds, while tangible net worth is the shareholders’ funds less intangible assets.

The result here is unconvincing as the score appears to rise whereas all the indicators so far have pointed to a weaker financial situation. On closer examination, the main contender is X3 which rises owing to a reduction in current liabilities. It appears that credit is being squeezed and this leads to an increase in the ratio and the overall score. Given that there are equal weights, this would seem an unscientific method of determining potential financial weakness.

![Bathory model](image)
Altman and others have attempted to find statistical answers to why some companies go bust and others survive. The technique is known as multi-dis-criminant analysis which uses a sample of companies and then splits them into failed and survivor companies. Studies take a number of ratios and then determine combinations of ratios and weightings which result in a score that predicts failure.

Altman started with 22 ratios and classified them into five ratio groups:

1. liquidity
2. profitability
3. leverage
4. solvency
5. activity.

The original data sample consisted of 66 firms, half of which had filed for bankruptcy under Chapter 11 of the US bankruptcy code. All businesses in the database were manufacturers, and small firms with assets of less than $1 million turnover were eliminated. The Z score calculates five ratios:

- **X1** = Working capital/Total assets.
- **X2** = Retained earnings/Total assets. This is a measure of cumulative profitability that should increase with the firm’s age as well as earning power. Studies have shown failure rates to be closely related to the age of the business especially for mature companies.
- **X3** = Earnings before income taxes/Total assets. This is a measure of operating efficiency separated from any leverage effects. It recognizes operating earnings as a key to long-term viability.
- **X4** = Market value of equity/Book value of debt. This ratio adds a market dimension, and academic studies of stock markets suggest that security price changes may foreshadow upcoming problems.
- **X5** = Sales/Total assets. This is a standard turnover measure of activity.

The formula calculates a weighted score:

\[ 1.2 \times X1 + 1.4 \times X2 + 3.3 \times X3 + 0.6 \times X4 + 0.999 \times X5 \]

These ratios are then multiplied by the predetermined weight factors above, and the results are added together. The final number (Z score) normally yields a number between –4 and +8. Financially sound companies show Z scores above 2.99, while those scoring below 1.81 are in fiscal danger, maybe even heading toward bankruptcy. Scores that fall between these ends indicate potential trouble. In Altman’s initial study of 66 bankrupt...
companies, Z scores for 95 per cent of these companies pointed to trouble or imminent bankruptcy.

Although the numbers that go into calculating the Z score (and a company’s financial soundness) are influenced by external macro factors, it provides a useful quick analysis of where an organization stands, and a tool for analysing the variances in a company’s financial stability over time. In the example below, the deteriorating financial position is clearly visible in the Z score which ends the period at 1.24 within the range for high probability of failure (see Figure 7.16).

The model uses the `SUMPRODUCT` function from the Functions Library to multiply the factors by the ratios and then adds them to form the score. The probability of failure uses IF statements between the limits of 2.9 and 1.81. The results are 1 for unlikely, 01 for not sure and zero for high, and the colours are set using square brackets as per the custom number format below.

```
[Black]"Unlikely";[Red]"Not Sure"; [Black]"High"?_;_;@_;-
```

Using the sample, Altman gained the results shown in Table 7.1 over five years. The model appeared to provide success of up to 72 per cent over two years.
Privately held firms

If a firm’s stocks and shares are not publicly traded, the X4 term (Market value of equity/Book value of debt) cannot be calculated. To correct for this problem, the Z score can be re-estimated using book values of equity. This provides the following score:

\[
Z \text{ score} = 0.717 \times X1 + 0.847 \times X2 + 3.107 \times X3 + 0.420 \times X4 + 0.998 \times X5
\]

The upper limit is set at 2.9 and the lower limit at 1.23 with the uncertain zone in the middle.

Merchandising and service firms

The X5 (Sales/Total assets) ratio is believed to vary significantly by industry. It is likely to be higher for merchandising and service firms than for manufacturers, since the former are typically less capital intensive. Consequently, non-manufacturers would have significantly higher asset turnovers and Z scores. The model is thus likely to underpredict certain sorts of bankruptcy. To correct for this potential defect, Altman used a correction that eliminates the X5 ratio:

\[
Z \text{ score} = 6.56 \times X1 + 3.26 \times X2 + 6.72 \times X3 + 1.05 \times X4
\]

The upper limit is set at 2.6 and the lower limit at 1.11 with the uncertain zone in the middle. Figure 7.17 displays the results for this example with bankruptcy predicted in all periods. The example is, however, a public company so the results are for illustration only.
SPRINGATE ANALYSIS

This model was developed in 1978 by Gordon Springate, following procedures developed by Altman. Springate used step-wise multiple discriminate analysis to select 4 out of 19 popular financial ratios that best distinguished between sound businesses and those that actually failed. The Springate model uses this formula:

\[
Z = 1.03A + 3.07B + 0.66C + 0.4D
\]

where:

\[
\begin{align*}
A &= \text{Working capital/total assets} \\
B &= \text{Net profit before interest and taxes/total assets} \\
C &= \text{Net profit before taxes/current liabilities} \\
D &= \text{Sales/total assets}.
\end{align*}
\]

If \(Z < 0.862\) then the firm is classified as 'failed' (see Figure 7.18).

This model achieved an accuracy rate of 92.5 per cent using the 40 companies tested by Springate and can be used in conjunction with other models. Companies achieving low scores may not go bust within the time period and the analysis merely suggests those companies exhibiting risk characteristics.

LOGIT ANALYSIS

The Altman model has been widely used but despite the positive results of his study, Altman’s model has some weaknesses for commercial use:
the model assumes variables in the sample data to be normally distributed;
- beyond two years prior to failure, it has a poorer predictive ability than a
random chance model of 50 per cent;
- it is based on small samples so may not be representative;
- it does not eliminate all the problems relating to accounting ratios and
book values;
- it is based on US industrial companies.

The Logit model attempts to correct the problem of abnormal distribution. The output from the model is a probability (in terms of a percentage) of bankruptcy (see Figure 7.19). This could be considered a measure of the effectiveness of management since effective management would not allow a company to drift towards bankruptcy.

Application of the Logit model requires four steps:

2. Each ratio is multiplied by a coefficient unique to that ratio (coefficient either positive or negative).
3. Resulting values are summed together ($y$).
4. The probability of bankruptcy for a firm is calculated as the inverse of $(1 + e^y)$.
The model uses the ratios above and multiplies them out by the factors shown in Table 7.2.

The formula in cell H98 = 1/(1 + $G$89^H97). The evaluation using the formula auditing tool at Formulas, Formula Auditing, Evaluate Formula (Excel 2003 – Tools, Formula Auditing, Evaluate Formula) is as in Figure 7.20 repeating the formula (1 + $e^y$).

<table>
<thead>
<tr>
<th>Financial ratio</th>
<th>Coefficient</th>
</tr>
</thead>
<tbody>
<tr>
<td>Constant</td>
<td>+0.23883</td>
</tr>
<tr>
<td>Average inventories/sales</td>
<td>-0.108</td>
</tr>
<tr>
<td>Average receivables/average inventories</td>
<td>-1.583</td>
</tr>
<tr>
<td>(Cash + marketable securities)/total assets</td>
<td>-10.78</td>
</tr>
<tr>
<td>Quick assets – current liabilities</td>
<td>+3.074</td>
</tr>
<tr>
<td>Income from continuing operations/(total assets – current liabilities)</td>
<td>+0.486</td>
</tr>
<tr>
<td>Long-term debt/(total assets - current liabilities)</td>
<td>-4.35</td>
</tr>
<tr>
<td>Sales/(net working capital + fixed assets)</td>
<td>+0.11</td>
</tr>
</tbody>
</table>

\[
y = \text{Sum of (coefficient \times ratio)}
\]

\[
\text{Probability of bankruptcy} = \frac{1}{1 + e^y}
\]

Explanatory variables with a negative coefficient increase the probability of bankruptcy because they reduce $e^y$ toward zero, with the result that the bankruptcy probability function approaches 1/1, or 100 per cent. Likewise, independent variables with a positive coefficient decrease the probability of bankruptcy. The example above shows an increasing probability of bankruptcy (see Figure 7.19).
H-FACTOR MODEL

Fulmer used step-wise multiple discriminate analysis to evaluate 40 financial ratios applied to a sample of 60 companies: 30 failed and 30 were successful. The average asset size of these firms was $455,000. Fulmer reported a 98 per cent accuracy rate in classifying the test companies one year prior to failure and an 81 per cent accuracy rate more than one year prior to bankruptcy.

The H-factor model takes the following form:

\[ H = 5.528(V1) + 0.212(V2) + 0.073(V3) + 1.270(V4) - 0.120(V5) + 2.335(V6) + 0.575(V7) + 1.083(V8) + 0.984(V9) - 6.075 \]

where:

- \( V1 \) = Retained earnings/total assets
- \( V2 \) = Sales/total assets
- \( V3 \) = EBIT/equity
- \( V4 \) = Cash flow/total debt
- \( V5 \) = Total debt/total assets
- \( V6 \) = Current liabilities/total assets
- \( V7 \) = Log tangible total assets
- \( V8 \) = Working capital/total debt
- \( V9 \) = Log EBIT/Interest

Constant = 6.075.
The model multiplies out the factors and adds up the score (see Figure 7.21). If the score is less than zero, the company is classed as failed. Again, this company is classed as failed using this analysis since it has a negative score.

**RATINGS AGENCY**

One widely used measure of a firm’s default risk is its bond rating, which is assigned by an independent ratings agency. The ratings process begins when a company requests a rating from a bond ratings agency. Information is collated from public and company sources and the agency analyses the information to ascertain the company’s ability to service and repay the debt. The rating will provide a score of financial strength. Firms that are profitable and have low debt ratios with strong cash flow are more likely to be rated higher than indebted companies with marginal profitability.

This model is introduced on the FRatios_Debt sheet. It produces a score for each year but the scores should be treated as a guide in conjunction with other methods:

- the medians are not intended to be hurdles or scores that have to be achieved to attain a specific rating score;
- caution should be exercised when using the ratio medians for comparisons with specific company or industry data because of major differences in method of ratio computation, importance of industry or business risk, and the impact of mergers and acquisitions;
- since company ratings are designed to be valid over the entire business cycle, ratios of a particular firm at any point in the cycle may not appear to be in line with its assigned debt ratings;
- particular caution should be used when making cross-border comparisons, owing to major differences in accounting principles, financial practices and business environments.

Table 7.3 sets out the characteristics for each category. The financial ratios used to measure default risk are:

1. EBIT interest coverage = \( \frac{\text{earnings from continuing operations before interest and taxes}}{\text{gross interest incurred before subtracting (1) capitalized interest and (2) interest income}} \)

2. EBITDA interest coverage = \( \frac{\text{earnings from continuing operations before interest, taxes, depreciation and amortization}}{\text{gross interest incurred before subtracting (1) capitalized interest and (2) interest income}} \)

3. Funds from operations/total debt = \( \frac{\text{net income from continuing operations + depreciation, amortization, deferred income taxes and other}}{\text{total debt}} \)
non-cash items)/[long-term debt + current maturities, commercial paper and other short-term borrowings]

4 Free operating cash flow/total debt = [funds from operation – capital expenditures, – (+) increase (decrease) in working capital (excluding changes in cash, marketable securities and short-term debt)]/[long-term debt + current maturities, commercial paper and other short-term borrowings]

5 Return on capital = EBIT/[average of beginning of year and end of year capital, including short-term debt, current maturities, long-term debt, non-current deferred taxes and equity]

6 Operating income/sales = [sales – cost of goods manufactured (before depreciation and amortization), selling, general and administrative, and research and development costs]/sales

7 Long-term debt/capital = long-term debt/[long-term debt + shareholders’ equity (including preferred stock) + minority interest]

8 Total debt/capital = [long-term debt + current maturities, commercial paper and other short-term borrowings]/[(long-term debt + current maturities, commercial paper and other short-term borrowings) + shareholders’ equity (including preferred stock) + minority interest].

### Table 7.3: Ratings

<table>
<thead>
<tr>
<th>Rating</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>Issues rated AAA are judged to be of the best quality and offer the highest safety for timely payment of interest and principal.</td>
</tr>
<tr>
<td>AA</td>
<td>High safety for timely payment of interest and principal.</td>
</tr>
<tr>
<td>A</td>
<td>Adequate safety for timely payment of interest and principal. More susceptible to changes in circumstances and economic conditions than debts in higher-rated categories.</td>
</tr>
<tr>
<td>BBB</td>
<td>Moderate safety for timely payment of interest and principal. Lacking in certain protective elements. Changes in circumstances are more likely to lead to weakened capacity to pay interest and principal than debts in higher-rated categories.</td>
</tr>
<tr>
<td>BB</td>
<td>Inadequate safety for timely payment of interest and principal. Future cannot be considered as well-assured.</td>
</tr>
<tr>
<td>B</td>
<td>High risk associated with timely payment of interest and principal. Adverse business or economic conditions would lead to lack of ability on the part of the issuer to pay interest or principal.</td>
</tr>
<tr>
<td>CCC</td>
<td>Very high risk of default. Factors present make them vulnerable to default. Timely payment of interest and principal possible only if favourable circumstances continue.</td>
</tr>
<tr>
<td>D</td>
<td>Payment of interest and/or repayment of principal are in arrears. Already in default.</td>
</tr>
</tbody>
</table>
The example medians scores used for each of the rating classes are shown in Table 7.4.

Figure 7.22 shows the calculation of the rating for EBIT coverage. The ratio is calculated as 2.29 in the final historic year. The next line then compares each ratio against the listing and converts it back into a rating.

This is the code in cell M123 which uses the MATCH function along the listing of EBIT coverage for each rating. The value of 2.29 is closest to the fifth value 2.1 and therefore the function returns 5.

=IF(M17>$I137,0,IF(M17<$O137,7,MATCH(M17,$I137:$O137,-1)))+1

In cell M18 this can be used as an OFFSET value along the list of ratings letters, which in this case is BB. This process is repeated for each ratio and the values are averaged as a score (see Figure 7.23). For December 2002, this is 5.50, which is rounded up using the ROUNDUP function with zero decimal places:

=ROUNDUP(M131,0)

Again, this score can be read using the list of ratings with an OFFSET function where cell M132 has the value 6. The result is a B rating:

=OFFSET($H$136,0,M132)
Again, Figure 7.23 provides a trend over time and the score above is declining from a BBB in December 1999 to a B in December 2002. This confirms the same results trend as the default models earlier in this chapter. At the bottom, there is a dynamic chart allowing review of any line. Figure 7.24 is the EBITDA/Interest coverage. The chart shows clearly the volatility and the declining financial strength.
SUMMARY

This chapter has reviewed credit risks and introduced methods for extending financial analysis to understand more fully an organization’s solvency risk and ability to repay debts. The methods have included cash flow sensitivity, sustainability and growth measures, insolvency models such as Z scores or Logit analysis and finally bond ratings. The modular approach demonstrates again how a basic model can be extended with further blocks to improve the quality of management information. The model now yields extra information since the example company shows declining financial strength, and this is reinforced by the findings of sustainability and bankruptcy models.

REFERENCES

Valuation

Introduction

Inputs

Cash flow

Capital structure

Valuation and returns

Sensitivity analysis

Management summary

Summary

File: MRM2_08
INTRODUCTION

Financial analysis models can be extended to include valuation using cash flow methods. This chapter introduces a free cash flow company valuation model as a buyout model with options. The transaction value is funded by a mixture of cash and debt, and the company is forecast to grow over a 10-year period to a planned exit point. The objective is to understand and develop the net present value (NPV) or valuation for the equity investors and the whole firm. Value is derived from the free cash flows over the forecast period and the compounded or exit value of the firm on expiry. The internal rate of return (IRR) to the firm and investors is also important in determining the acceptability of the proposal. The lower the cost of capital, the higher the eventual valuation derived. In addition, the mix of debt and equity drives the value as the model needs to find an acceptable mix between value and interest cover as measured by debt service ratios.

Figure 8.1 shows the necessary tasks. The model must calculate the future cash flows to equity and to the organization, which will vary based on sales growth costs, interest rates and capital expenditure requirements. A suitable discount rate is required, which reflects the weighted cost of the sources of capital and a terminal value as a value of the organization in ten years. A completed model is structured with these key components:

- inputs or control section for the initial transaction, funding rates, future growth rates, costs, capital expenditure, cost of capital and exit route;
- cash flow to equity and to the organization over ten years to build up the profit and loss and cash statements with terminal values;
- capital structure sheet for calculation of the debt/equity ratio, cost of equity, after-tax cost of debt and weighted average cost of capital;
- results such as the NPV and IRR to equity and to the firm, and a decision on their acceptability;
- sensitivity of the answer to equity injection against the firm’s beta or the exit multiple built up with Sensitivity tables, conditional formatting and dynamic charts;
- management summary of key inputs and results.
The first inputs are for the cost of the transaction and the breakdown of funding (see Figure 8.2). Here 20 per cent is equity and the remaining 80 per cent debt. There is space for up to three funding facilities together with preference shares. Debt will increase the interest burden and depress cash flow, but a smaller more efficient equity injection will increase returns for the investors. The model should therefore show how returns to the organization and equity investors flex as the percentage of equity investment increases.

Figure 8.3 sets out the interest cost for each facility and the repayment percentages per annum. The percentages are added on the right-hand side and error checked with the formula below to ensure that they add up to 100 per cent or less:

```
=IF(OR($Q$16>1,$Q$17>1,Q18>1),"ERROR: Check the loan repayment schedule","No errors")
```

The model has an option of using an exit multiple or a growth model calculation to derive the terminal value. The interest rate on debt remaining in the terminal year is used in the calculation of interest in the final year. If the debt outstanding is zero, as in the inputs above, then the value is not used.
Figure 8.4 shows the income statement variables together with the growth rates over the 10-year period. The revenue starts at 10,000 and grows at 10 per cent per annum. Similarly, capital spending commences at 500 and grows by 5 per cent per annum. Cost of goods sold is a calculated cell using the formula:

$$1 - \frac{EBIT + Depreciation}{Revenues}$$

The current risk-free rate, tax rate and risk premium are needed in the cost of capital calculations.

The section is mainly control driven by scroll bars and combo boxes (see Figure 8.5). Sliding the scroll bars changes the organization’s beta and exit multiple using cell links in the workings area below the printed schedule (see Figure 8.6). Using a control means that cells E38 and E41 can be formulas, and the same formulas can be used in the Sensitivity tables. Since these are indirect references, this ensures that the tables remain synchronized without resorting to macros.
The model includes both single discount rate and periodic discount rate calculations. An NPV is simpler to derive with a single rate and both answers are given (see Figure 8.7). The exit formula is either an exit multiple of cash flow or a derivation of the perpetuity (Gordon’s) model.
The Sensitivity tables are set up to return multiple values. Rather than creating a matrix table just to look at a single value, the combo box returns an index number which can be used to make the tables more flexible. This means that the tables can include any one of the following options:

- present value of cash flow to equity investors;
- present value of cash flow to all investors;
- valuation for equity investors;
- valuation for all investors;
- IRR for equity investors;
- IRR for all investors;
- decision for equity investors;
- decision for all investors.

The text in the combo box is an updating text string, for example:

=Capital_Structure!$F$35&" "&Capital_Structure!$C$36 (Valuation Equity Investors: Periodic WACC)

The control area contains all the entries for the cash flow and other sheets. The cash flow and capital structure sheets build up the cash flows using these inputs to a valuation and return result.

**CASH FLOW**

The cash flow schedule includes line numbers and references to show the source of the figures. This is achieved by formulas, for example row eight:

Cell B8="P"&TEXT(ROW(A8),"000")
Cell D8=$B$8"*(1+"&Inputs!$B$28")"
Each line uses dynamic references and this means that references will remain synchronized even if lines are inserted or deleted. The statement builds up the earnings before interest and tax, and charges interest on each of the facilities against earnings. The income is taxed and depreciation added back to form cash from operations. To achieve cash due to equity, capital expenditure, the change in working capital and capital repayments are subtracted. The final cash flow due to the organization reduces the cash flow to equity by preference dividend, after-tax interest and principal repayments.

Lines 26 and 30 of Figure 8.8 show the cash flow to equity and the firm. The terminal value is also required as the end cash flow. This is the forecast valuation at the end of the forecast period. The choices are an exit multiple or a perpetuity model calculation. Option one is an exit multiple, which takes the final equity cash flow and multiplies it by the exit multiple input in the control area.

=IF(Inputs!D67=1,Cash_Flow!P26*Inputs!E41,$P$26/(Capital_Structure!$P$20-Inputs!$O$28))
The second option uses the perpetuity model with the formula below. This formula presents values cash flows growing at a constant rate in perpetuity.

**Final cash flow** *(Cost of equity – Revenue growth rate)*

For example: \( \frac{1154.77}{(10.77\% – 5\%)} = \frac{1154.77}{5.77\%} = 20,013.34 \).

Figure 8.9 shows all the cash flows necessary for the valuation with the flexibility to choose the method of calculating the terminal value. There are no inputs on this sheet and all the variables are contained on the Inputs sheet.

**CAPITAL STRUCTURE**

The schedule needs to calculate a discount rate that reflects the cost of each source of capital and weights the final cost by the market weighting of each source of capital. The first lines of the schedule calculate the percentages of debt, equity and preferred shares (see Figure 8.10). In year one after the acquisition, debt is four times equity or, alternatively, debt is 80 per cent of the combined capital.

### Completed cash flow

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>P008</td>
<td>Revenues</td>
<td>10,000.00</td>
<td>11,000.00</td>
<td>11,500.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>P009</td>
<td>Cost of Goods Sold (COGS)</td>
<td>(8,850.00)</td>
<td>(8,850.00)</td>
<td>(8,850.00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>P010</td>
<td>Depreciation</td>
<td>(556.00)</td>
<td>(556.00)</td>
<td>(556.00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10</td>
<td>P011</td>
<td>Earnings before Interest and Tax (EBIT)</td>
<td>1,000.00</td>
<td>1,126.00</td>
<td>1,151.25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11</td>
<td>P012</td>
<td>Interest: Facility 1</td>
<td>(206.00)</td>
<td>(206.00)</td>
<td>(206.00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12</td>
<td>P013</td>
<td>Interest: Facility 2</td>
<td>(160.00)</td>
<td>(160.00)</td>
<td>(160.00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13</td>
<td>P014</td>
<td>Interest: Facility 3</td>
<td>(144.00)</td>
<td>(144.00)</td>
<td>(144.00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14</td>
<td>P015</td>
<td>Taxable Income</td>
<td>800.00</td>
<td>705.00</td>
<td>977.25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15</td>
<td>P016</td>
<td>Taxes</td>
<td>(240.00)</td>
<td>(229.60)</td>
<td>(263.16)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16</td>
<td>P017</td>
<td>Net Income</td>
<td>560.00</td>
<td>555.40</td>
<td>614.08</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17</td>
<td>P018</td>
<td>Depreciation</td>
<td>500.00</td>
<td>525.00</td>
<td>567.25</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18</td>
<td>P019</td>
<td>Cash Flow from Operations</td>
<td>1,000.00</td>
<td>1,065.00</td>
<td>1,166.53</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19</td>
<td>P020</td>
<td>– Capital Expenditure</td>
<td>(556.00)</td>
<td>(525.00)</td>
<td>(567.25)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td>P021</td>
<td>– Working Capital Change</td>
<td>(126.00)</td>
<td>(150.00)</td>
<td>(182.50)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21</td>
<td>P022</td>
<td>– Preference Dividend</td>
<td>–</td>
<td>–</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>22</td>
<td>P023</td>
<td>– Principal Repayment: Facility 1</td>
<td>(400.00)</td>
<td>(400.00)</td>
<td>(400.00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23</td>
<td>P024</td>
<td>– Principal Repayment: Facility 2</td>
<td>(200.00)</td>
<td>(200.00)</td>
<td>(200.00)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>P025</td>
<td>– Principal Repayment: Facility 3</td>
<td>–</td>
<td>–</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25</td>
<td>P026</td>
<td>Cash Flow to Equity</td>
<td>423.84</td>
<td>423.84</td>
<td>(58.42)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>P027</td>
<td>– Preference Dividend</td>
<td>–</td>
<td>–</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27</td>
<td>P028</td>
<td>– Interest (1-Tax)</td>
<td>145.80</td>
<td>252.80</td>
<td>212.80</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>P029</td>
<td>– Principal Repayment</td>
<td>–</td>
<td>800.00</td>
<td>800.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29</td>
<td>P030</td>
<td>Cash Flow to Firm</td>
<td>503.84</td>
<td>535.50</td>
<td>744.30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>P031</td>
<td>Terminal Value of Firm</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31</td>
<td>P032</td>
<td>Terminal Value of Equity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

*Figure 8.9*
The cost of equity is based on the Capital Asset Pricing Model (CAPM) using the formula:

\[
\text{Cost of equity} = \text{Risk free rate} + \beta \times \text{risk premium}
\]

Beta is a measure of risk plotted as the volatility of the share against the market, which here was input as 1.13. The market is one and therefore this share appears more risky than the market. Betas can be derived from plotting the returns on a share against, and index or betas are available from on-line feeds such as Bloomberg. The other variables are also on the Input sheet. The beta needs to be un-levered to strip out the effect of the historic debt burden and then re-levered using the forecast debt to equity ratio. The formulas are:

Un-levered or Asset $\beta = \beta (1 + (1 - \text{Tax}) \times \text{Debt/Equity})$

Re-levered or Equity $\beta = \beta * (1 + (1 - \text{Tax}) \times \text{Debt/Equity})$
In the example above, the initial beta is 1.13 which reduces to 0.96 as an asset beta. With the effect of the high forecast debt/equity ratio, the beta rises to 3.65. The cost of equity is therefore:

\[
\text{Cost of equity} = \text{Risk free rate} + \beta \times \text{Risk premium}
\]

\[
= 5\% + 3.65 \times 6\%
\]

\[
= 26.9\%
\]

The cost of debt depends on the balances outstanding, and the formula below weights the interest rate against the balance in each of the three facilities. Since the company is paying tax, the cost of debt used in the final cost of capital calculation will be multiplied by \((1 - \text{Tax})\) as an after-tax rate.

\[
\text{Cell F21} = \frac{(F8*Inputs!\$E16 + F9*Inputs!\$E17 + F10*Inputs!\$E18)}{\text{SUM}(F8:F10)}
\]

The weighted average cost of capital uses the market weights of each source and multiplies them out by the individual costs. The cost of capital changes in each period as the capital structure changes with the repayment of loans.

\[
\text{Cell F22} = F20 \times (1 - F14 - F15) + F21 \times (1 - Inputs!\$E36) \times F14 + F15 \times Inputs!\$E15
\]

In order to compute a present value based on the periodic, it is necessary to compound the discount rate in rows 24 and 25 (see Figure 8.11). The number increases progressively as a compound figure to year 10. Rows 27 and 28 bring forward the cash flows from the previous schedule. The present value for the period is therefore the cash flow divided by the compounded discount rate. The periodic values can simply be added to form the total in the last column. The final results are in Figure 8.12.

![Present value calculations](image-url)
The objective of the model is to compute the valuation and returns to investors and the firm. There is an alternative using a single cost of capital, but this would tend to give an incorrect answer since the capital structure changes markedly during the period. The IRR formula uses the full cash flows on the schedule and the decision is a simple IF statement, where the valuation needs to be greater than the initial investment:

$$\text{IF}(F36>\text{ABS}(G36), \text{"Accept"}, \text{"Decline"})$$

Results are shown in Figure 8.13.

The cell formatting uses conditional formatting to emphasize the answer (see Figure 8.14).
Other answers include background information on the cash flows, leverage and beta. The cash flow formulas use simple formulas:

\[
\begin{align*}
\text{Average} &= \text{AVERAGE}(\text{Cash Flow!F30:O30}) \\
\text{Max} &= \text{MAX}(\text{Cash Flow!F30:O30}) \\
\text{Min} &= \text{MIN}(\text{Cash Flow!F30:O30}) \\
\text{Standard Deviation} &= \text{STDEV}(\text{Cash Flow!F30:O30})
\end{align*}
\]

The single discount rate workings use the discount rates from cells E20 and E22, 11.78 per cent and 10.82 per cent respectively (see Figure 8.15). This provides a simple Sensitivity table against the rates and the chart is plotted on the Sensitivity_Beta sheet.
SENSITIVITY ANALYSIS

Since the inputs for data tables have to be on the same sheet, all the workings for the two sets of data tables are at the bottom of the Inputs sheet in the workings area. The two tables are:

1. equity injection across and organization beta (b) down;
2. equity injection across and exit cash flow multiple down.

Office 2007 – Data, Data Tools, What-if Analysis (Excel 2003 – Data, Data Table)

This is to provide information on how the answers change as you vary the beta or the exit multiple. Remember that the tables are flexible in that you can choose using the combo box in the Inputs area:

- present value of cash flow to equity investors;
- present value of cash flow to all investors;
- valuation for equity investors;
- valuation for all investors;
- IRR for equity investors;
- IRR for all investors;
- decision for equity investors;
- decision for all investors.

The inputs for the tables are the equity injection in cell 16, the beta in cell E38 and the exit multiple in cell E41 (see Figure 8.16). Note that these cells are updated by spinners and are not input cells. The data table axes are also linked to the spinners in order to keep the tables synchronized.

The tables have conditional formatting to generate the exact formatting for the answer and the distinctive stripes for the $x$- and $y$-axis of the answer. The answer should always stay in the middle of the table. Figure 8.17 shows the conditional formatting for the first table which uses both cell value and formula parameters.

There are two sensitivity schedules to bring forward the data from the tables and display charts. You need the charts to be able to assess easily the rate of change in the underlying result. The two schedules are Sensitivity_Beta (see Figure 8.18) and Sensitivity_Exit (see Figure 8.19). Each provides a dynamic chart to plot a single row from the table and insert the answer as a point. The beta represents the risk on the share, so as you increase risk the valuation declines because of the increased cost of capital.
Figure 8.18 illustrates how the equity value rises with increased investment at a constant beta. The downside is that the rate of return falls as the effect of leverage decreases.

The exit multiple could be the projected sale price at the end of the period and therefore Figure 8.19 shows an increased valuation with a higher multiple. The values range from 2,624 to 6,923. As an alternative, the second table in Figure 8.19 highlights the cells where the answers are within the input 15 per cent plus or minus of the single point value.
The conditional formatting uses the formulas: 

\[ = B11 \times (1 - C20) \]

and 

\[ = B11 \times (1 + C20) \]

to capture the values (see Figure 8.20). This allows a range of values to be used since the variables are not hard coded.

Figure 8.21 explains how valuation increases with increased equity injection and uses the same format as the beta chart.

**MANAGEMENT SUMMARY**

The management summary brings together all the findings on a single-page report (see Figure 8.22). This includes an executive summary of the initial
transaction, the valuations and return calculations, and the Sensitivity tables. This provides all the key findings, without the detail, on a simple report.

**Conditional formatting**

![Figure 8.20: Conditional formatting](image)

**Cash flow exit multiple**

![Figure 8.21: Cash flow exit multiple](image)

The data tables are shown in Figure 8.23.

**SUMMARY**

This chapter uses a leveraged buyout valuation model to show the key elements in free cash flow models and includes advanced data tables to demonstrate the variability in the answers as a result of changing the beta or the exit multiple. The steps comprise sufficient inputs to calculate a free
cash flow to equity and to the company, formulate a method for computing a terminal value, setting out a suitable risk-adjusted discount rate, and then calculating the valuation and the return to investors and the organization. With a single-point answer in place, advanced data tables provide more management information on the possible spread of expected results.

Figure 8.22

Summary results

<table>
<thead>
<tr>
<th></th>
<th>PV of CF</th>
<th>Investment</th>
<th>Valuation</th>
<th>IR</th>
<th>Decision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Investors: Periodic WACC</td>
<td>5,834.90</td>
<td>(1,000.00)</td>
<td>4,834.90</td>
<td>36.16%</td>
<td>Accept</td>
</tr>
<tr>
<td>Ad Investors: Periodic WACC</td>
<td>11,429.71</td>
<td>(4,000.00)</td>
<td>4,429.71</td>
<td>23.83%</td>
<td>Accept</td>
</tr>
</tbody>
</table>

Cashflow to Firm:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average FCF</td>
<td>0.50%</td>
<td>0.50%</td>
<td>0.50%</td>
</tr>
<tr>
<td>Maximum FCF in period 1</td>
<td>1.05%</td>
<td>1.05%</td>
<td>1.05%</td>
</tr>
<tr>
<td>Minimum FCF in period 1</td>
<td>0.57%</td>
<td>0.57%</td>
<td>0.57%</td>
</tr>
<tr>
<td>Standard Deviation of FCF</td>
<td>1.02%</td>
<td>1.02%</td>
<td>1.02%</td>
</tr>
</tbody>
</table>

Leverage:

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt/Equity Ratio before Transaction</td>
<td>0.28</td>
<td>0.28</td>
<td>0.28</td>
</tr>
<tr>
<td>Debt/Equity Ratio after Transaction</td>
<td>0.45</td>
<td>0.45</td>
<td>0.45</td>
</tr>
<tr>
<td>Debt/Equity Ratio in Year 5</td>
<td>0.22</td>
<td>0.22</td>
<td>0.22</td>
</tr>
<tr>
<td>Debt/Equity Ratio in year 10</td>
<td>0.22</td>
<td>0.22</td>
<td>0.22</td>
</tr>
</tbody>
</table>

Figure 8.23

Data tables

<p>| | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Valuation Equity Investors: Periodic WACC: Sensitivity Table to Equity Injection Across and Organisation Betas (β) Down</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Organisation Beta</td>
<td>1.15</td>
<td>1.00</td>
<td>0.90</td>
<td>0.80</td>
<td>0.70</td>
</tr>
<tr>
<td>α</td>
<td>4,834.90</td>
<td>5,834.90</td>
<td>6,834.90</td>
<td>7,834.90</td>
<td>8,834.90</td>
</tr>
<tr>
<td>Valuation Equity Investors: Periodic WACC: Sensitivity Table to Equity Injection Across and Equity Cash Flow Multiple Down</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Cash Flow Multiple</td>
<td>15.00</td>
<td>20.00</td>
<td>25.00</td>
<td>30.00</td>
<td>35.00</td>
</tr>
<tr>
<td>α</td>
<td>9.00</td>
<td>11.00</td>
<td>13.00</td>
<td>15.00</td>
<td>17.00</td>
</tr>
<tr>
<td>Valuation Equity Investors: Periodic WACC: Sensitivity Table to Equity Injection Across and Equity Cash Flow Multiple Down</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity Cash Flow Multiple</td>
<td>15.00</td>
<td>20.00</td>
<td>25.00</td>
<td>30.00</td>
<td>35.00</td>
</tr>
</tbody>
</table>
Bonds

Introduction

Bond prices

Interest rates

Yield

Duration and maturity

Convexity

Comparison

Summary

File: MRM2_09
INTRODUCTION

This chapter reviews risk on fixed-income products. Bonds are instruments that usually pay interest (coupon) during the loan period and repay the capital on expiry. Bonds can be valued as the present value of the regular interest payments and the final principal payments discounted at a rate that reflects the risk of default. The level of the interest payments is fixed on issue and therefore an investor is purchasing the right to receive a set of regular coupon or interest payments together with the final return of the principal. The final cash flow includes the final interest payment and the principal. Governments and commercial institutions issue bonds as a form of financing and there are a range of possibilities based on convertibility, term and coupon payments.

BOND PRICES

For clarity, these terms are used in the bonds market:

- issue date – original issue date of the bond;
- settlement – pricing or yield date;
- maturity – date when principal and final coupon is due;
- redemption value – par value, usually 100;
- coupon (per cent) – interest rate fixed for the period of the bond;
- coupons per annum – usually paid once (annual) or twice (bi-annual) a year;
- basis – see Table 9.1;
- yield to maturity – inherent interest rate that varies during the period based on markets;
- price – price of bond based on yield to maturity.

An example of bond cash flows showing final coupon and principal repayment is shown in Figure 9.1.

Since the payments are fixed, the price of a bond is inversely linked to the yield to maturity. As yield increases, the price of the bond must decline and vice versa. Bond pricing assumes:

- round periods rather than actual days, as used for other borrowing instruments;
- individual periods are regular;
- pricing is the compound net present value (NPV).
If the pricing is required on the date a coupon is due, then there are no issues with accrued interest. Between periods, a seller expects to receive the accrued coupon within the period, while the buyer will only pay the present value of the future payments. The convention for quoting prices is:

- **clean price** – present value of the coupons and principal (dirty price – accrued coupon);
- **dirty price** – clean price plus the accrued interest (NPV of all cash flows).

Accrued interest on the coupon from the last payment date is payable using simple interest calculations. If there are 30 days from the start of the period and it is assumed there are 360 days in the year, then the interest would be calculated as \( \frac{30}{360} \times \text{coupon rate} \). The first period could be less than the coupon periods depending on the purchase date, but thereafter coupons are payable annually, bi-annually or sometimes quarterly. The dates are the same, for example 15 September and 17 September for a bi-annual bond, and are not based on the exact number of days.

Day and year conventions vary and these are used in the various Excel functions. The methods are the number of days in the month and days in the year (see Table 9.1).

The conventions used in Excel functions are as below:

- 0 US (NASD) 30/360
- 1 Actual/actual
- 2 Actual/360
- 3 Actual/365
- 4 European 30/360
There are a number of defined bond functions in Excel, which are present in the Analysis Toolpak. Go to Tools, Add-ins and ensure that the add-in is ticked. This is a complete list of security-related functions:

- ACCRINT – accrued interest for a security that pays periodic interest;
- ACCINTM – accrued interest for a security that pays interest at maturity;
- AMORDEGRC – depreciation for each accounting period by using a depreciation;
- COUPDAYBS – number of days from the beginning of the coupon period to the settlement date;
- COUPDAYS – number of days in the coupon period that contains the settlement date;
- COUPDAYSNC – number of days from the settlement date to the next coupon date;
- COUPNCD – next coupon date after the settlement date;
- COUPNUM – number of coupons payable between the settlement date and maturity date;
- COUPPCD – previous coupon date before the settlement date;
- CUMIPMT – cumulative interest paid between two periods;
- CUMPRINC – cumulative principal paid on a loan between two periods;
- DURATION – annual duration of a security with periodic interest payments;
- MDURATION – Macaulay modified duration for a security with an assumed par value of $100;
- ODDFPRICE – price per $100 face value of a security with an odd first period;
- ODDFYIELD – yield of a security with an odd first period;
- ODDLPRICE – price per $100 face value of a security with an odd last period;
- ODDLYIELD – yield of a security with an odd last period;
- PRICE – price per $100 face value of a security that pays periodic interest;
- PRICEDISC – price per $100 face value of a discounted security;
- PRICEMAT – price per $100 face value of a security that pays interest at maturity;
TBILLEQ – bond-equivalent yield for a US Treasury bill;
TBILLPRICE – price per $100 face value for a US Treasury bill;
TBILLYIELD – yield for a US Treasury bill.

The main functions used in the file are:

- PRICE – price of a bond;
- YIELD – yield to maturity;
- DURATION – duration discussed later;
- MDURATION – modified duration.

INTEREST RATES

Bond prices change with rises or falls in the required rate of return. As a bond’s credit status falls, the rate investors are required to accept the risk of the future cash flows increases and therefore the price of the bond falls. The issue for investors is to assess the sensitivity of the bond to changes in interest rates. The price of the bond is simply the present value of future cash flows discounted at a periodic nominal rate.

This is an example of a bi-annual bond with six years remaining priced at 10 per cent with an annual coupon rate of 6 per cent. Combo boxes offer selection of the periodicity and payment convention as set out in the previous section (see Figure 9.2).

The resulting cash flows can be discounted at 5 per cent per period to form a price of 82.27 (see Figure 9.3).
Figure 9.4 shows the bond with 12 coupons remaining and the price is calculated by adding the periodic discounted cash flows. An alternative would be to use the \texttt{PRICE} Excel function.
The bond price responds inversely to changes in yield. As the yield increases, so the price of the bond falls as shown by Figure 9.5 – a table of two bonds on the Cash Flow sheet. This example shows a five- and ten-year bond with the same coupon rate.

**YIELD**

**Yield to maturity**

The bond calculator includes various measures of yield. If you know the yield of a bond, you can calculate the market price; if you know the price, then you can compute the yield. There are a number of derivations and they are usually referred to as:

- yield to maturity (YTM);
- yield;
- redemption yield;
- gross redemption yield (GYR).

The yield is an iterative formula, which like the internal rate of return (IRR), assumes that all cash flows can be reinvested at the same rate. This is a failing with internal rates of return since this may not always be true; nevertheless this is a simple concept and most investors understand the implied return on an investment.
The yield measures are in the Model sheet with the summary answers as shown in Figure 9.6. All the examples are saved as scenarios using Data, Data Tools, What-if Analysis (Excel 2003: Tools, Scenarios, New) and can be accessed using the combo box control to the right of the sheet.

**Bond calculator**

![Figure 9.6: Bond calculator](image)

**Workings**

![Figure 9.7: Workings](image)

**YIELD function**

![Figure 9.8: YIELD function](image)
The model calculates the clean price as 82.27 – the present value of the coupons and principal. There are no coupons accrued and therefore the dirty price is the same as the clean price. The yield workings are shown in Figure 9.7.

**Current yield**

This is a simple measure and is calculated as:

\[
\text{Current yield} = \frac{\text{Coupon rate}}{\text{Clean price/100}}
\]

In this case, it is \(\frac{6\%}{(82.27/100)} = 7.2927\%\). The method ignores the time value of money and therefore it cannot be used for comparing different maturity dates and coupon periods.

**Simple yield to maturity**

The simple yield to maturity again does not consider time value of money:

\[
\frac{(\text{Coupon} + ((\text{Redemption} - \text{Clean})/\text{Years to maturity})}{\text{Clean}/100}
\]

The example is paying annual 6 per cent coupons and is priced at 82.27 with the simple yield computed as 10.88 per cent.

**Yield to maturity**

The yield to maturity function uses the settlement and maturity dates, the rate and number of payments per annum, the redemption value and the payment convention, to return the annual yield (see Figure 9.8).

**DURATION AND MATURITY**

There are four measures of sensitivity that are commonly used to measure risk in a bond. These are:

1. simple maturity
2. duration
3. modified duration
4. convexity.

**Simple maturity**

Simple maturity is the time left on the bond. Since risk increases with time, then a long-dated bond is more risky than one which is due to mature
sooner. Since the principal is paid back on expiry, bonds are dissimilar to loans where a portion of the principal is paid with each instalment. Figure 9.9 shows two zero coupon bonds: the first is five years and the second ten years. The series plots the changes to the price as interest rates rise. The interest rise has a greater impact on the bond with the longer maturity.

Duration

The maturity of a bond is not a suitable indicator of risk since the cash flows occur during the period to and at maturity. A bond with a longer maturity is more risky owing to the possibility of adverse yield changes over a longer period. Duration attempts to provide a weighted measure of maturity in the formula:

\[ Duration = \frac{\text{PV of cashflow} \times \text{Period no}}{\text{Price}} \]

This is the value-weighted average of the timing of the included cash flows. The cash flow schedule multiplies out the present value cash flow by its weighting and then adds them at the bottom of the schedule (see Figure 9.10). There is also a function for duration as in cell D31:

\[ =DURATION(D8,D9,D11/100,IF(D12=0,D28,D12)/100,C134,F139) \]

If the bond carries no coupon, as in a zero coupon bond, then the duration will always be its maturity. Duration can be applied to any groups of cash flows and is useful when linked to the concept of immunization. If yields fall, then the following occurs:

- earnings on reinvesting coupons will fall;
- the price of the bond rises if held to maturity.
At some point between the date and maturity, the loss of interest returns, and the capital gains from a higher bond price balance or cancel each other out if an investor devises an immunized portfolio where:

- present value of assets equals the present value of liabilities;
- duration of assets is equal to the duration of liabilities.

**Modified duration**

The model also includes a calculation of modified duration which is a more accurate measure of the link between interest rates and bond prices. This is defined as:

\[ D = - \frac{1}{P} \times \frac{\Delta P}{\Delta Y} \]
where:

\[ P = \text{bond price} \]
\[ \Delta P = \text{change in price} \]
\[ \Delta \text{yield} = \text{change in the yield to maturity.} \]

\[
= \text{MDURATION(D8,D9,D11/100,IF(D12=0,D28,D12)/100,C134,F139)}
\]
\[
= \text{MDURATION(Settlement,Maturity,Coupon,Yield,Frequency,Basis)}
\]

This is equivalent to:

\[
= \left( \frac{1}{(1 + \text{Yield to Maturity/100/Pmts per Year})} \right) \times \text{Duration}
\]

Duration varies with yield and time, and the model has a Sensitivity sheet for reviewing the effect of these two variables on a number of answers. This is a dynamic table enabling the selection of multiple lines, which updates the charts (see Figure 9.11).

The selection for the combo box is the range D18 to D55 on the Model sheet (see Figure 9.12). Making the data table dynamic increases the potential range of information. The second combo box selects a row from the two-dimensional data table for the chart. Since the variables are located on the Model sheet, the actual data table is contained in workings and looked up on the Sensitivity sheet. The cell at the top left of the table uses an OFFSET function to return the value for the row selected by the combo box.

\[
= \text{OFFSET(D18,Sensitivity!G5,0)}
\]
The table in Figure 9.13 shows duration and therefore risk declining as the time moves towards maturity. Duration also increases as the yield declines. The chart in Figure 9.13 plots the middle series of the table as an XY scatter and draws the answer as a single point with a data label. Duration assumes that the relationship between the bond price and yield to maturity is linear whereas the true relationship is not linear. The strict relationship is only true over small changes in yield or price. In practice, the line is slightly curved as shown in Figure 9.13 since the slope changes as you move along it.

**CONVEXITY**

Duration and modified duration do not fully explain the link between prices and yield, and convexity provides a partial solution to predicting prices. The actual change depends on the amount of curvature of the price line and this is known as convexity. The Model sheet contains three formulas of calculating convexity and the sensitivity is explored on a second sheet called Convexity.
Formula 1

The first formula is an approximation to be used for small changes since it still assumes a linear relationship. The formula calculates the price movement based on a 1 per cent yield change. The coupon rate is the periodic rate rather than the annual rate. This is the formula for a 1 per cent change:

\[ 1 - Duration \times Price \times \left[ \frac{1}{1 + (1 \text{ Periodic coupon rate})} \right] \times 0.01 \]

Cell D34: =-$D$31*$D$20*(1/(1!($D$28/$C$134)/100))*C120/100

This is derived as −7.8635 (cell G52) or 9.55 per cent for an increase to a 12 per cent yield. The answer is revised price (1) which is 74.4100 (see Figure 9.14).

Formula 2

The modified duration can also be used for calculating the price change per 1 per cent of yield using the formula:

\[ \text{Dirty price} \times \text{Change in yield} \times \text{Modified duration} \]

This results in the same answer for the 12 per cent yield. Again, this assumes a linear relationship and will become progressively inaccurate.
The first convexity formula is:

\[ C = 10^8 \left( \frac{\Delta P_{d+1}}{P_d} + \frac{\Delta P_{d-1}}{P_d} \right) \]

This involves calculating the price change for plus and minus 100 basis points using a data table in workings on the right-hand side (see Figure 9.15). Convexity is calculated as:

Cell D43: \( =(((N35/D20) + (P35/D20))*10^8) \)

The formula for a change in price is then:

\[ \Delta Price = \text{Modified duration} \times \Delta Yield + \frac{\text{Convexity}}{2} \times \Delta Yield^2 \]

Cell D43: \( =(-$D$32*($C$124/100) + 0.5*D42*($C$124/100)^2)*100 \)

The final result owing to the curvature is 74.8485 rather than 74.4100 by the simpler linear formula.
The model also includes the full convexity formulas in the cash flow on the model sheet (see Figure 9.16) built up as a schedule using the formula below:

\[
Convexity = \frac{1}{P} \cdot \frac{\Delta^2 P}{(\Delta y)^2} \cdot \frac{1}{(1+y)^2} \cdot \sum_{t=1}^{r} t(t+1) \cdot \frac{C_t}{(1+y)^t} / P
\]

The weightings column is the present value in column E of Figure 9.16 divided by the sum of the cash flows in cell E91. The duration is the period number multiplied by the weighting. The convexity for the period is:

\[
\text{Period}\times\text{Next Period}\times\text{Weighting}\times(1/(1+\text{Periodic Yield})^2)
\]

Cell H66 = B66*B67*F66*(1/(1+($D$28/Pmt_Year/100))^2)

At the bottom of the schedule the periodic convexity results are added:

Cell H91 = SUM(H66:H90)

The annual rate is the sum divided by (payments per year ^ payments per year). The convexity is 27.80 and with this factor the change in the bond price can be derived from:

\[
\Delta \text{Price} = -\text{Modified duration} \times \Delta \text{Yield} + \frac{Convexity}{2} \times (\Delta \text{Yield})^2
\]

The value is 74.8675 (see Figure 9.17). The schedule also includes data table workings for comparison to the calculated values and this is 74.8878 (see Figure 9.17).

**COMPARISON**

The Convexity sheet calculates the bond price at each of the yield to maturities on the left using a PRICE function.
Figure 9.16

Convexity workings

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<thead>
<tr>
<th>Period</th>
<th>Date</th>
<th>Cashflow</th>
<th>PV wg</th>
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</tr>
</tbody>
</table>

Figure 9.17

Convexity results

=PRICE(Model!$D$8,Model!$D$9,Model!$D$11/100,B10/100,Model!$D$10,Model!$C$138,Model!$F$143)
Column F of Figure 9.18 repeats formula 2 (–dirty price * change in yield * modified duration) as the duration multiplied by the change in yield to obtain the percentage change. This can then be multiplied out against the existing price. Column I uses formula 4 to obtain the percentages and these are added in column J. You can see that the differences are small when close to the current yield to maturity but owing to convexity, become more pronounced as you move further from the existing price.

Two further charts illustrate the table (see Figures 9.19 and 9.20). Figure 9.19 plots the actual and predicted changes in amounts from formulas 2 and 4. The convexity formula rather than the duration-based formula is more accurate in tracking the actual price changes. The periodic convexity follows the actual change closely.

Figure 9.20 plots the percentage differences against the predicted actual prices. The duration-based formula becomes progressively less accurate away from the current yield of 10 per cent. By contrast, formula 4, based on the convexity cash flows, remains more accurate further from the current yield.
Bond mathematics provides a method of assessing risk in fixed income products. The requirements include assessing price, yield and risk. Since the value of a bond varies inversely with the yield, this chapter has provided methods of assessing the sensitivity of a bond’s value to changes in interest rates. The main methods are duration and convexity, which provide a standardized measure of risk in the product. Using these measures, it is possible to assess the sensitivity to interest rate changes which will affect the value of the bond cash flows.
Options

Introduction

Options

Options example

Options hedging strategy

Black–Scholes

Simulation options pricing

Binomial model

Summary
INTRODUCTION

This chapter introduces options models, and maps the pricing and pay-offs whereby the holders can use these instruments to reduce downside risk upon payment of premiums. The models show how downside risk is removed and how combinations of options can deal with varying expectations of future volatility in the markets. Definitions of options are as follows.

- An option provides an opportunity to buy or sell a specified quantity of an underlying asset at or before an expiry date at a strike or exercise price.
- A call option is a contract giving its holder the right (but not the obligation) to buy at a fixed price at any time on or before a given date. The premium is paid at the beginning and if at expiration, the asset value is less than the strike price, then the option is worthless and the holder would decide not to exercise the option. If it is greater, the holder would exercise the option and purchase at the exercise price. The variance between the asset price and the exercise price would constitute a profit less the initial price for the option.
- A put option is a contract giving its holder the right (but not the obligation) to sell at a fixed price at any time on or before a given date. The holder pays the premium. On expiry, if the price of the asset is greater than the strike price, the option would not be exercised. If the price is less than the strike price, the put option would be exercised and stock sold at the strike price. The difference between the strike price and the expiry market value of the asset would represent a profit on the transaction.

American options use the above definitions whereas European options can only be exercised on the expiry date. Since you can allow an option to lapse if it is worthless, options can be useful in covering possible downside risk. Since there are two sides to the bargain, the pricing reflects perceptions of risk and uncertainty in the underlying asset. The pricing of options is determined by:

- volatility of variance in the price of the underlying asset since the uncertainty has to be priced into the contract;
- initial value of the underlying asset;
- strike price at expiry;
- time to expiry since risk usually increases with time;
- risk less interest rate for the period of the option.

Table 10.1 shows the effects on call and put values of various variables.
The sheet called Call_Put_Option demonstrates the workings of an option. The scenario called Example 1 contains the example shown in Figure 10.1. The option is the right to buy shares at 5.00 over a period ending in June. The underlying price at the time of writing the contracts is 5.00 and the price of the option is 0.78. This fixes the maximum loss at 0.78 since this is a right and not an obligation to buy. Likewise, the maximum loss on the put options is limited to 0.38. The possible courses of action are:

- the price rises – sell the option in the market or exercise the option on expiry;
- the price falls – allow the option to lapse as it is worthless.

<table>
<thead>
<tr>
<th>Table 10.1</th>
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<tbody>
<tr>
<td><strong>Variable</strong></td>
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<tr>
<td>Increase in volatility</td>
</tr>
<tr>
<td>Increase in asset price</td>
</tr>
<tr>
<td>Increase in strike price</td>
</tr>
<tr>
<td>Increase in time to expiry</td>
</tr>
<tr>
<td>Increase in risk-free rate</td>
</tr>
</tbody>
</table>

**OPTIONS**

The sheet called Call_Put_Option demonstrates the workings of an option. The scenario called Example 1 contains the example shown in Figure 10.1. The option is the right to buy shares at 5.00 over a period ending in June. The underlying price at the time of writing the contracts is 5.00 and the price of the option is 0.78. This fixes the maximum loss at 0.78 since this is a right and not an obligation to buy. Likewise, the maximum loss on the put options is limited to 0.38. The possible courses of action are:

- the price rises – sell the option in the market or exercise the option on expiry;
- the price falls – allow the option to lapse as it is worthless.

**Figure 10.1**

Option inputs

**Figure 10.2**

Call option table and pay-off diagrams
The inputs section checks the pricing of the call and put options since the pricing should, in theory, equate to call put parity through this formula:

$\text{Spot Price} + \text{Put} = \text{Call} + \text{Present value of exercise price}$

The present value is calculated in the model using the basic formula $1/(1 + \text{Interest rate})$ using the periodic interest rate entered in cell C11. Plotting the pay-offs for a call and a put are clearer in Excel and this schedule contains tables and charts (see Figures 10.1, 10.2 and 10.3).

If the share price was below the strike price of 5.00 plus the cost of the option of 0.78, Figure 10.2 shows losses and the options would not be exercised. The maximum loss is fixed at 0.78 per unit. Above 5.78, the profits increase since the strike plus premium price remains at 5.78.

The reverse is true for the put option where the losses increase as the price rises. The break even is 5.00 less the price of the option of 0.38 per unit (see Figure 10.4).
The chart is driven by the workings area on the right, which calculates both series simultaneously (see Figure 10.5). The code uses simple IF statements to decide whether to adopt the result or not. This means, for example, that the call option will adopt the 5.78 figure.

This Options_Example sheet allows you to choose a call or a put and view the net pay-offs at different strike prices. The data inputs are shown in Figure 10.6.

The controls allow you to select a call or a put and to select the option to be drawn in the chart at the bottom of the schedule. This is the code in cell C25, which contains a first IF statement using cell C75 (the result cell from the Call/Put control).

\[
\text{=IF(} \text{C75=} 1, \text{IF(} \text{B25}>\text{C22}, \text{B25}-\text{C22}, \text{B25})\text{, IF(} \text{B25}<\text{C22}, \text{C22}-\text{B25}, \text{B25})\text{)}\text{)}
\]

With the call, if the market price is greater than the contract price it calculates a profit, otherwise the loss is the maximum, which is the option premium. With a put option, the opposite is true and a margin is available if the market price is below the contract price.

Below the inputs, there is a table showing the results from a put option on market prices between 95.00 and 110.00 (see Figure 10.7). There are workings for the chart on the right-hand side and column K displays the
results from the ‘do nothing’ alternative. At the strike price of 103.00, the only loss is the premium, but below this figure, the losses mount.

Inputs and prices

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<tr>
<th>Strike Price</th>
<th>Premium (points)</th>
<th>Strike Price</th>
<th>Premium (points)</th>
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The chart plots several of the price lines to illustrate the trade-off on the put option (see Figure 10.8). The losses are limited to the premium paid for the put.

The chart is reversed with a call option where there are gains below the mid-price of 103.00 (see Figure 10.9). This method of charting pay-off diagrams makes it easier to understand the profit and losses under different prices. It is also another method of auditing the model to ensure that it produces plausible values.
Figure 10.8  Put options chart

Figure 10.9  Call option chart
OPTIONS HEDGING STRATEGY

The strategy sheet allows the investigation of options strategies since there are inputs for up to two strike prices of:

- buy call
- buy put
- sell/write call
- sell/write put.

The spreadsheet uses a series of eight blocks of workings on the right which collect data from the inputs area (see Figure 10.10). This is to allow strategies such as so-called butterflies with options purchased at different rates.

In each case, the workings use the number of options, the price and premium paid, if received, to work out if the options is in or out of the money (see Figure 10.11). This decides whether the option is worth exercising or not and then the block derives the amount, and removes the premium to leave the net pay-off for the underlying expiry price.

The calculations can be checked to show the net sum from writing and buying a put or a call. Figures 10.12 and 10.13 show the charts from both methods with a zero pay-off since both options are at the same price of 103.0. The net position series runs along the x-axis. Using the grid, the next section considers option strategies in stable and volatile environments.
Mastering Risk Modelling

**Figure 10.11**

*Workings*

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(1) Buy Call

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6.25
2.38

**Figure 10.12**

*Buy and write a call*

*Check Chart*
Neutral – sell straddle

Each of the following strategies are saved as scenarios to the model to allow easy loading of the values. The expectation with a sell straddle is for a stable environment where prices are likely to fluctuate in a very narrow range (see Figure 10.14). A call option and a put option are sold with the same strike price since the expected is not likely to move. There is a profit if the market stays within a narrow range but losses on both sides if there is greater fluctuation.


The lower point will be the strike minus the value of two premiums received and the upper point will be the strike plus the two premiums received. There is, of course, unlimited downside risk if the market rises or falls outside the band.

Neutral – sell strangle

Prices here are expected to fluctuate in a broader range (see Figure 10.15). A put option is sold with a strike price at the money and a call option is sold with the higher strike price. The breakeven will be the lower strike minus
the two premiums received and the upper point will be the higher strike plus the two premiums received. Again, the downside risk is unlimited outside the bands chosen.

**Figure 10.14**

Sell straddle

**Figure 10.15**

Sell strangle
Neutral – long butterfly

Here investors are moderately certain that prices will not fluctuate much outside the current band (see Figures 10.16 and 10.17). Investors think that the market will not be volatile during the term, but wants to cap the downside risk. A call option with low strike is bought, two call options with medium strike are sold, and a call option with high strike is bought. The upside potential is limited to the difference between the lower and middle strikes minus the net debit of establishing the spread. The downside risk is limited to the initial net debit of establishing the spread.

**Neutral – long butterfly**

![Figure 10.16](image1)

![Neutral – long butterfly chart](image2)

**Neutral – long butterfly chart**

![Figure 10.17](image3)
Volatile – buy straddle

Investors expect prices to be very volatile and want to be protected against extreme movements (see Figure 10.18). The position will lose if prices do not fluctuate outside the narrow range. A call option and put option are bought with the same strike price, usually at-the-money. There is upside potential at expiry away from the strike prices and the lower point is the strike minus the two premiums paid while the upper position is the strike plus the two premiums. The downside is limited to the total of the two premiums paid.

Volatile – buy strangle

Prices are expected to be volatile and the investor therefore purchases a put option with low strike price (103 as shown in Figure 10.19) and a call option is bought with at a higher strike price (105 as shown in Figure 10.19). The upside potential is unlimited if the market falls or rises greatly. The downside is limited to the two premiums paid.
Volatile – short butterfly

Investors here expect prices to be moderately volatile (see Figures 10.20 and 10.21). A call option is sold with a low strike price, two call options are bought with a medium strike price, and a call option is sold with a higher strike price. The upside is limited to initial credit received while the downside is limited to the difference between the lower and middle strikes minus the initial spread credit.

Volatile – short butterfly inputs

<table>
<thead>
<tr>
<th>Number</th>
<th>Strike</th>
<th>Call</th>
<th>Put</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>109.00</td>
<td>3.50</td>
<td>0.69</td>
</tr>
<tr>
<td>0</td>
<td>109.00</td>
<td>2.80</td>
<td>0.95</td>
</tr>
<tr>
<td>0</td>
<td>109.00</td>
<td>2.10</td>
<td>1.20</td>
</tr>
<tr>
<td>0</td>
<td>109.00</td>
<td>1.50</td>
<td>1.50</td>
</tr>
<tr>
<td>0</td>
<td>109.00</td>
<td>1.20</td>
<td>2.20</td>
</tr>
<tr>
<td>0</td>
<td>109.00</td>
<td>0.95</td>
<td>2.55</td>
</tr>
<tr>
<td>0</td>
<td>109.00</td>
<td>0.70</td>
<td>2.65</td>
</tr>
</tbody>
</table>

Figure 10.19: Volatile – buy strangle

Figure 10.20: Volatile – short butterfly inputs
The Black–Scholes schedule uses the standard option pricing model which was outlined in the paper written by F. Black and M. Scholes in 1973, ‘The pricing of options and corporate liabilities’ in the *Journal of Political Economy* (May/June, pp.637–54). This paper was a breakthrough since the model appeared to price risk correctly and used a limited number of observable quantities such as:

- maturity date ($T$)
- domestic interest rate ($Int$)
- volatility of the share price as measured by standard deviation ($S$)
- current stock price ($P$)
- exercise price ($X$).

The main assumptions for the model are:

- Relative price rises in the future are independent of changes in the current price.
- Interest rates and volatility remain constant during the period and assume that future volatility equals past volatility in prices. This may not be true since volatility reduces as you near the maturity date.
The probability distribution of relative price changes is lognormal, which means that there is a smaller probability of significant deviations from the mean.

There are no transaction costs to distort the pricing patterns.

The workings for a call and put options are located at the bottom of the Black–Scholes schedule (see Figure 10.22). To make the workings more understandable, the cells have been named as in cells C115 to C120 and this shows how the formula is built up.

**Black–Scholes workings**

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
</tr>
</thead>
<tbody>
<tr>
<td>115</td>
<td>Days in current year</td>
<td>365.0</td>
<td>1.459 yrs</td>
<td>r (t)</td>
<td>0.05%</td>
<td>Stock rate of interest</td>
<td>Stock rate of interest</td>
<td>Stock rate of interest</td>
</tr>
<tr>
<td>116</td>
<td>1.459 yrs</td>
<td>12.00%</td>
<td>Stock volatility</td>
<td></td>
<td></td>
<td>Current stock (share)</td>
<td>Current stock (share)</td>
<td>Current stock (share)</td>
</tr>
<tr>
<td>117</td>
<td>220.0000</td>
<td>225.0000</td>
<td>Exercise price</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>118</td>
<td>(1) Call Option</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>119</td>
<td>d1</td>
<td>0.2472</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>120</td>
<td>d2</td>
<td>0.1832</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>121</td>
<td>N(d1)</td>
<td>0.5979</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>122</td>
<td>N(d2)</td>
<td>0.5346</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>123</td>
<td>Call price</td>
<td>0.4251</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>124</td>
<td>(2) Put Option</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>125</td>
<td>-d1</td>
<td>0.2473</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>126</td>
<td>-d2</td>
<td>0.1832</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>127</td>
<td>N(-d1)</td>
<td>0.4021</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>128</td>
<td>N(-d2)</td>
<td>0.4352</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>129</td>
<td>Put price</td>
<td>0.5264</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>130</td>
<td>(3) Check Put-call Parity Formula</td>
<td></td>
<td>S + P = C + Present Value of Exercise Price</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>131</td>
<td>Formula</td>
<td>S + P = C + Present Value of Exercise Price</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>132</td>
<td>P - P</td>
<td>225.5264</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>133</td>
<td>Col Price</td>
<td>9.4257</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>134</td>
<td>PV at X</td>
<td>219.2290</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>135</td>
<td>C + PV</td>
<td>225.5242</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>136</td>
<td>Variance</td>
<td>0.3275</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>137</td>
<td>Error in Parity</td>
<td>0.33</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The inputs for the example are as shown in Figure 10.23, saved as a scenario called Example 1. The workings for the pricing are at the base of the schedule and summarized on the right.

The results from the workings are repeated as a management summary at the top and there are two Sensitivity tables, one each for calls and puts (see Figure 10.24). The two axes are the exercise price across and the volatility down, and the answers are highlighted by conditional formatting. An update table macro is linked to the button at the top and this code copies down the share price and volatility to the inputs on each table.
Mastering Risk Modelling

Figure 10.23  
Black–Scholes inputs

| Start Date | 1 Jun 10 |
| Maturity Date | 4 Dec 10 |
| Days | 182 days |
| Maturity | T |
| Interest Rate | 5.00% |
| Volatility | 12.00% |
| Current Stock Price | 220.00 |
| Exercise Price | x |

Results:

| Units 30 |
| Price |
| Call Price | 2.4251 |
| Put Price | 5.8292 |
| Delta | 0.690 |
| Gamma | 0.021 |
| Theta | 0.109 |
| Vega | 56.109 |

Sensitivity to Call Price:

Exercise Price Across Slope
| 2.60% |

Sensitivity to Put Price:

Exercise Price Across Slope
| 2.60% |

Figure 10.24  
Black–Scholes chart
The chart at the bottom gives a representation of the two options in the centre of the tables. The selection is linked to a pull-down control and an OFFSET function to find the data. This is an XY scatter chart with lines, and the put and call options are plotted as individual series.

There are two important advantages with using the Black–Scholes formula to value the option and this information can be useful in formulating hedging strategies.

- There is no requirement to forecast the price on expiry.
- You can deduct mathematically the price sensitivities since as a call increases:
  - the exercise price decreases;
  - the time to expiry increases;
  - the stock price increases;
  - the interest rate increases;
  - the volatility increases.

These sensitivities are sometimes known as the ‘Greeks’, and these formulas are modelled in the workings together with notes on their derivation (see Figures 10.25 and 10.26).

The definitions of the factors are:

- delta measures how much the option’s price will change when there is a change in the price of the underlying asset;
- gamma measures the rate at which the delta changes – a high gamma value means that a moderate change in the underlying price results in a larger change in delta;
theta measures the change in value over time;

vega is the change in the option value which results from increased volatility and this is always a positive value. Increases in volatility increase the value of options since it is the risk or volatility that contributes to the price.

In order to show the sensitivity, there is a table of each of the values plotted against volatility (see Figure 10.27).

The chart includes a combo box for selecting multiple lines from the Sensitivity table (see Figure 10.28).
This is an alternative to the Black–Scholes, which although time-consuming will produce a similar result. The Simulation sheet is set to run 1,000 scenarios using an input volatility value and standard deviation. The rest of the data is looked up from the Black–Scholes sheet. The volatility is randomized within the standard deviation limits, entered on the Black–Scholes sheet and recalculated. The model recalculates 1000 times and notes the volatility, call and put results for each scenario. These are then pasted as a table on the right (see Figure 10.29). The application then updates the scatter chart and a histogram together with the workings for the call and put. Finally, the results are compared against the Black–Scholes formula pricing in the summary table and the variances noted.

The results are reasonably close between the two methods. If you were to run the model for 2000 or 3000 attempts, then the margin of error between the two methods would reduce further.

The variance between the two is 0.075. The difference will vary each time you rerun the simulation. The results from the table on the right of Figure 10.29 are plotted on the scatter chart, and there are two parallel series for the call and one for the put (see Figure 10.30).
The call results show the number and percentage in each of the frequency bins. The simulation macro updates the mid-point and you can vary the interval manually. The call price is the arithmetic mean in the table on the right of Figure 10.31. The other statistics of median, skew and kurtosis are also calculated using the MEDIAN, SKEW and KURTOSIS functions.

The histogram shown in Figure 10.32 provides an illustration of the range of values with the majority of values clustered around the mean. The quartiles chart demonstrates the high and low values and the borders between each 25 per cent band.

Call simulation histogram
There is also a box plot as an alternative form of chart to display a box for each series consisting of a minimum, first quartile, media, third quartile and maximum (see Figure 10.33). This can be helpful in displaying the shape and characteristics of a distribution.

The method is as follows:

- Set up the data exactly in the order in Figure 10.33.
- Highlight the whole table, including figures and series labels.
- Click on Insert, Charts, Line Chart (Excel 2003 – Chart Wizard).
- Select a Line Chart.
- At Step 2 plot by Rows (the default is Columns), then press Finish.
- Select each of the data series in turn.
- Use Format Data Series to remove each of the connecting lines.
- Select any of the data series and go to Format Data Series.
- Select the Options tab and switch on the checkboxes for High–Low lines and Up–Down bars.
The binomial model is an alternative to the Black–Scholes model for options pricing and is based on the fact that asset prices can move up or down at the end of a time period (see Figures 10.34 and 10.35). This is the view that prices follow binomial paths and there is a probability of moving in one direction or another. The model checks the calculations against the Black–Scholes model.

The formulas for the call and put options are:

\[
\text{Call} = \begin{cases} 
\text{IF} & (B98 \leq E12, \text{COMBIN}(E12, B98) \cdot C19^B98 \cdot C20^{(E12-B98)} \cdot \text{MAX}(E7 \cdot C15^B98 \cdot C16^{(E12-B98)} - E10, 0), 0) \\
\text{Call Previous Result} + \text{COMBIN}(N, \text{Period}) \cdot Q_{\text{up}}^\text{Period} \cdot Q_{\text{down}}^{(N - \text{Period})} \cdot \text{Max}(\text{Strike} \cdot Q_{\text{up}}^\text{Period} \cdot Q_{\text{down}}^{(N - \text{Period})} - \text{Exercise}, 0) 
\end{cases}
\]

\[
\text{Put} = \begin{cases} 
\text{IF} & (B98 \leq E12, \text{COMBIN}(E12, B98) \cdot C19^B98 \cdot C20^{(E12-B98)} \cdot \text{MAX}(E10 - C15^B98 \cdot C16^{(E12-B98)} \cdot E7, 0), 0) \\
\text{Put} = \text{Previous Result} + \text{COMBIN}(N, \text{Period}) \cdot Q_{\text{up}}^\text{Period} \cdot Q_{\text{down}}^{(N - \text{Period})} \cdot \text{Max}(\text{Exercise} - \text{Up}^\text{Period} \cdot \text{Down}^{(N - \text{Period})} \cdot \text{Strike}, 0) 
\end{cases}
\]

The function \text{COMBIN} is used to return the number of combinations for a given number of items. Here the function determines the total possible number of groups from the period number and the total number of periods. The \text{COMBIN} formulas are as follows:

\[
\frac{n!}{k!(n-k)!} = \frac{P_{k,n}}{k!} = \frac{n!}{k!(n-k)!}
\]

where:

\[
P_{k,n} = \frac{n!}{(n-k)!}
\]
The schedule sets out the cumulative results for the number of steps in the binomial lattice. The maximum number of steps is 25 and, using IF statements, the model will accept a lesser number (see Figure 10.36).

The Black–Scholes results are calculated on the schedule shown in Figure 10.37. The formulas used are the same as before.
Figure 10.38 shows how the binomial option moves closer to the Black–Scholes result. With fewer steps the binomial model will converge more quickly on the Black–Scholes result.

Figure 10.39 plots the differences between the options and the Black–Scholes model, and in this example the difference reduces to 0.01 by the last period.
Options products seek to manage the risk of price change in underlying assets and this chapter has presented some examples of options pay-offs, trading strategies and pricing using the Black–Scholes and binomial models. The trading strategies and pricing are based on the variables of the underlying and expiry prices, a risk-free rate, the length time and the volatility in the price of the underlying asset.
Real options

Introduction
Project
Option to delay
Option to abandon
Option to expand
Summary
INTRODUCTION

This chapter reviews further methods of adding risk to project appraisal and by extension to company valuation. The traditional view of investment analysis is that payback and accounting return are deficient when compared to time value of money methods such as net present value (NPV). You produce a set of pre- and post-tax free cash flows for a project and then discount them to a present value at a rate which reflects the cost of capital and any implied project risk. If a project yields a positive NPV then you may decide to proceed; otherwise the project fails on value grounds. A positive result adds value to the company whereas a negative result destroys value. This approach may assist with cash-saving projects but may be inflexible when applied to technology or other industries where operational flexibility is required. The traditional NPV method is thought to be deficient since the cash flows appear fixed from inception without any possibility of variance. In reality, management has the ability to terminate a failing project by incurring extra costs or salvaging work to date. Alternatively, the market prospects may rise allowing the choice of continuation or expansion to capitalize on new market opportunities. As a third alternative, a delay could be useful to gather more information or wait for competitive response.

When a company undertakes a capital project, it possesses a series of options to grow or contract. The flexibility has a value and the model in this chapter uses options theory to calculate a variance and a value for the option. Uncertainty and volatility are generally accepted to have increased in the past decade and this methodology enhances the NPV rule by incorporating the risk and uncertainty. A company with an opportunity to invest holds a financial call option since it has the right, but not the obligation, to make the investment in return for an uncertain stream of cash flows. The ‘now or never’ NPV rule is therefore replaced by a series of options which may or may not be exercised. By committing to an investment a company effectively destroys the option and dispenses with the possibility of waiting. The lost option value represents an opportunity cost which should be included as part of the investment. Instead of an NPV greater than or equal to zero, the present value of the expected cash flows should exceed the initial cost of the investment by an amount equal to the value of retaining the open option. (See Figure 11.1.)

The opportunity cost is highly sensitive to change in economic conditions and options theory uses a Black–Scholes model for pricing in volatility or uncertainty. Risk is present in the receipt of future cash flows and changes could have an impact on the decision to invest. A delay could allow more information or market knowledge to become available. Only when the option has been exercised does it become irreversible. If the option value
increases, so does the benefit of investing, while a decline means that the project can be abandoned with the cost capped at the value of the preliminary or sunk work. This chapter introduces a project model and then calculates the value of options to undertake alternative actions comprising delay, abandonment and expansion.

**Figure 11.1**

*Call option pay-off diagram*

**Figure 11.2**

*Project inputs*

**PROJECT**

The basic model uses a non-tax project based on the inputs shown in Figure 11.2. The project lasts 10 years and there are sales and costs per unit of
output with annual price and cost variances. The volume is set at 50,000 per annum for 10 years in the Case 1 scenario.

Financial statements

The schedule builds up a manufacturing account, income statement, balance and cash flow, and calculates an NPV at the input cost of capital of 12 per cent. The cash flow is dependent on the volume and sale price per unit against the declining cost price. The model displays the present value and addresses other management tests in a summary box at the top of the schedule (see Figure 11.3). Following the Systematic Design Method, you can see changes in the answers immediately you amend the inputs.

The management tests show that this project passes all the tests (see Figure 11.4). The workings at the side use MATCH and IF statements to work out if the periodic cash flows or profits are below the input minimums. The first statement checks if the value is below the minimum; the second row puts in a ‘1’ if it is below the required level; and the third uses a MATCH function to look for ‘1’ along the line so it can report the period number in which the rule failed.
There are two further scenarios in the model and these provide changed inputs and results. One is more pessimistic and the other more optimistic. A further sheet called Scenarios contains the scenarios report with probabilities as an expected net present value (ENPV) – see Figure 11.5. The user assigns a probability to each of the scenarios and then the model multiples out the answer. Thus, 50,831.72 is 254,158 * 0.20.
The data table suppresses impossible values by ensuring that all values add up to one. Case 3 is not used and the sensitivity uses Case 1 as the x-axis and Case 2 as the y-axis. The formula at the top-left of the data table is:

\[ \text{=IF(AND(D7>=0,D6>=0,D6+D7+D8=1),E10,0)} \]

The formulas ensure that all the inputs add up to one and that the X and Y inputs are positive or equal to zero. The answer is in the middle of the table using 0.20 of Case 1, 0.40 of Case 2 and 0.40 of Case 3. The three scenarios are the best estimates of the future, and further risk techniques such as data tables, standard deviation and simulation could be applied. However, the emphasis here is on extending the model to find a value for possibilities other than committing the 2,000,000 in its entirety on inception.

**OPTION TO DELAY**

The first section introduced flexibility into the investment process by introducing the possibility of delay, expansion or abandonment. The sheet called ‘Delay’ uses a Black–Scholes model with inputs from the Project sheet. The extra inputs are the risk-free rate and the volatility. The latter could be gained from a Monte Carlo simulation or previous projects, but for simplicity these are inputs to this model (see Figure 11.6).

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
</tr>
</thead>
<tbody>
<tr>
<td>4</td>
<td>Years</td>
<td>Risk Free Interest Rate</td>
<td>Volatility</td>
</tr>
<tr>
<td>5</td>
<td>13.0 yrs</td>
<td>T</td>
<td>Int</td>
</tr>
<tr>
<td>6</td>
<td>5.00%</td>
<td>29.00%</td>
<td>2,264,158.58</td>
</tr>
<tr>
<td>7</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The number of years, present value (PV) of future cash flows and the initial investment are looked up from Case 1 on the Project sheet. The inputs are:

- years – life of the project;
- risk-free rate – rate such as a 10-year government bond currently at around 5 per cent;
- volatility – forecast future variance in cash flows;
- present value of future cash flows before subtracting initial investment;
- initial investment as the cost of the project on inception.
Mastering Financial Modelling

This project achieves a positive NPV but there may still be advantages in delaying the investment. The rule in the first section was that the NPV should be greater than the option value of the delay. A delay could allow more market research, better use of technology or gaining more information on competitive response.

The workings at the bottom of the schedule (see Figure 11.7) calculate the terms d1 and d2 and use the function NORMSDIST to return the standard normal cumulative distribution function. This distribution has a mean of 0 (zero) and a standard deviation of one, as shown in Figure 11.8 generated by the function.
The value of the option is 103,918 and this can be compared against the NPV – the variance is positive. There is also a data table showing the sensitivity to the present value of cash flows and the volatility displaying the change in the option price (see Figure 11.9). A dynamic chart also provides the possibility of reviewing individual lines in the table.

**Sensitivity to cash flows and volatility**

![Figure 11.9](image)

The table uses two types of conditional formatting to form an XY cross at the answer together with particular formatting for the answer (see Figure 11.10). $D8$ is the input for the present value of the cash flows and $D7$ is the input for volatility used by the data table.

**Conditional formatting**

![Figure 11.10](image)

It is also interesting to know how the value of the option changes over time and to understand at what point in the 10-year cycle the option ceases to have value. The present value calculation on the Project sheet uses a lookup for period zero against a table of NPVs for year zero, one, two, etc. This means that a data table can be constructed using the offset value as the input. Line
124 contains the delay option which rises in value and then declines towards the expiry date (see Figure 11.11). Calculating a price in this manner assumes that the behaviour of the cash flows does not change over time. This may be ultimately unrealistic but it at least creates a benchmark.

**OPTION TO ABANDON**

Investment means that an option has been exercised but there are still possibilities to abandon or expand. If the value of the project is greater than abandonment then you continue; otherwise you consider exercising the option. This takes the form of a put option (see Figure 11.12).

The Abandon sheet calculated the value of this option in the first year. The inputs here change since the liquidation or salvage value is needed as opposed to an initial investment (see Figure 11.13).

The number of years and the present value are brought forward from the Project sheet. The extra inputs are the number of years remaining and the percentage salvage value of the original investment. The calculation therefore provides a value immediately after inception and assumes a constant salvage value of 50 per cent. See Figures 11.14 and 11.15.

There are workings to calculate the option value against falling salvage values in future years. The PV in cell D8 depends on the number of years remaining and uses this offset to look along the row of present values on the Project sheet. This is illustrated in Figure 11.11.

=OFFSET(Project!C122,0,10-Abandon!D10)
11 · Real options

**Figure 11.12**

Put option

**Figure 11.13**

Abandon sheet inputs

**Figure 11.14**

Abandonment sensitivity
The workings table at the bottom of the schedule uses a salvage value from input percentages and the number of years remaining to generate a grid of values (see Figure 11.16). The values in bold are possible values and other values should be ignored. The value $87,239$ represents 10 years outstanding and the initial salvage value.

The net result is a table of present values remaining in each year and the put option associated with it (see Figure 11.17). The salvage values can be adjusted and this will work through the tables and update the option values. The value declines as the present value and salvage values decrease in the latter stages of the project.
OPTION TO EXPAND

Expansion is the last of the possibilities since management may have the flexibility to increase the investment and thereby improve the overall NPV (see Figure 11.18). This is dependent on an initial investment in the project and therefore there is a cut-off at the expiry of the project life. Also, it depends on the competitive position and the ability to retain control over future cash flows. The pay-off diagram is similar to the option to delay with characteristics of a call option.

The inputs are:

- years – this is looked up from the Project sheet;
- interest rate – the risk-free rate;
- volatility – volatility of future cash flows which could be different to the other options;
- expansion potential – this is expressed as a percentage of the present value of cash flows;
- investment required – this is a percentage of the initial investment, here 2,000,000;
- cost of delay – this is the cost of waiting until the new investment starts to provide positive benefits.

The Sensitivity table (see Figure 11.19) shows the variance of the percentage expansion against the volatility using the inputs of cells D8 (expansion) and D7 (volatility). As the expansion percentage rises, with the investment remaining static, the value of the option increases. With greater volatility, the value also rises.
Figure 11.20 shows the single series of 20 per cent volatility rising from 5 to 35 per cent expansion in the initial present value.
The workings at the base of the schedule repeat the methodology of the abandonment schedule (see Figure 11.21). The \( x \)-axis of the table represents the number of years outstanding and the \( y \)-axis the expansion amounts assigned to each of the years. Again, the possible combinations are represented in bold type.

**Expansion table**

<p>| | | | | | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td>23.4%</td>
<td>452,632</td>
<td>187,307</td>
<td>184,445</td>
<td>171,617</td>
<td>170,722</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td>19.6%</td>
<td>469,249</td>
<td>131,737</td>
<td>132,384</td>
<td>143,293</td>
<td>140,360</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>14.8%</td>
<td>360,685</td>
<td>186,900</td>
<td>111,044</td>
<td>116,321</td>
<td>110,747</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td>10.8%</td>
<td>315,505</td>
<td>83,015</td>
<td>82,767</td>
<td>88,635</td>
<td>91,321</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>8.8%</td>
<td>230,498</td>
<td>56,030</td>
<td>62,087</td>
<td>63,481</td>
<td>64,759</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td></td>
<td>225,816</td>
<td>40,277</td>
<td>40,791</td>
<td>40,965</td>
<td>41,094</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>8.8%</td>
<td>185,283</td>
<td>23,030</td>
<td>22,736</td>
<td>22,253</td>
<td>21,563</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>152,500</td>
<td>10,045</td>
<td>9,535</td>
<td>9,639</td>
<td>9,520</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>4.8%</td>
<td>109,106</td>
<td>2,465</td>
<td>2,198</td>
<td>1,792</td>
<td>1,413</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>2.6%</td>
<td>69,000</td>
<td>46</td>
<td>46</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Expansion summary**

<table>
<thead>
<tr>
<th>Year</th>
<th>BPV</th>
<th>Expansion</th>
<th>Value</th>
<th>Option</th>
<th>Variance</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>574,657</td>
<td>16.0%</td>
<td>405,746</td>
<td>137,383</td>
<td>280,364</td>
</tr>
<tr>
<td>2</td>
<td>502,865</td>
<td>10.0%</td>
<td>380,565</td>
<td>115,321</td>
<td>245,343</td>
</tr>
<tr>
<td>3</td>
<td>242,163</td>
<td>14.0%</td>
<td>315,352</td>
<td>91,321</td>
<td>224,360</td>
</tr>
<tr>
<td>4</td>
<td>104,408</td>
<td>12.0%</td>
<td>270,499</td>
<td>65,030</td>
<td>234,362</td>
</tr>
<tr>
<td>5</td>
<td>112,261</td>
<td>15.0%</td>
<td>255,415</td>
<td>40,231</td>
<td>195,164</td>
</tr>
<tr>
<td>6</td>
<td>159,123</td>
<td>8.0%</td>
<td>180,332</td>
<td>17,430</td>
<td>162,503</td>
</tr>
<tr>
<td>7</td>
<td>840,973</td>
<td>6.0%</td>
<td>135,236</td>
<td>3,142</td>
<td>132,190</td>
</tr>
<tr>
<td>8</td>
<td>1,191,144</td>
<td>4.0%</td>
<td>30,166</td>
<td>24</td>
<td>30,141</td>
</tr>
<tr>
<td>9</td>
<td>1,548,657</td>
<td>2.0%</td>
<td>45,000</td>
<td>0.0</td>
<td>45,000</td>
</tr>
</tbody>
</table>

Figure 11.21

Figure 11.22
Figure 11.22 shows the present values for expansion against the option value with a chart of the option. The option loses value during the life of the project as the benefits from expansion decline.

**SUMMARY**

This chapter uses a 10-year project model with three initial scenarios based on the expected Case 1 and two alternative pessimistic and optimistic views. Given that management has operational flexibility, the chapter develops an options model for reviewing other choices such as expansion, delay or abandonment. The basic methodology follows the Black–Scholes model. Delay and expansion possess characteristics similar to call options, while abandonment is similar to a put option. The chapter also provides some Sensitivity tables to show how the values flex with changing present value and volatility. Gaining further information on the value of different options can provide more insight and alleviate some of the deficiencies of the rigid NPV rule. As part of a decision process, the method provides more risk information for management.
Equities

Introduction

Historic data

Returns summary

Simulation

Portfolio

Summary

References

File: MRM2_12
INTRODUCTION

Portfolios of stocks possess varying levels of risk and return, and this chapter models the possible future returns over the next 12 months based on historic data. Different stocks possess different characteristics of risk and return, and portfolio risk can easily be modelled. Excel is used to generate 1000 future scenarios and these are incorporated into the monthly returns over the next year.

Modern portfolio theory is based on the 1952 work of Harry Markowitz, whose doctoral thesis suggested a new method of assessing stock performance. He looked at the performance of a portfolio of assets based on the combination of its components’ risk and return rather than fundamental analysis of stocks. Whilst it was assumed that diversification was better than investing in single stocks, previously there was no underlying theory to back this up. Portfolio theory provides the mathematical basis and shows how you can combine risky assets into portfolios, which then contain less overall risk because of the effect of diversification.

With any stock, you can calculate the expected return at the end of a time period. Since the assets are risky, you cannot be sure about the return on these assets. By using the past to project into the future, investors can determine the likelihood of a certain return. The expected return on a risky asset is based on the probabilities attached to all possible rates of return for the asset. With a 50–50 chance of a favourable outcome, the expected return on a portfolio with one asset returning 30 per cent and the other 10 per cent is its weighted average of 20 per cent. Figure 12.1 shows a normal distribution with the percentage results contained by one, two and three standard deviations.
In many problems involving probabilities, the probabilities of all possible outcomes are assumed to have a bell-shaped normal distribution as in Figure 12.1. The mean is the top of the distribution and the area under the normal curve is the probability of realizing a return between the extreme points on the curve. This probability is equal to one.

The historical annual volatility or the degree of variation from the expected return is measured by the standard deviation. Assuming a normal distribution, we can say with a 68.26 per cent certainty that the actual one-year return will be somewhere between a low of the expected return less one standard deviation and a high of the expected return plus one standard deviation. You can calculate similar results for two and three standard deviations. The actual return of a less volatile stock, say, one with a standard deviation of 10 per cent, will move within a narrower range of possible returns than a stock with a standard deviation of 15 per cent.

Diversification involves a trade-off between risk and return. If you were certain of a stock’s future value, then you would buy only that asset yielding the maximum return under those conditions, and no trade-off would be necessary. The theory makes some assumptions about the way investors behave regarding risk. Although some investors can take more risk than others, investors are assumed to be risk averse rather than risk seeking. Risk averse means that where assets promise the same return, you would choose the assets with the least downside risk. In order for you to accept higher risk, you would want to be compensated with the potential for earning a higher return and vice versa. Table 12.1 and Figure 12.2 show the US experience from 1926 to 1994 where stocks, bonds and bills show different rates of risk defined by standard deviation and average return.

<table>
<thead>
<tr>
<th>Measure</th>
<th>Small companies</th>
<th>Large companies</th>
<th>Government bonds</th>
<th>Treasury bills</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return</td>
<td>12%</td>
<td>10%</td>
<td>5%</td>
<td>4%</td>
</tr>
<tr>
<td>Standard deviation</td>
<td>35%</td>
<td>20%</td>
<td>9%</td>
<td>3%</td>
</tr>
</tbody>
</table>

The general assumptions for the portfolio model are:

- each possible investment has a probability distribution of expected returns over time;
- investors are risk averse and require increased returns for increased risk;
- risk is measured by the variability of expected returns (standard deviation);
- only risk and expected return are used in making investment decisions;
- investors will choose the highest return for a given risk level.
If the correlation between assets is one, then there would be no point in diversifying as all stocks would move in the same direction and would provide no benefit for diversification. However, this is unlikely to be the case across a basket of stocks. By combining assets in different weights, the theory shows that it is possible to produce portfolios with different characteristics of risk and return. Efficient portfolios are efficient if there is no other portfolio (or asset) offering a higher level of return for the same or lower risk. It therefore follows that there is a limit or frontier where a portfolio ceases to be efficient. It is an intensive modelling exercise to find the ‘best’ portfolio, and the model in this chapter uses random number generation and Solver within Excel to find the optimum weights in a five-stock portfolio.

**HISTORIC DATA**

The Data sheet in the model contains returns for five stocks over a five-year period. These are expressed as decimal percentages and show the gain or loss in each month (see Figure 12.3). There are 60 data points in all.

In the previous section, it stated that diversification would not yield benefits with perfectly correlated assets. A correlation matrix (see Figure 12.4) shows the relationship between the stocks using the function CORREL.

```excel
= CORREL($D$9:$D$68, E$9:E$68)
```
The Returns sheet summarizes the data and includes a table for generating future scenarios. The scenario number uses the `RANDBETWEEN` function to generate a number between 1 and 60. This is a uniform distribution since the possibility of any of the outcomes is equal. The random number is used as a row number in the table on the Data sheet to look up a return and then multiplies the result to the cumulative amount in the previous row. The starting point is one so the gains and losses are percentages.

C7 formula: `RANDBETWEEN(Data!$B$9,Data!$B$68)`
D7 formula: `D6*(1!OFFSET(Data!$B$8,$C7,2))`

The formula uses a two-dimensional `OFFSET` formula to start at the top left-hand corner of the table and go down by the number of rows generated by the `RANDBETWEEN` function and across to the column containing Stock 1.
(see Figure 12.5). By pressing F9 and recalculating, further scenarios can be generated based on the historic data. Each month adds a new gain or loss to the previous cumulative amount. This is the uniform distribution where any result is equally likely.

### Scenario table

<table>
<thead>
<tr>
<th>Month</th>
<th>Scenario</th>
<th>Stock 1</th>
<th>Stock 2</th>
<th>Stock 3</th>
<th>Stock 4</th>
<th>Stock 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>5</td>
<td>50</td>
<td>1.03000</td>
<td>1.03000</td>
<td>1.03000</td>
<td>1.03000</td>
<td>1.03000</td>
</tr>
<tr>
<td>6</td>
<td>20</td>
<td>1.07361</td>
<td>1.07361</td>
<td>1.07361</td>
<td>1.07361</td>
<td>1.07361</td>
</tr>
<tr>
<td>7</td>
<td>15</td>
<td>1.05262</td>
<td>1.05262</td>
<td>1.05262</td>
<td>1.05262</td>
<td>1.05262</td>
</tr>
<tr>
<td>8</td>
<td>14</td>
<td>1.10365</td>
<td>1.10365</td>
<td>1.10365</td>
<td>1.10365</td>
<td>1.10365</td>
</tr>
<tr>
<td>9</td>
<td>13</td>
<td>1.10942</td>
<td>1.10942</td>
<td>1.10942</td>
<td>1.10942</td>
<td>1.10942</td>
</tr>
<tr>
<td>10</td>
<td>12</td>
<td>1.16183</td>
<td>1.16183</td>
<td>1.16183</td>
<td>1.16183</td>
<td>1.16183</td>
</tr>
<tr>
<td>11</td>
<td>11</td>
<td>1.17364</td>
<td>1.17364</td>
<td>1.17364</td>
<td>1.17364</td>
<td>1.17364</td>
</tr>
<tr>
<td>12</td>
<td>10</td>
<td>1.21665</td>
<td>1.21665</td>
<td>1.21665</td>
<td>1.21665</td>
<td>1.21665</td>
</tr>
</tbody>
</table>

### Effective interest rates

At the bottom, the inherent interest rates are calculated using the RATE and EFFECT functions. Note that the latter function is only available if you have selected Analysis Toolpack as one of the Excel add-in options in the Home tab (Excel 2003 – Tools, Add-ins). The periodic rate is calculated by the number of periods per annum (12) to form the nominal rate.
The RATE function is equivalent to this calculation: \([1.0793/1.000]^{1/12}\). The EFFECT function provides the effective (annual equivalent) based on the number of compounding periods in the year (see Figure 12.6). The formula to convert nominal to effective rates is \([(1 + \text{Nominal}/C)^C] - 1\), where \(C\) is the number of compounding periods per annum.

You can see the range of outcomes in Figure 12.7, where two of the stocks have virtually doubled over the 12-month period. This of course will change every time you press F9. However, the range of outcomes will be based on the average and standard deviation of the historic returns.

The second part of the schedule summarizes the historic data. This uses a FREQUENCY array function to count the number of results in the bins between −20 per cent and +20 per cent. To further describe the distributions, the minimum, maximum, median, skew, kurtosis, mean standard deviations and range are shown (see Figure 12.8). The distributions offer different characteristics of mean and standard deviation with Stocks 1 and 2 with the highest mean, and Stock 2 with the highest standard deviation. Stock 2 seems to offer a higher return than the other stocks but only with higher risk expressed by standard deviation.

The formulas are:

- Maximum = MAX(Data!D$9:D$68)
- Minimum = MIN(Data!D$9:D$68)
- Median = MEDIAN(Data!D$9:D$68)
- Skew = SKEW(Data!D$9:D$68)
Kurtosis = \text{KURT}(\text{Data!D$9:D$68})

Mean = \text{AVERAGE}(\text{Data!D$9:D$68})

Standard deviation = \text{STDEVP}(\text{Data!D$9:D$68})

Another method of describing the distributions is to draw out the quartiles using the same data. This is a convenient way of calculating the minimum, maximum and median together (see Table 12.2 and Figure 12.9).

The chart of the table also illustrates the spread of results effectively: the range on Stock 2 shows up clearly with the lowest minimum and the highest maximum (see Figure 12.10). By contrast, Stock 4 has the lowest range.

Figure 12.10 is a non-standard chart called a box plot and was created with the data in the specific order in Table 12.3.

The instructions are:

- highlight the whole table, including figures and series labels and then click on Insert, Charts, Line Chart (Excel 2003 – Chart Wizard);
select a Line Chart;
- at Step 2 plot by Rows (the default is Columns), then Finish;
- select each data series in turn and use Format Data Series to remove the connecting lines;
- select any of the data series and Format Data Series; select the Options tab and switch on the checkboxes for High–Low lines and Up–Down bars.

<table>
<thead>
<tr>
<th>Quartile number</th>
<th>Answer</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>Minimum value</td>
</tr>
<tr>
<td>1</td>
<td>First quartile (25th percentile)</td>
</tr>
<tr>
<td>2</td>
<td>Median value (50th percentile)</td>
</tr>
<tr>
<td>3</td>
<td>Third quartile (75th percentile)</td>
</tr>
<tr>
<td>4</td>
<td>Maximum value</td>
</tr>
</tbody>
</table>
A further chart on the schedule allows you to compare two distributions (see Figures 12.11 and 12.12). This allows you to test the shape of Stocks 2 and 4 with the individual frequencies and the variance between them.

**Table 12.3**

<table>
<thead>
<tr>
<th></th>
<th>Stock 1</th>
<th>Stock 2</th>
<th>Stock 3</th>
<th>Stock 4</th>
<th>Stock 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>25th</td>
<td>(0.00388)</td>
<td>(0.04138)</td>
<td>(0.02689)</td>
<td>(0.03500)</td>
<td>(0.03005)</td>
</tr>
<tr>
<td>Minimum</td>
<td>(0.30295)</td>
<td>(0.37391)</td>
<td>(0.31166)</td>
<td>(0.16666)</td>
<td>(0.24590)</td>
</tr>
<tr>
<td>50th (median)</td>
<td>0.02563</td>
<td>0.01096</td>
<td>0.00917</td>
<td>0.00900</td>
<td>0.01397</td>
</tr>
<tr>
<td>Maximum</td>
<td>0.19342</td>
<td>0.49768</td>
<td>0.19287</td>
<td>0.19099</td>
<td>0.15578</td>
</tr>
<tr>
<td>75th</td>
<td>0.05423</td>
<td>0.07371</td>
<td>0.05372</td>
<td>0.05122</td>
<td>0.04630</td>
</tr>
</tbody>
</table>

**Comparison of two stocks**
The Simulation sheet contains 1000 lines of data generated by the Simulation macro. The macro recalculates and, based on the random numbers generated by the `RANDBETWEEN` function, builds up to a value at the end of 12 months. This value is pasted into the stock returns row and the process repeats 1000 times through a `FOR NEXT` loop. This assumes that the possibility of any of the previous months happening again is random. The process is repeated 1000 times so that there is sufficient data to provide a theoretical distribution.

The portfolio return (see Figure 12.13) is composed of the values for that row multiplied by the weightings in row nine on the Portfolio sheet. The `SUMPRODUCT` function is a convenient method for multiplying out the two arrays.

\[
= \text{SUMPRODUCT(Portfolio!$C$9:$G$9,Simulation!C6:G6)} - 1
\]

Where the portfolio return falls below the minimum (in this case 10 per cent), this is recorded using an `IF` function. This is used later to calculate the probability of a loss.

\[
= \text{IF(H6<Portfolio!$C$7,Portfolio!$C$7-H6,0)}
\]

Below is the text of the macro, which recalculates and pastes the data into the sheet. Each time you run the macro a fresh set of data is created in the Simulation sheet:

```excel
=SUMPRODUCT(Portfolio!$C$9:$G$9,Simulation!C6:G6) - 1
```

Where the portfolio return falls below the minimum (in this case 10 per cent), this is recorded using an `IF` function. This is used later to calculate the probability of a loss.

\[
= \text{IF(H6<Portfolio!$C$7,Portfolio!$C$7-H6,0)}
\]
Sub Simulation()
Dim Original_Answer
Original_Answer = Range("Returns!d18:h18")
Range("Simulation_Results") = "" 'Zero previous results

Randomize
Application.Calculation = xlSemiautomatic
Application.ScreenUpdating = False

For r = 1 To 1000 'START OF LOOP
RandomFactor = Rnd
Calculate
Sheets("Returns").Select
Range("d18:h18").Select
Selection.Copy

Sheets("Simulation").Select
Range("C5").Select
ActiveCell.Offset(r, 0).Select

Selection.PasteSpecial Paste: = xlPasteValues, Operation: = xlNone,
SkipBlanks: = False, Transpose: = False

Application.CutCopyMode False
Range("a2").Select

Sheets("Data").Select
Range("A2").Select
Application.ScreenUpdating = True
Range("data!h5") = r
Application.ScreenUpdating = False
Next r 'END OF LOOP

Sheets("Returns").Select
Application.CutCopyMode = False
Range("a2").Select
Application.ScreenUpdating = True
Application.Calculation = xlAutomatic
End Sub
The Portfolio sheet uses the Simulation sheet data to construct optimum portfolios with the Solver add-in. This allows you to maximize, minimize or target a particular cell value by changing multiple cells subject to a number of rules or constraints. On the schedule, there are inputs for the required return, risk-free rate, a minimum return (for working out the possibility of loss) and weighting for each of the five stocks (see Figure 12.14). The sum of the weightings must be equal to one.

The statistics are calculated as follows:

- **Mean**
  \[ \text{Mean} = \text{AVERAGE(Simulation!H6:H1005)} \]

- **Standard deviation**
  \[ \text{Standard deviation} = \text{STDEVP(Simulation!H6:H1005)} \]

- **Possibility of loss**
  \[ \text{Possibility of loss} = \text{PERCENTRANK(Simulation!I6:I1005,0)} \]

- **Downside risk**
  \[ \text{Downside risk} = -\text{AVERAGE(Simulation!I6:I1005)} \]

- **Sharpe ratio**
  \[ \text{Sharpe ratio} = \left( \frac{H13-C6}{H14} \right) \]
The mean is the weighted average return on the portfolio. The standard deviation uses the function for a population with the following formula:

$$\sqrt{\frac{n \cdot \bar{x}^2 - (\bar{x})^2}{n^2}}$$

The possibility of loss uses the function PERCENTRANK to derive the percentage of results below zero and therefore constituting a loss. Similarly, the downside risk is the percentage of observations which fall below the minimum input of 10 per cent.

The Sharpe ratio of the portfolio is a composite measure for evaluating performance. It seeks to measure total risk by including the standard deviation of returns. The measure provides the risk premium earned per unit of total risk. It follows therefore that a high score indicates a more efficient portfolio in terms of risk and reward:

$$\frac{\mu - r}{\sigma}$$

where

- $\mu$ = mean return on the portfolio
- $\rho$ = risk-free rate
- $\sigma$ = standard deviation of the portfolio.

The standard deviation, possibility of loss, downside risk and Sharpe ratio are all portfolio measures that could be used to define a portfolio with certain characteristics. You could minimize the first three or maximize the Sharpe ratio. The model attempts to maximize the Sharpe ratio by changing the weights afforded to each stock with the provisos that the minimum return has to be met and that the weights cannot be less than zero or add up to more than 100 per cent. This is the manual Solver dialog box (see Figure 12.15).
Note that there are sometimes problems with different language versions Solver used in code. The fact that Solver will be required has to be noted as a reference in the Visual Basic Window (see Figure 12.16). If you get an error while running the macro, then check that Excel can find the Solver add-in. Browse and re-click the add-in and the macro should run.

The Solver Parameters box shown in Figure 12.15 produces a single portfolio at a given rate but a chart of several portfolios is required to
understand how it ‘behaves’. The sheet contains a macro to take required returns in order, perform a Solver analysis, paste the weightings and the answers into a table and then go on to the next expected return. The full text of the SolverTable macro is as follows:

```vba
Sub SolverTable()

    Dim Original_Answer, Required_Return
    Application.Calculation = xlSemiautomatic

    SolverOk SetCell:= "$H$19", MaxMinVal:= 1,
    ValueOf:= 0, ByChange:= "$C$11:$G$11"
    SolverSolve userFinish:= True

    Original_Answer = Range("portfolio!c11:g11")
    Required_Return = Range("c5")
    Range("SolverTable") = ""

    For r = 1 To 7
        Range("c11:g11") 0
        Range("B21").Select
        ActiveCell.Offset(r, 0).Select
        Selection.Copy
        Range("c5").Select
        Selection.PasteSpecial Paste:= xlPasteValues,
        Operation:= xlNone, SkipBlanks := False,
        Transpose:= False
        SolverOk SetCell:= "$H$19", MaxMinVal:= 1, ValueOf:= 0,
        ByChange:= "$C$11:$G$11"

        SolverOk SetCell:= "$H$14", MaxMinVal:= 2, ValueOf:= 0",
        ByChange:= "$C$9:$G$9"
        SolverSolve userFinish:= True
        Range("C11:G11").Select
        Selection.Copy
        Range("C21").Select
        ActiveCell.Offset(r, 0).Select
        Selection.PasteSpecial Paste:= xlPasteValues, Operation:= xlNone,
        SkipBlanks := False, Transpose:= False

        Range("H15:H19").Select
        Application.CutCopyMode False
        Selection.Copy
        Range("H21").Select
```

12 · Equities
The result is a table of returns stepping up in predetermined intervals showing the weighting of stock and the results in terms of standard deviation and the Sharpe ratio. As the required return increases, Stocks 4 and 5 are removed since they do not offer a sufficient return (see Figure 12.17).

Standard deviation increases with return whereas the probability of loss and the downside risk reduce and then start to increase. The Sharpe ratio increases until the required return of 27 per cent and then starts to decline (see Figure 12.18).

The chart is an XY scatter chart with standard deviation as the x-axis and the required return as the y-axis. This shows the efficient frontier where it leads to diminishing returns after 27 per cent to demand a greater return (see Figure 12.19). Each extra unit of return costs more in risk. As a check the market line has been calculated using a market rate of 12 per cent and a risk free rate of 5 per cent. Based on a standard deviation of 10 per cent, the Sharpe ratio is 0.70. The market line is drawn on the chart and a forecast linear trend line directed through it. Portfolios at expected returns of 19 per cent and 31 per cent lie below the market line. The optimum portfolio lies between 25 per cent and 27 per cent.
Figure 12.20 shows the composition of each of the portfolios. Stock 1 increases as a percentage of the portfolio until the required return is 29 per cent and is then overtaken by Stock 2 when the higher yield is specified. Stock 5 hardly features since the return is low compared with the other stocks.
A third chart allows you to select one of the measures and check the answer along the line. Figure 12.21 illustrates how the Sharpe ratio starts to decline with the increasing risk inherent in the higher yielding portfolios. This type of chart allows you to test the portfolios graphically, and here it emphasizes the viable portfolios up to about 30 per cent after which each unit of return brings decreased portfolio benefits.

**Summary**

Portfolio theory shows how you can combine risky assets and use diversification to reduce overall portfolio risk. This model uses simulation to generate a data set of possible portfolios and then analyses the findings using Solver to build portfolios with the optimum balance of risk and return at required portfolio rates of return. The model goes one stage further using macros to build up a table of solved portfolios and draws charts of the portfolios. The Portfolio sheet provides a graphical and tabular answer to finding the optimum portfolios for this set of data. Using these tools, portfolios can be constructed with predetermined rates of risk and return.
REFERENCES

Risk adjusted returns

Introduction

Economic capital

Risk-adjusted return on capital (RAROC)

Summary
INTRODUCTION

The measurement of economic capital provides a common framework for quantifying risk arising from varied sources and also allows the calculation of equity that a bank should hold to support the various levels of risk taking. Banks need a certain level of capital to support their liabilities and this framework is contained in the Basel II documentation. ‘Capital’ is defined here as the difference between the value of assets and the value of liabilities. The value of both sides of the equation can change daily and this can impact on the bank’s ability to pay its debts. This means that there is a direct relationship between the amount of capital held, the amount of risk capacity generated and the probability of default.

ECONOMIC CAPITAL

Economic capital is said to represent the emerging best practice for measuring and reporting all kinds of risk across a financial organization. It is called ‘economic’ capital because it measures risk in terms of economic realities rather than potentially misleading regulatory, accounting or book values. The term ‘economic capital’ is also used since part of the measurement process involves analysing and converting a risk distribution to the amount of capital that is required to support the risk, in line with the institution’s target financial strength or credit rating.

While some risk distributions can be calculated with more certainty than others, market risks tend to be more accessible than operating risks. For example, the approach can be applied in principle to almost all bank risks, and to any business line within the institution. Economic capital therefore provides management with a standardized unit, for comparing and discussing potential profit opportunities and related threats and downsides. Economic capital numbers can also be multiplied by an institution’s equity hurdle rate (the minimum acceptable rate of return on equity) to offer a ‘cost of risk’ number that is comparable to other kinds of bank expense.

In the example shown in Figure 13.1, the bank is 95 per cent leveraged and invests in 1000 bonds paying 6 per cent and repayable in one period’s time. The model calculates the in and outflows. The assets in one year’s time should be 1000 plus 6 per cent, from which the debt and equity holders can be paid. Paying the debt holders for the 950 debt leaves 62.5 which equates to a 25 per cent return. If the default rate rise above zero, then the return to shareholders falls since the debt needs to be paid out of a declining income. At 2 per cent default, the return is already –17 per cent.
The model uses a table to generate the potential losses with increasing default percentages. The interest and capital repayment do not decrease; however, there is less income to repay the debt.

Figure 13.2 explains the cell formulas.
Reducing the leverage (see Figure 13.3) reduces the initial return to 10 per cent but the overall losses are also reduced as the default percentage increases. At 4 per cent, the negative return is 11 per cent against 59 per cent, demonstrating the trade-off between risk and return.

The next stage could be to generate a number of scenarios (see Figure 13.4) based on the probability of default and show how the future value of the portfolio could vary. The outcome is a continuous variable as there are an infinite number of outcomes. The representation is a probability density function, where the $x$-axis is the value of the assets and the $y$-axis is the probability. With increased capital, the probability of bank default is reduced because of the increased capital base. Economic capital represents this trade-off between initial capital, risks taken and the probability of the bank being forced to default. Economic capital is therefore a framework for translating risks into a single measure.
The table in Figure 13.4 is based on the RAND function to generate the probability and the NORMINV function to compute the overall default rate. The table returns the return on equity and the total capital after deduction of default. The frequency table and chart (see Figure 13.5) show the spread of results based on a 2 per cent default rate.

Economic capital is the net value that a financial institution must have at the beginning of a trading period to ensure that there is only a small probability of defaulting during the period and producing a loss. The net value is the assets less the liabilities. The small probability is based on the credit rating of the institution, for example an A rating normally equates to about 0.1 per cent over the coming year. Economic capital in this sense represents the buffer against default in that the shareholders and directors must ensure sufficient capital such that the bank can maintain the business profile and target credit rating.
RISK ADJUSTED RETURN ON CAPITAL (RAROC)

Banks are not only interested in the risk but also the profitability associated with the risk. Risk adjusted performance can be used to assist with business and credit decisions:

- deciding which products are profitable and how they should be priced to be profitable;
- deciding which client relationships yield the highest return;
- deciding whether or not to enter into a transaction and at what price;
- reviewing business units in their use and return on capital in return for the risks undertaken.

Table 13.1 shows the action that management could take to improve profitability or choose between operating units. If a bank loses heavily on its loan portfolio, it has to maintain minimum percentages of equity capital and therefore has to attract new capital or reduce its borrowings.

<table>
<thead>
<tr>
<th>Overcapitalized</th>
<th>Undercapitalized</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduce capital base</td>
<td>Increase capital base</td>
</tr>
<tr>
<td>Buy back shares</td>
<td>Issue shares (ordinary and preference)</td>
</tr>
<tr>
<td>Increase dividends</td>
<td>Reduce dividends to shareholders</td>
</tr>
<tr>
<td>Increase risks taken</td>
<td>Reduce risks taken</td>
</tr>
<tr>
<td>Grow existing units with RAROCs</td>
<td>Cut back on activities with low or negative RAROCs</td>
</tr>
<tr>
<td>Buy or build further business activities</td>
<td>Transfer out concentrated risks to others</td>
</tr>
</tbody>
</table>
Common ratios such as return on assets (net operating profit/total assets) or return on equity (earnings after tax/shareholders' funds) do not provide an adequate metric for return since risk is not encapsulated in the measure. The earlier model can be extended to include a further measure called the risk adjusted return on capital (RAROC).

This is calculated as the net risk adjusted profit divided by the economic capital based on market values:

$$RAROC = \frac{ENP}{EC}$$

RAROC treats all transactions as additions to a portfolio, and the price is the amount of capital that must be set aside to make the transaction happen. The return equates to the net increase in value. A more complete formula is:

$$RAROC = \frac{(Initial\ Loan \cdot Interest) + Fees - (Debt \cdot Interest) - Operating\ Cost - Losses}{EC}$$

$$RAROC = \frac{(Loan \cdot Interest) + Fees - (Loan - EC) \cdot Interest - Operating\ Cost - Losses}{EC}$$

For a trading position, the RAROC is the net change in the value of the position minus operating costs. The required profitability that must be reached is the hurdle rate multiplied by the economic capital. The equation is:

$$RAROC = \frac{\Delta Value - Operating\ Cost}{Economic\ Capital}$$

Shareholder value added gives an alternative measure of profitability as the amount of value added. This is the amount as per the economic capital equation minus a hurdle return multiplied by economic capital.

$$SVA = (Loan \cdot Interest) + Fees - (Loan - EC) \cdot Interest - Operating\ Cost - Losses - Hurdle - EC$$

In this example, the inputs are as shown in Figure 13.6.

The loan is 100 sold to the client at a rate of 7 per cent against an inter-bank rate of 5.5 per cent. The average default correlation with the rest of the portfolio is 3 per cent and the capital multiplier is 6. The calculation for economic capital is:
Expected loss = loan * loss in event of default
* probability = 0.06

Unexpected loss = loan * loss in event of default
* probability – probability ^ 2 = 1.34

Unexpected loss contribution (ULC) = default correlation
* unexpected loss = 0.232

Economic capital = multiplier * ULC = 6 * 0.232 = 1.393

The RAROC calculation of 37.09 per cent is:

\[(\text{Loan} \times \text{customer interest rate} – (\text{loan} – EC) \times \text{interbank rate} – \text{operating costs} – \text{expected loss})/EC\]

The shareholder value added of 0.168 is:

\[(\text{Loan} \times \text{customer interest rate} – (\text{loan} – EC) \times \text{interbank rate} – \text{operating costs} – \text{expected loss}) – (\text{hurdle rate} \times EC)\]

Figure 13.7 shows the sensitivity to the customer interest rate and the probability of default. The customer interest rate is plotted across and the probability down. As the customer rate and default correlation fall, the RAROC declines. The chart displays the middle 0.020 series computed above.

Over multiple periods, the RAROC is the expected net profit divided by the economic capital or the internal rate of return of the cash flows. This is more complex since:

- over longer periods, the probability of default increases and therefore increases the required economic capital and debt needed to support loans;
- if the default of debt increases, the likelihood of paying all the administration costs therefore declines;
- the outstanding loan can vary accordingly to the amortization profile;
- the security or collateral can change in value thereby increasing or decreasing the potential exposure.
The bank loans the funds at the beginning of the period and to fund this invests some economic capital and raises debt. The net cash flow is equal to the economic capital which has been paid to the customer. During the loan period, the client pays back interest and principal and the bank needs to pay operating costs. The expected receipt is dependent on the probability of default:

\[
\text{Cashflow}_{\text{In}} = \text{Loan} \times (1 + \text{Interest}) \times (1 - \text{Default\_Probability}) + \text{Recovery} \times \text{Default\_Probability}
\]

\[
\text{Cashflow}_{\text{Out}} = \text{Debt} \times (1 + \text{Interest}) + \text{Operating\_Cost}
\]

Using these formulas, it is possible to construct cash flows for longer periods and find the internal rate of return or RAROC over longer periods. By understanding the capital at risk and the cash flows, it is possible to understand the return being made for the risk incurred.

The inputs in Figure 13.8 show a two-year loan using the same figures as the previous schedule. The loss in the event of default rises in the second year as does the probability of default. This implies that the RAROC in the second year will be lower because of the rise in these two factors.
The cash flows are as in Figure 13.9. The cash on inception is the loan less the economic capital.

The formulas are:

\[
\text{Cash}_{\text{In}_1} = \text{Loan} \times \text{Interest} \times (1 - \text{Prob}) + \text{Recovery} \\
* \text{Prob} + \text{Loan}_2 \times (1 - \text{Prob})
\]

\[
\text{Cash}_{\text{Out}_1} = \text{Debt} \times (1 + \text{Debt}_\text{Interest}) + \text{Operating Costs}
\]

\[
\text{Cash}_{\text{In}_2} = \text{Loan} \times (1 + \text{Interest}) \times (1 - \text{Prob}) \times (1 - \text{Prob}_2) \\
+ \text{Recovery} \times (1 - \text{Prob}) \times \text{Prob}_2
\]

\[
\text{Cash}_{\text{Out}_2} = \text{Debt}_2 \times (1 - \text{Prob}) \times (1 + \text{Debt}_\text{Interest}) \\
+ \text{Operating Costs} \times (1 - \text{Prob})
\]
The Sensitivity table is shown in Figure 13.10.

The RAROC for two years is below the initial answer of 37 per cent. One solution is to use Goal Seek (see Figure 13.11) to solve the customer rate needed to achieve a RAROC of 37 per cent. In this case this is 7.12 per cent using the macro code. Here the target cell is D35 and the changing cell is E8. Since Goal Seek does not allow you to set the target as a cell reference, you can record it easily as a macro and then change the hard-coded value to a cell reference:

```vba
Application.Calculation = xlCalculationSemiautomatic
Range("d35").Goalseek Goal:=Range("i13"), ChangingCell:=Range("e8")
Range("a2").Select
Application.Calculation = xlCalculationAutomatic
End Sub
```
Risk adjusted return on capital is a measurement that includes volatility to the calculation of returns. It states the return on capital required to offset losses on the underlying asset should volatility cause its value to decline by two or three standard deviations. This chapter has used an example to show the basic calculations and the effect on returns of changing key variables such as the rate or default probability.
Value at risk

Introduction

Single asset model

Two assets

Three asset portfolio

Summary
INTRODUCTION

Value at risk (VaR) was developed in the early 1990s in response to failures and problems in financial institutions. Initially, the purpose of VaR is to quantify financial risks facing institutions by using standard statistical techniques. It measures the worst expected loss over a given horizon under normal market conditions at a given confidence level. On a $100 million facility, it is unlikely that a bank will lose all its capital, and this measure tries to denote the amount that could be lost at a particular confidence interval based on historic experience. Conditions are said to be normal and past volatility is assumed to continue into the future. In addition, quantitative techniques are used so that the models do not capture operational, political, liquidity or personnel risk. However, VaR is now being used to control and manage risk actively rather than just provide information. By making use of VaR tools, institutions obtain more information and can decide how to allocate economic capital and how to evaluate the trade-off of risk and return.

VaR is considered by risk managers and regulators because of the promise it holds for improving risk management. The Basel Accords I and II encourage banks to develop their own risk measurement systems to assist in calculating capital adequacy. Rather than impose a set of rigid regulations, VaR may be seen as a system of self-regulation. The proposals create incentives since the required amount of risk capital can be reduced compared with banks that follow a standard approach. Similarly, the globalization of capital markets emphasizes the links between institutions and their role in the entire system. In 1994, J. P. Morgan made its RiskMetrics system and data sets available on the Internet and this allowed institutions to develop their own systems or use the growing number of proprietary models. This chapter first outlines the basic concepts and then works through a simple VaR model in stages.

Definitions

Two more precise definitions of VaR are as follows:

- a forecast of a given percentile, usually in the lower tail, of the distribution of returns on a portfolio over some period; similar in principle to an estimate of the expected return on a portfolio, which is a forecast of the 50th percentile;
- an estimate of the level of loss on a portfolio which is expected to be equalled or exceeded with a given, small probability.
You need to understand both the return and the risk on a portfolio since a higher spread or risk usually means a higher loss at the given probability. If you are told, for example, that there is a 1 in 100 chance of losing $x$ dollars over the forecast holding period, then following portfolio theory, this is easy to understand and provides an estimate of the capital at risk. Portfolio theory provides the basic equations and these are modelled in the following sections.

### SINGLE ASSET MODEL

This model is on the Single_Asset sheet. In order to measure the VaR for a single asset, the inputs are as shown in Figure 14.1.

The standard deviation is the daily volatility or fluctuation from the mean. If an asset is volatile, there is the opportunity to make large profits or large losses against an index. An institution needs to know both its return and also its risk position. The confidence level is 95 per cent and the VaR amount 1,000,000. The model assumes that returns on an asset are normally distributed and follow a classic bell curve (see Figure 14.2). The advantage is that much is known about the attributes of normal distributions.
With a normal distribution, most of the results are clustered around the mean and the standard deviation. Table 14.1 uses the NORMSDIST function to return the probability for a given standard deviation. Thus 0.5 deviations in either direction from the mean encompass 69 per cent of the observations.

Table 14.2 uses a NORMSINV function to return the number of standard deviations for a given probability. This provides a table of the probability or degree of confidence required against the number of standard deviations. Therefore 99 per cent confidence is equivalent to 2.33 standard deviations from the mean.

<table>
<thead>
<tr>
<th>Standard deviation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.2500</td>
<td>0.5987</td>
</tr>
<tr>
<td>0.5000</td>
<td>0.6915</td>
</tr>
<tr>
<td>1.0000</td>
<td>0.8413</td>
</tr>
<tr>
<td>1.5000</td>
<td>0.9332</td>
</tr>
<tr>
<td>1.6449</td>
<td>0.9500</td>
</tr>
<tr>
<td>2.0000</td>
<td>0.9772</td>
</tr>
<tr>
<td>2.5000</td>
<td>0.9938</td>
</tr>
<tr>
<td>3.0000</td>
<td>0.9987</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Standard deviation</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>0.950</td>
<td>1.6449</td>
</tr>
<tr>
<td>0.955</td>
<td>1.6954</td>
</tr>
<tr>
<td>0.960</td>
<td>1.7507</td>
</tr>
<tr>
<td>0.965</td>
<td>1.8119</td>
</tr>
<tr>
<td>0.970</td>
<td>1.8808</td>
</tr>
<tr>
<td>0.975</td>
<td>1.9600</td>
</tr>
<tr>
<td>0.980</td>
<td>2.0537</td>
</tr>
<tr>
<td>0.985</td>
<td>2.1701</td>
</tr>
<tr>
<td>0.990</td>
<td>2.3263</td>
</tr>
<tr>
<td>0.995</td>
<td>2.5758</td>
</tr>
<tr>
<td>0.999</td>
<td>3.0903</td>
</tr>
</tbody>
</table>
The horizon standard deviation is derived from the formula:

\[ \text{Daily standard deviation} \times \sqrt{\frac{\text{Days}}{\text{Period days}}} \]

\[ 0.05 \times \sqrt{\frac{5}{20}} = 0.05 \]

VaR increases with the time horizon and this is logical since the level of risk usually increases with time. The assumption is that the standard deviation increases with the square root of time, which is based on the random movement of financial asset prices.

The number of standard deviations is derived by the `NORMSINV` function. The unit VaR is the horizon multiplied by the number of standard deviations (see Figure 14.3).

\[ 0.05 \times 1.64485 = 0.08224 \]

\[ \text{Position limit} = \frac{\text{VaR amount}}{\text{Unit VaR}} = \frac{1,000,000}{0.08224} \]

Figure 14.4 shows the VaR percentage, position limit and the variance to the 95 per cent position. The percentage increases at higher confidence levels and therefore the position limit declines.

The chart and combo box allow the VaR percentage, position limit and variance to be plotted (see Figure 14.5). The workings at the bottom transpose the labels from the table to form the text for the combo box. The chart workings use an `OFFSET` based on the cell link for the column offset to look up the data.
The chart demonstrates that the position limit declines from 13 million to 6.5 million based on a VaR amount of 1 million (see Figure 14.6). Similarly, the VaR percentages rise on the second chart with increasing confidence levels (see Figure 14.7).

The sensitivity chart shows the relationship between the number of days and the confidence level where the VaR increases with the number of days and a higher confidence level (see Figure 14.8).
The Two_Assets sheet shows a series of sections leading to a portfolio risk measure. The calculations are:
- mean and standard deviation
- correlation
- VaR.

**Mean and standard deviation**

Figures 14.9 and 14.10 show two portfolios both with a mean of 8 per cent. Portfolio A is close to the means on all observations and therefore the standard deviation is also low. If past volatility holds, then the future returns are likely to be close to the mean. Portfolio B has the same mean, but there is a greater variety in the observations and therefore the standard deviation is
higher. It follows that a risk adverse investor would choose Portfolio A since the return overall is the same as Portfolio B and the volatility is lower. Thus they could be more sure of returning 8 per cent. Since the risk is higher on Portfolio B it follows that the VaR figure would be higher, in this case at 1.5 per cent.

**Two assets**

![Figure 14.9](image)

**Two assets chart**

![Figure 14.10](image)

Figures 14.11 and 14.12 show a mean observation of 5 per cent and then target returns starting below the target and rising above it. Using the standard deviation of 2 per cent, minus two standard deviations means that only 2.28 per cent of future observation will be below 1 per cent. On the other hand, at the mean 50 per cent of observations are likely to be below and 50 per cent above. At the confidence level of 95 per cent, 1.64 standard deviations are needed while 2.32 are required for 99 per cent confidence.
The table uses the formula \((\text{Target return} - \text{Mean return})/\text{Standard deviation}\) to work out the number of standard deviations. The function \text{NORMSDIST}\text{\text{DIST}}\text{\text{DIST}} from the statistical function library is used to compute the probabilities.

**Correlation**

Portfolio theory suggests that risk can be reduced through diversification. Lower risk means a lower VaR figure and encourages holding a variety of assets, taking risk and minimizing the downside through spreading risk. The diversification assists since all assets in a portfolio are unlikely to rise or fall to extreme values. Traders can reduce their own positions through hedging while contributing to the overall risk of the institution, and correlation shows the effect this has on the overall result.
Figure 14.13 shows a number of assets together with returns. The average returns are the same but correlation plots the degree to which they move together. Correlation values and what they signify are as follows:

- 1 = both sets of values move perfectly together in a positive manner;
- 0 = no relationship between the data sets;
- -1 = both sets of values move perfectly in a negative linear manner.

In the example shown in Figure 14.13, Asset 2 moves negatively to Asset 1 which implies that when the former is doing well, the latter will perform badly and vice versa. In terms of value, change would have a neutral effect on a portfolio and VaR would be low. This conclusion ignores other factors such as overall market sentiment since steep falls in certain shares or sectors have a consequent effect on the whole market.

Asset 3 is positively correlated and therefore there will be little positive gain from diversification. Both stocks appear to move together and so a change in price for one will be matched by a similar change in the other stock. Asset 4 shows no strong relationship with correlation around zero. There will be some benefit from diversification but this will not be as great as if the correlation were more strongly negative.
The formula for cell D84 uses the statistical function `CORREL` for correlation:

```
= CORREL(D74:D81, $C$74:$C$81)
```

The formulas for covariance and correlation are:

\[
\text{Covariance} = \left\{ \frac{1}{\text{No of observations}} \right\} \times \sum (A - \text{Mean A}) \times (B - \text{Mean B})
\]

\[
\text{Correlation} = \frac{\text{Covariance}}{(\text{Std Dev A} \times \text{Std Dev B})}
\]

The VaR calculation is the standard deviation multiplied by the number of standard deviations for the confidence level of 95 per cent. Figure 14.14 shows the strong negative correlation on Asset 2 as a declining linear series while the positive correlation for Asset 3 is plotted as rising linear trend.

**Portfolio VaR**

The VaR for the whole portfolio required the standard deviation for the whole portfolio. Figure 14.15 brings forward the data from the last section for the volatility and correlation coefficients. The weightings for Asset 1 are inputs to show portfolios composed of 50 per cent of Asset 1 and a balance of Assets 2, 3 and 4. The first step is to compute the portfolio standard deviation. The formula is:

\[
\text{Variance} = ((W_A)^2 \times (SDev_A)^2) + ((W_B)^2 \times (SDev_B)^2) + 2 \times W_A \times SDev_A \times W_B \times SDev \times \text{Correlation}
\]
where:

\[ W_A \] = weighting A  \\
\[ SDev_A \] = standard deviation A  \\
\[ W_B \] = weighting B  \\
\[ SDev_B \] = standard deviation B  \\
\[ Correlation \] = correlation between the two assets.

**Portfolio VaR**

![Figure 14.15](image1)

**Portfolio mix with Assets 1 and 2**

![Figure 14.16](image2)
The portfolio standard deviation is multiplied by the number of standard deviations required and then by the total amount to derive the portfolio VaR. The undiversified VaR is simply the individual VaR multiplied by their weights, for example in cell D135:

\[
= \text{C125} \times \text{D120}!\text{D125} \times \text{D126}
\]

\[
= [4.03\% \times 50\%] + [13.25\% \times 50\%] = 8.64\%
\]

The first column of Figure 14.15 had the same figure of 4.03 per cent since this assumes only Asset 1. The benefits from diversification appear in the next three columns where Asset 2 with the negative correlation obtains a reduced figure, whereas Asset 3 with positive correlation yields little benefit between the diversified and undiversified figures.

Figure 14.16 demonstrates how the risk increases as the more risky Asset 2 appears in the portfolio. The amounts on the left are the percentages of Asset 1. At a split of 20:80, diversified VaR increases to 9.86 per cent from 4.82 per cent.

### THREE ASSET PORTFOLIO

The formula for standard deviation becomes more complex with more than two assets, and it is easier to use matrix methods to multiply out the correlations using the variance–covariance approach. This uses the function `MMULT` to multiply matrices as an array as shown in Figure 14.17. To calculate the product using the `MMULT` function (see Figure 14.18), enter both arrays and lock them with $ symbols. Copy across and down to form the four squares for the result (see Figure 14.19) and then Control, Shift and Enter at the same time to enter the function. Array functions have to be entered in this manner or they will not work correctly.

The Three Asset sheet starts with an example of three assets together with their weightings and standard deviations. The correlation is shown as a matrix such that A:B is 0.6, A:C is 0.5 and B:C is 0.3 (see Figure 14.20). The number of standard deviations relates to the confidence level of 99 per cent.
The first stage is to multiply the matrices for standard deviation and correlation using \texttt{MMULT} in the cells VC below. The formula is as below with the outer brackets denoting the array function:

\[
\{ =\text{MMULT}($D$21:$F$23,$G$21:$I$23) \}
\]

The first stage is to multiply the matrices for standard deviation and correlation using \texttt{MMULT} in the cells VC below. The formula is as below with the outer brackets denoting the array function:

\[
\{ =\text{MMULT}($D$21:$F$23,$G$21:$I$23) \}
\]
The VC matrix is then multiplied by the standard deviation matrix to form the VCV or Variance–Covariance matrix (see Figure 14.21). The covariance determines the relationship between two data sets.

**Figure 14.21**

<table>
<thead>
<tr>
<th>Portfolio VaR using Matrices</th>
<th>Variance &amp; correlation</th>
<th>S. Deviation (V)</th>
<th>Correlation</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>B</td>
<td>5.00%</td>
<td>1.00</td>
</tr>
<tr>
<td>B</td>
<td>1.00%</td>
<td></td>
<td>0.50</td>
</tr>
<tr>
<td>C</td>
<td>3.00%</td>
<td>0.50</td>
<td>1.00</td>
</tr>
</tbody>
</table>

The third step is to multiply the VCV matrix by the weightings matrix and the answer in this example is 0.1 per cent (see Figure 14.22). Standard deviation is the square root and the VaR the product multiplied by the number of standard deviations, 2.32.

An alternative approach would be to calculate the undiversified VaR and then to include the correlation to calculate the diversified VaR. The undiversified VaR assumes the correlation is equal to one. The first stage is to multiply the matrices for the weightings and the standard deviation as per WV in Figure 14.23. The standard deviation is the sum of the elements and the VaR is the standard deviation multiplied by 2.32. The VaR is simply the amount multiplied by 7.27 per cent.

**Figure 14.22**

**Portfolio VaR**

<table>
<thead>
<tr>
<th>Weighting * VCV</th>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.15%</td>
<td>0.54%</td>
<td>0.07%</td>
</tr>
</tbody>
</table>

**Table: Weightings**

<table>
<thead>
<tr>
<th>Name</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>0.45</td>
</tr>
<tr>
<td>B</td>
<td>0.25</td>
</tr>
<tr>
<td>C</td>
<td>0.50</td>
</tr>
</tbody>
</table>

To derive the diversified VaR, you multiply the WV matrix by the correlation matrix and this results in the UC matrix. You multiply out the UC matrix by the WV matrix using the function `SUMPRODUCT` as each matrix
has only one axis and the square root of this is the standard deviation. The standard deviation is then multiplied by the confidence and the amount to produce the VaR amount. The figure is the same as that produced by the first method. Again, this shows the benefits of diversification since the VaR reduces from 8.49 per cent to 7.27 per cent (see Figure 14.24).

Problems

The normal distribution does not provide all the answers, and basic VaR models cannot capture all the facets of market risk. Some of the problems are as follows.

- Markets do not always behave normally. Empirical data suggests that markets deviate consistently from normal distributions. There are more observations clustered around the mean and there are more extreme
values possible. This is ‘excess kurtosis’ and causes problems with predicting values especially over short time horizons.

- Normal distributions assume randomness and do not take account of the ‘herd’ mentality. When markets are falling, there is often extra pressure to sell and this pushes the market more quickly to extremes.
- Liquidity and operational risks are not included in the calculation.
- Volatility is not constant since the future does not exactly equal the past. Whilst the models suggest that the future will follow average volatility, empirical evidence appears to show periods where volatility changes. This again has an effect on VaR, especially in the area of options pricing where the Black–Scholes formula prices options accordingly to past volatility.

**SUMMARY**

This chapter summarizes the main elements of value at risk (VaR) as a statistical measure of risk exposure. The measure attempts to provide a figure of potential losses over a time period at a given confidence level using as its basis normal distribution curves. The tool has assumed greater importance as banks try to allocate capital more efficiently and regulators seek to understand the individual and collective risk positions built up by institutions. The model builds up positions with one, two and three assets and shows the use of different methods and more advanced array functions in calculating each of the parameters of standard deviation and VaR.
Credit value at risk

Introduction
Portfolio approach
Overview of components
Single asset
Two-bond portfolio
Simulation
Summary

File: MRM2_15_01 and MRM2_15_02
INTRODUCTION

Credit value at risk (VaR) is the application of value at risk methodology to credit portfolios. Institutions traditionally have placed limits on individual clients in an effort to manage overall exposure. Portfolio managers similarly need to know just how much risk is contained in a portfolio of deals. In this context it is assumed:

- risk can be measured and analysed through probabilities and distributions;
- uncertainty consists of random events, which cannot easily be measured.

The advances in VaR methodology have shown that it is possible to produce models to quantify risk based on historic experience and assist managers in identifying potential areas of future risk. While credit modelling does not replace the intuitive judgement of experienced credit managers, a VaR approach may improve the understanding of marginal credit risk. The caveat is always that the future may not equal the past because of extreme or unexpected events. Credit VaR may allow an organization to consolidate credit risk across a company, industry or sector, and provides an amended VaR statement based on probabilities owing to:

- upgrades in value – improvement in the credit status of the underlying credit;
- downgrades in value – deterioration in the credit rating of the underlying credit;
- default – ultimate failure of the underlying credit.

The above takes into account that credit may deteriorate before ultimate failure. Loans generally exhibit signs of delinquency such as slow or missed payment before ultimate default. The aims of the method are:

- defining benchmarks for credit risk measurement as a common point of measurement for comparing different sources and measures of risk;
- promoting credit risk transparency and improved risk management tools for improving understanding and market liquidity;
- encouraging a regulatory capital framework that more closely reflects the economic risk associated with credit instruments;
- complementing other elements of credit risk management decisions, for example ‘soft’ factors.

With more in-depth understanding of a sector and its clients, an institution may be in a better position to predict economic downturns and the subsequent non-performing loans. This concentrates risk and leaves an institution open to cyclical downturns and therefore the ideal situation is to
build up specialist knowledge and then diversify risk using financial instruments. VaR methods identify:

- loans that produce the most risk;
- areas where credit derivatives can reduce the overall risk.

Institutions are now faced with taking more complex lending decisions. For example:

- credit spreads have narrowed in the last decade and banks now retain a greater percentage of their liabilities on their own books without syndication;
- the increase in the number and complexity of financial instruments has created uncertain and market sensitive exposures, which require more ‘management’ than traditional bonds;
- the increase in ‘off balance sheet’ special purpose vehicles;
- the increase in high yield ‘junk’ bonds and emerging markets with globalization is a significant factor;
- the deregulation and proliferation of institutions such as insurance companies offering credit.

Using VaR methodology is therefore a framework for evaluating credit derivatives and other credit transactions on a portfolio basis to provide a monetary value for risk.

**PORTFOLIO APPROACH**

Credit VaR is a framework for evaluating credit derivatives and other credit transactions on a portfolio basis. This is important for two reasons:

- credit risks for each client across a whole portfolio are included;
- correlations of credit quality are taken into account.

The benefits of diversification can be taken into account and quantified. This allows managers to quantify concentrations of risk to individual clients or groups of correlated clients, which can be mitigated through diversification or hedging. Furthermore, portfolios can be viewed along different dimensions such as industry, rating, country, type of instrument, etc.

The measures include both expected losses and VaR. This is uncertainty or volatility of value owing to changes in client quality across an entire portfolio and for marginal transactions, which occurs because of changes in credit events or ‘migrations’.

Market risk and VaR are significantly different to credit risk. Market distributions are usually reasonably symmetrical and exhibit bell-shaped or
normal distributions. Credit portfolio values change little on upgrades and downgrades, but can be substantial on default. This remote possibility gives rise to skewed returns with long downside tails rather than standard normal distributions as shown in Figure 15.1.

Market VaR and other risk models look to a specific horizon and estimate risk across a distribution of estimated market outcomes. Credit VaR constructs a distribution of value given different credit outcomes. The challenge of modelling is not easy in practice since there are two distinct differences:

- Long tails, as in Figure 15.1, where there is a remote possibility of a big loss. More information is needed in addition to the mean (expected value) and standard deviation (volatility).
- Correlations in credit portfolios cannot be directly observed and must be derived indirectly from other sources.

**OVERVIEW OF COMPONENTS**

As stated, Credit Metrics estimates portfolio VaR due to credit events that include upgrades, downgrades and default. The information comes from long-term estimates of migration in order to avoid bias and it is based on probability. This section provides an overview of the components:
- exposures and their distribution;
- VaR framework;
- correlations between individual exposures.

**Components**

The components are:

- Calculation of different exposure profiles and changes for each exposure type on a comparable basis.
- Derivation of the volatility of value due to credit quality migrations for each individual obligor (VaR framework). This is derived from a transition matrix where each migration results in a change in value. Each value outcome is weighted by its likelihood to create a distribution of value across each credit state from which the asset’s expected value and volatility are calculated.
- Calculation of volatility of value due to credit quality migrations across a portfolio and estimation of correlation between the obligors. Individual value distributions are combined to yield a portfolio value, which requires the estimated correlation between the assets.

The sections below explain the principles using a portfolio model with one and then two bonds.

**Outputs**

The outputs of the model are:

- Standard deviation – this is the standard measure of symmetrical dispersion around the mean. As discussed earlier, standard deviation may not capture the full range of possibilities. The upside may be one standard deviation above the average, while the downside could be many standard deviations below the average.
- Percentile levels – these demonstrate the possibility that the portfolio value will fall below a specified level. In order to calculate percentiles, a full range of values must be computed, usually through a simulation technique such as Monte Carlo simulation. This allows a model to run through many scenarios and produce either a histogram or cumulative probability graph of possible outcomes.
SINGLE ASSET

This section follows the main calculations with a single asset in the Excel file called MRM2_15_01.xls.

**Estimating credit exposure amounts**

Many different types of instruments encompass credit risk where exposures vary. Variable exposures can change in a way that is related to upgrades and downgrades or because of non-credit-related market moves. These include receivables, bonds and loans. Therefore the features of the model are:

- likelihood (possibility) of credit quality changes;
- changes in value assessed against an exposure amount in the event of each credit quality change.

Receivables are non-interest-bearing debt or trade credit where the exposure is typically less than one year. The exposure on a floating rate note or loan will always be close to face value (par) but the value of fixed-rate bonds and loans moves with market interest rates. The risk horizon is the present value of the remaining coupons and principal and here one can use the yield curve for the category. Figure 15.2 shows yield curves for different credit categories denoted by credit ratings.

**Estimating credit quality migrations**

There are three key steps to calculating the volatility of value in a stand-alone credit exposure:

- estimating credit quality migrations from one grade to another using a transition matrix;
- estimating changes of value upon credit quality migration across grades;
- computing the distribution of resultant bond values.

Estimating credit quality migrations is based on upgrades, downgrades and defaults, which is represented by a transition matrix (see Figure 15.3). This shows the possibility of moving from one ratings band to another: for example, there is a 7.70 per cent chance that a BB will upgrade to BBB within a year. These matrices are published by the ratings agencies as a result of observing historical patterns and then applying smoothing techniques. These tables are on the Data sheet.
Estimating changes in value at the end of a forecast period involves revaluation, it follows, for each credit state that the possibilities are:

- upgrade
- downgrade
- default.

In default, the recovery rate depends on the seniority class, but there is great variation (volatility) within a class, as Figure 15.4 suggests. For upgrades and downgrades, the new value is simply the present value of the cash flows at the revised interest rates or yield. Thus, as interest rates go down the value of a bond rises.

Cumulative values show the varying experience of default between the different credit categories. The possibility of a CCC rating defaulting rises from 20 per cent to 45 per cent over a 10-year period (see Figure 15.5).

Computing the distribution of values consists of a probability-weighted value and standard deviation. Figure 15.6 shows a BBB bond together with its transition matrix and the bond values.
## Transition matrix

**Figure 15.3**

<table>
<thead>
<tr>
<th></th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
<th>J</th>
<th>K</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>AAA 50.80</td>
<td>AA 8.30</td>
<td>A 6.70</td>
<td>BB 10.70</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
</tr>
<tr>
<td>A</td>
<td>AAA 0.70</td>
<td>AA 96.70</td>
<td>A 7.80</td>
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<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
</tr>
<tr>
<td>A</td>
<td>AAA 0.10</td>
<td>AA 2.30</td>
<td>A 9.10</td>
<td>BB 5.60</td>
<td>BB 0.70</td>
<td>BB 0.30</td>
<td>BB 0.30</td>
<td>BB 0.30</td>
<td>BB 0.30</td>
<td>BB 0.30</td>
<td>BB 0.30</td>
</tr>
<tr>
<td>B</td>
<td>BBB 6.00</td>
<td>BBB 8.50</td>
<td>BBB 5.30</td>
<td>BBB 1.20</td>
<td>BBB 0.10</td>
<td>BBB 0.20</td>
<td>BBB 0.20</td>
<td>BBB 0.20</td>
<td>BBB 0.20</td>
<td>BBB 0.20</td>
<td>BBB 0.20</td>
</tr>
<tr>
<td>C</td>
<td>BB 0.10</td>
<td>BB 0.70</td>
<td>BB 7.10</td>
<td>BB 0.50</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
<td>BB 0.10</td>
</tr>
<tr>
<td>D</td>
<td>B 0.10</td>
<td>B 0.20</td>
<td>B 0.40</td>
<td>B 0.60</td>
<td>B 0.30</td>
<td>B 0.30</td>
<td>B 0.30</td>
<td>B 0.30</td>
<td>B 0.30</td>
<td>B 0.30</td>
<td>B 0.30</td>
</tr>
<tr>
<td>C</td>
<td>BBB 0.20</td>
<td>BBB 0.20</td>
<td>BBB 1.20</td>
<td>BBB 2.40</td>
<td>BBB 3.30</td>
<td>BBB 4.40</td>
<td>BBB 5.50</td>
<td>BBB 6.60</td>
<td>BBB 7.70</td>
<td>BBB 8.80</td>
<td>BBB 9.90</td>
</tr>
</tbody>
</table>

### Default

**Figure 15.4**

<table>
<thead>
<tr>
<th></th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
<th>J</th>
<th>K</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>Senior secured 53.00</td>
<td>Senior unsecured 51.00</td>
<td>Senior subordinate 38.00</td>
<td>Subordinated 22.00</td>
<td>Junior subordinate 17.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Cumulative default

**Figure 15.5**

<table>
<thead>
<tr>
<th></th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
<th>G</th>
<th>H</th>
<th>I</th>
<th>J</th>
</tr>
</thead>
<tbody>
<tr>
<td>B</td>
<td>AAA 0.10</td>
<td>AAA 0.20</td>
<td>AAA 0.30</td>
<td>AAA 0.40</td>
<td>AAA 0.70</td>
<td>AAA 1.10</td>
<td>AAA 2.20</td>
<td>AAA 3.00</td>
<td></td>
</tr>
<tr>
<td>C</td>
<td>BBB 0.20</td>
<td>BBB 0.40</td>
<td>BBB 0.60</td>
<td>BBB 0.80</td>
<td>BBB 1.00</td>
<td>BBB 1.40</td>
<td>BBB 2.40</td>
<td>BBB 3.00</td>
<td></td>
</tr>
<tr>
<td>D</td>
<td>BB 1.10</td>
<td>BB 1.30</td>
<td>BB 1.60</td>
<td>BB 1.90</td>
<td>BB 2.40</td>
<td>BB 3.40</td>
<td>BB 4.40</td>
<td>BB 5.00</td>
<td></td>
</tr>
<tr>
<td>E</td>
<td>B 2.20</td>
<td>B 2.40</td>
<td>B 2.60</td>
<td>B 2.80</td>
<td>B 3.00</td>
<td>B 3.40</td>
<td>B 3.60</td>
<td>B 4.00</td>
<td></td>
</tr>
<tr>
<td>F</td>
<td>CCC 10.00</td>
<td>CCC 20.00</td>
<td>CCC 30.00</td>
<td>CCC 40.00</td>
<td>CCC 50.00</td>
<td>CCC 60.00</td>
<td>CCC 70.00</td>
<td>CCC 80.00</td>
<td></td>
</tr>
</tbody>
</table>

**Credibility**
Single model

The sheet called ‘Single’ models the values starting with these inputs. The rating uses a combo box to highlight the available grades (see Figure 15.7). The redemption is 100 and the bond has four years to run, and on expiry the final coupon and principal is payable. The assumed coupon rate is 6 per cent.

The value of the bond is calculated using an interest rate table on the Data sheet (see Figure 15.8) and the values are looked up using an OFFSET function:

\[=\text{OFFSET(Data!C68,Base!$C$115,0)}\]

The individual values are present valued and added to complete the value of the bond.

\[=\text{PV(G22/100,B22,0,-F22,0)}\]
The probabilities and yields are derived from the transition matrix on the Data sheet using OFFSET functions. The easiest way of calculating the bond values for each credit state is to use a data table based on the number of the rating. The inputs area uses a combo box to generate an index number for the bond. The workings area contains the data table which uses cell C115 as the column input and this approach saves the individual calculation of each of the values (see Figure 15.9).

\[=\text{TABLe(,C115)}\]

The calculation of standard deviation is thus shown in Figure 15.10.

The distribution of values shows the distinctive 'fat tail' represented by the 51 per cent recovery on default and the relatively small upside to the right of the BBB rating (see Figure 15.11).
Output

The probability-weighted value is the value at the interest rate for the grade multiplied by the probability of moving to the relevant credit state. The variance is a probability-weighted difference squared, which is 9.51 (see Figure 15.12). The standard deviation is the square root of the variance at 3.08.

The input confidence level was 95 per cent and therefore the number of standard deviations is 1.6449. This uses the NORMSINV function:

\[=\text{NORMSINV}(1 - (D53/100))\]
The standard deviation is multiplied by 1.6449 and subtracted from the current bond value of 107.53. This means that using standard deviation as the measure, there is a 5 per cent risk that the value of the bond will fall to 102.46.

It has already been stated that the distribution is not a normal bell curve. The 5 per cent percentile is found by looking up the rows of probabilities from the bottom of the table until 5 per cent is reached. In this case, the probabilities cross 5 per cent at BB, which gives a value of 102.01. This is lower than the standard deviation derived figure confirming the long downside credit tails.

Column M adds the probabilities in column D starting with the 0.20 default (see Figure 15.13). The formula matches the required confidence of 5 per cent to the list in the range M40:M47. This is declining so the flag is set to –1 in the function.

\[=\text{MATCH}(100-\$D53,\$M40:\$M47, -1)\]

The MATCH function finds the answer five and this is used as the row offset in the OFFSET function starting at cell F39. The answer returns as 102.01. Standard deviation overstates the value since it ignores the tail of default and there is a variance of 0.45 between the two results.


### Estimating credit quality correlations and calculating portfolio risk

With one bond, there are only eight observable states or outcomes. With two bonds, the number rises to 64 \((8^2)\) and with \(N\) bonds the number is \(8^N\). To derive the portfolio values, you have to estimate the probabilities of observing the combinations of values. This would be simple if all the values...
were independent but, in the real world, the outcomes are not completely independent of each other. The correlations have to be estimated from empirical data such as actual rating and default correlations. The next section shows the modelling of a two-bond portfolio.

**Figure 15.13**

**Cumulative probabilities**

![Cumulative probabilities](image)

**TWO-BOND PORTFOLIO**

The simple analysis above needs to be extended to portfolios containing many individual exposures. This worked example uses two bonds with these characteristics in the file MRM2_15_02.xls:

**Figure 15.14**

**Inputs for two bonds**

![Inputs for two bonds](image)
- Bond #1: BBB rated, senior unsecured, 6% annual coupon, five-year maturity;
- Bond #2: A rated, senior unsecured, 5% annual coupon, three-year maturity.

The inputs are shown in Figure 15.14.

The process initially follows the same pattern as the single bond and then combines the values using joint probabilities. The steps are:

- estimating credit quality migrations using transition matrices;
- estimating changes of value upon credit quality migration;
- computing distribution of bond values;
- calculation of all possible portfolio values;
- calculation of joint probabilities;
- summation of a portfolio value;
- outputs – standard deviation and 5 per cent threshold value.

**Bond prices**

The model calculates the prices of two bonds using the interest rates and transition matrix on the Data sheet (see Figure 15.15). Controls are used as on the single bond to ease the inputs, and the workings are at the bottom of the schedule. More output is available and the schedule makes use of more advanced functions such as DURATION, MDURATION, COUPONDAYNC, COUPONNC and ACCRINT.

### Bond price calculations

<table>
<thead>
<tr>
<th>Column</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Price</td>
</tr>
<tr>
<td>B</td>
<td>Weighting</td>
</tr>
<tr>
<td>C</td>
<td>Class price</td>
</tr>
<tr>
<td>D</td>
<td>Coupon days</td>
</tr>
<tr>
<td>E</td>
<td>Accrued interest at 6%</td>
</tr>
<tr>
<td>F</td>
<td>Dirty price</td>
</tr>
<tr>
<td>G</td>
<td>Price amount</td>
</tr>
<tr>
<td>H</td>
<td>Yield</td>
</tr>
<tr>
<td>I</td>
<td>Adjusted coupon yield</td>
</tr>
<tr>
<td>J</td>
<td>Yields to maturity</td>
</tr>
<tr>
<td>K</td>
<td>Duration</td>
</tr>
<tr>
<td>L</td>
<td>Modified duration</td>
</tr>
<tr>
<td>M</td>
<td>Change in price per 0.1%</td>
</tr>
<tr>
<td>N</td>
<td>(B) dates</td>
</tr>
<tr>
<td>O</td>
<td>Days to next coupon</td>
</tr>
<tr>
<td>P</td>
<td>Interest remaining</td>
</tr>
<tr>
<td>Q</td>
<td>Ex-dividend price</td>
</tr>
<tr>
<td>R</td>
<td>Next coupon date</td>
</tr>
<tr>
<td>S</td>
<td>No of remaining coupons</td>
</tr>
<tr>
<td>T</td>
<td>Total coupon amount paid</td>
</tr>
<tr>
<td>U</td>
<td>(B) Inversion</td>
</tr>
<tr>
<td>V</td>
<td>Price amount</td>
</tr>
<tr>
<td>W</td>
<td>Duration</td>
</tr>
<tr>
<td>X</td>
<td>Modified duration</td>
</tr>
</tbody>
</table>

**Figure 15.15**
Estimating credit quality migrations and changes in value

Figure 15.16 picks out the probabilities for each rating and then derives a probability-weighted bond value. The standard deviation at the 95 per cent level and the 95 per cent percentile are then calculated. This repeats the calculations in the previous section.

Using the chart in the overview section, the joint likelihood in the credit quality co-movements must be calculated. The objective is to show the probability-weighted value of the portfolio based on the transition matrices and subsequent changes in value. For simplicity, correlation is not included and is assumed to be zero. This means that movement in the rating of one bond has no bearing on the movement in price of another bond. In reality, price movements may be correlated and combinations of bonds lead to a reduced risk (volatility or standard deviation) for an optimized return.

The standard deviation and 5 per cent level are calculated using the same method as in the first section (see Figures 15.16 and 15.17).

Calculation of all possible portfolio values

Following the calculations for individual bonds, the values can be added across and down as shown in Figure 15.18. The values for Bond A are across and the values for Bond BBB are down. The values are a simple summation.
Calculation of joint probabilities

There are eight possible outcomes for each bond, from default to AAA. This multiplies with two bonds to $2^8$ or 64 possible states. Thus 79.1659 in the middle of the table is the product of 91.1 per cent for A and 86.9 per cent for BBB (see Figure 15.19).
Row 113 uses the TRANSPOSE function to get the horizontal data for the second bond (see Figure 15.20).

\[ \text{Row 113: } \text{TRANSPOSE}($F$79:$F$86) \]

**Summation of a portfolio value**

The summation of portfolio values is the value multiplied by the probability. The value 162.6322 in cell F129 in the middle of the table (see Figure 15.21) is the value 205.4321 in cell F104 multiplied by the probability of 86.90 in cell F117.

The portfolio value is derived from the sum of all the probability weighted values and a variance against the initial portfolio value is given. This is the range D126 to K133 and adds up to 204.936 (see Figure 15.21).

**Outputs: standard deviation and 5 per cent threshold**

The outputs comprise the standard deviation and the percentiles value. In both cases, the 95 per cent confidence value is used. Owing to the skew of credit curves, the values are slightly different (see Figure 15.22).
The table uses the correlation in cell D15 across the top. The value in cell D15 is zero and so the schedule provides all the values for positive and negative correlation. The variance in cell D147 uses the formula:

\[
\frac{((\text{Weighting}_A)^2) \cdot (\text{SDev}_A)^2 + ((\text{Weighting}_B)^2) \cdot (\text{SDev}_B)^2 + 2 \cdot \text{Weighting}_A \cdot \text{SDev}_A \cdot \text{Weighting}_B \cdot \text{SDev} \cdot \text{Correlation}}{} = \left(\frac{D22}{100}\right)^2 \cdot D68^2 + \left(\frac{E22}{100}\right)^2 \cdot D91^2 + 2 \cdot \left(\frac{D22}{100}\right) \cdot D68 \cdot \left(\frac{E22}{100}\right) \cdot D91 \cdot D15
\]

The standard deviation is the square root of variance, and the schedule multiplies out the 95 per cent confidence. The percentile value uses the workings table to the right to match the value along the cumulative probability (see Figure 15.23).

The formula in cell O122 uses OFFSET and MATCH. The OFFSET starts in cell C100 and moves right by the number in cell D238. This is three and
therefore the starting point is cell F100. The cumulative probabilities are in the range O114 to O121 and the match reads off the value five cells down in F105.

=OFFSET(OFFSET(C100,0,D238),MATCH(100-$D$14,O114:O120,-1),0)

Figure 15.24 shows the cluster of results around the 200 value. This is also evident in the second area chart with the peak between BBB and A (see Figure 15.25).
SIMULATION

The method outlined above works for one or two bonds, but large portfolios require a simulation approach and the use of specialized Excel add-ins such as @RISK or Crystal Ball. These generate random numbers with defined distributions and model large numbers of possible scenarios.

The Model_Simulation sheet calculates the values for each bond and then adds up the two values to form the portfolio value (see Figure 15.26).

The random numbers are generated by the macro:

=NORMSINV(C7)

A RAND function in the maths function library could have been used but this slows down the workbook. The standard deviation uses the NORMSINV function which returns the inverse of the standard normal cumulative distribution. The distribution has a mean of zero and a standard deviation of one and the input is the probability (see Table 15.1).
The next row matches the standard deviation with the position on the list. For example, 0.8108 would read off as the fourth item in declining order. Column F provides the rating for the number using an OFFSET function. Therefore the further rating is a BBB.

=OFFSET(Data!$B$8,E10,0)

The value is also found by an OFFSET function using the values in range Model F56 to F63. This procedure is repeated for the second bond in columns H to N. Column O adds the two values and there are 1000 lines to provide a range of possible values.

The code for the random numbers is:

Sub Model_Simulation()

Dim RandomFactor, Count, StartA, StartB
Range("model_simulation!$C$6").Select
Application.ScreenUpdating = False
For Count = 1 To 1000 ‘START OF LOOP
Application.StatusBar = “Generating random numbers - ” & Count
ActiveCell.Offset(1, 0).Select
ActiveCell.FormulaR1C1 = Rnd
ActiveCell.Offset(0, 5).Select
ActiveCell.FormulaR1C1 = Rnd
ActiveCell.Offset(0, -5).Select
Next Count ‘END OF LOOP
Application.StatusBar = False
Application.ScreenUpdating = True
Application.Calculation = Application.CalculationSemiautomatic
End Sub

<table>
<thead>
<tr>
<th>Rating</th>
<th>Standard deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>AAA</td>
<td>9.51</td>
</tr>
<tr>
<td>AA</td>
<td>4.75</td>
</tr>
<tr>
<td>A</td>
<td>2.75</td>
</tr>
<tr>
<td>BBB</td>
<td>1.53</td>
</tr>
<tr>
<td>BB</td>
<td>(1.49)</td>
</tr>
<tr>
<td>B</td>
<td>(2.17)</td>
</tr>
<tr>
<td>CCC</td>
<td>(2.75)</td>
</tr>
<tr>
<td>Default</td>
<td>(2.88)</td>
</tr>
</tbody>
</table>

Table 15.1
The Simulation_Results sheet illustrates the results of 1000 scenarios using random number generation (see Figure 15.27). Most of the results reflect the current rating of the bond as A or BBB. The histogram counts the number of results in each sector to show the peaks for each of the bonds. This is a FREQUENCY function entered as an array using Control and Enter together.

![Simulation results](image)

Bond BBB shows 866 results remaining at the same rating against the theoretical value of 869 for each 1000. Similarly Bond A shows 905 against 910. The results of course will vary with each run because of the random numbers. Therefore the results with 1000 scenarios are close to the transition matrix.

The next stage is to combine the results to show the portfolio results in values and percentiles. Figure 15.28 shows the values for each bond at a number of confidence levels and then the combined value. The statistics are:

- mean – simple arithmetic average;
- median – number in the middle of a set of numbers: that is, half the numbers have values that are greater than the median, and half have values that are less;
- mode – most frequently occurring value;
- skew – degree of asymmetry of a distribution around its mean (a positive skew indicates a distribution with an asymmetric tail extending towards positive values; a negative skew indicates a distribution with an asymmetric tail extending towards negative values);
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- kurtosis – a relative peak or flatness of a distribution compared with the normal distribution (positive kurtosis indicates a relatively peaked distribution; negative kurtosis indicates a relatively flat distribution);
- percentiles to show the spread of values; again an array function.

\( (=\text{PERCENTILE(Model\_Simulation!N7:N1006,C50:C68}) \) \)

Figure 15.29 shows the percentiles chart of bond values.

Figure 15.30 is the combined values and the count of occurrences with the histogram showing a peak at A and BBB with 786 of the possible results. The combined values table is brought forward from the Model sheet so that there is a portfolio value for each possible eventual value. In the bottom right-hand corner at cell K107 is the result if both bonds default and the recovery is around 50 per cent. Here the portfolio is worth 102.26.

The next table uses a COUNTIF function to count the values if the values equal the combined amount in the table. In cell F115, the function counts...
the number of results in column O that concur with the value 205.59 in cell F103. This is approximately 800.

=COUNTIF(Model_Simulation!$O$7:$O$1006,F103)
Figure 15.31 is an alternative view of the histogram values showing the peak at the intersection of BBB and A together with the tail of values to default.

Figures 15.32 and 15.33 plot the values and probabilities, to show first the values and second the cumulative probability as percentages.
SUMMARY

Credit value at risk is a methodology for encompassing both default and the upgrades and downgrades, and produces value at risk scores for portfolios. The method is flexible for a number of different credit exposures, and this chapter has illustrated the main principles using a simple portfolio model with one and then two bonds. The main elements are:

- exposures and their distributions;
- the possibility of upgrade, downgrade and default;
- the calculation of a monetary value at the five percentile for a possible portfolio value at the end of a timeframe.

Using this approach provides a framework for considering risk as a monetary value across portfolios and industries, and it gives decision makers more information for setting credit limits and managing risk capital.
Software installation and licence

The appendix contains:

- system requirements
- installation
- accessing the application files
- licence
- file list.

A CD containing the Excel files and templates accompanies this book. The CD contains example files only and complete versions are available for purchase at www.financial-models.com. The file names relate to their chapter numbers and you should refer to the file list. The file notation is MRM2 and then the chapter number. For completeness, the files for a particular chapter are quoted at the beginning of each chapter.

Follow the instructions below to install the files and create a program group using the simple SETUP command.

SYSTEM REQUIREMENTS

This section summarizes the requirements for using the application:

- IBM-compatible personal computer;
- hard disk with 20Mb of free space;
- Microsoft Mouse or other compatible pointing device;
- EGA, VGA or compatible display (VGA or higher is recommended);
- Microsoft Windows and Excel 2003 or later.

INSTALLATION

- Insert the CD into your CD-ROM drive.
- Select the Start button in the bottom left of your screen.
- Select Run.
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- Write in the space provided: D:\SetUp.exe where D is your CD-ROM drive. (If this is not correct for your machine then change the letter accordingly.)
- The application will now install itself. Follow the instructions on-screen to select a destination directory.
- If you are prompted, please restart Windows.
- If you encounter any errors due to insufficient privileges for installing software on your machine, the files are also available in an uncompressed form in the CD_Files directory.

When the installation has finished, open Excel and select Tools – Add-ins. You need to make sure that Analysis Toolpak and Solver are selected. This is because the files use some of the advanced functions such as EDATE and XNPV or Solver routines. Analysis Toolpak is often not installed using a typical installation. If this is the case, use your original Office disks to install the missing option.

**Office 2007 – Office Button, Excel Options, Add-ins, Excel Add-ins**

![Figure A1.1 - Tools Add-ins](image)

This Toolpak contains extra statistical and financial functions needed by the applications. Click it to select it and press OK. If you do not select it, you will encounter errors on certain files.
ACCESSING THE APPLICATION FILES

- You will see that a program group has been created for you. The application will also now appear under Programs on the Start Menu.
- When installed, the program group should include all the files on the accompanying file list.
- To access any of the files, simply double-click the icons in the program group.
- You can also open a ReadMe file of installation instructions and a file list.
- Press OK to continue and the selected file will open.
- There is a master file list in the form of an Excel model and a list within the book.

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**FILE LIST**

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Models</th>
</tr>
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<tbody>
<tr>
<td>1   Overview</td>
<td>MRM2_01</td>
</tr>
<tr>
<td>2   Review of model design</td>
<td>MRM2_02</td>
</tr>
<tr>
<td>3   Risk and uncertainty</td>
<td>MRM2_03</td>
</tr>
<tr>
<td>4   Project finance model</td>
<td>MRM2_04</td>
</tr>
<tr>
<td>5   Simulation</td>
<td>MRM2_05_01</td>
</tr>
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<td></td>
<td>MRM2_05_02</td>
</tr>
<tr>
<td>6   Financial analysis</td>
<td>MRM2_06</td>
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<tr>
<td>7   Credit risk</td>
<td>MRM2_07</td>
</tr>
<tr>
<td>8   Equity valuation</td>
<td>MRM2_08</td>
</tr>
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<td>9   Bonds</td>
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<td>10  Options</td>
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<td>11  Real options</td>
<td>MRM2_11</td>
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<tr>
<td>12  Equities</td>
<td>MRM2_12</td>
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<tr>
<td>13  Risk management</td>
<td>MRM2_13</td>
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<td>14  Value at risk</td>
<td>MRM2_14</td>
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<td>15  Credit risk and credit metrics</td>
<td>MRM2_15_01</td>
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<tr>
<td></td>
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</table>

The above files comprise templates and files to allow you to practise building the finished spreadsheets rather than use or modify existing files. This is to allow you to learn by doing and thereby increase your own skill level. Complete versions are available for purchase at www.financial-models.com.
Microsoft Office 2007 (Office 12)

This appendix provides an introduction to Microsoft Office 2007 (Office 12) to show the differences in the menus and commands. Office 2007 marks a substantial departure from earlier versions of Office and attempts to make the menus, toolbars and options more accessible. This appendix provides an overview and some screenshots of the menu ribbon at the top of the screen. There is also a function reference on the disk (MRM2_Office_2007_Menus).

MICROSOFT OFFICE USER INTERFACE OVERVIEW

The whole Office interface has been redesigned to contain more features and new file formats. Microsoft explains that most Office users accessed only 8 to 10 per cent of the functions on the many toolbars and menus in previous versions of the applications, because most of the program’s features were buried in layers of menus and sub-menus. In response, Microsoft has placed the functions on a single, changeable ribbon to make them more visible, and thus more likely to be used. The result is a user interface that should make it easier for people to get more out of Microsoft Office applications so they can deliver better results faster. Microsoft Office Word 2007, Office Excel 2007, Office PowerPoint 2007 and Office Access 2007 will feature a similar workspace to offer the same style across the Office family.

KEY FEATURES

In previous releases of Microsoft Office applications, people used a system of menus, toolbars, task panes, and dialog boxes to get their work done. This system worked well when the applications had a limited number of commands. Now that the programs do so much more, the menus and toolbars system does not work as well. Too many program features are said to be too hard for many users to find. For this reason, the overriding design goal for the new user interface is to make it easier for people to find and use the full range of features these applications provide. The result should be better performing applications in Word, PowerPoint, Access and Excel.
THE RIBBON

The previous menus and toolbars have been replaced by the Ribbon, which presents commands organized into a set of tabs. The tabs on the Ribbon display the commands that are most relevant for each of the task areas in Office Word 2007, Office PowerPoint 2007, Office Excel 2007, or Office Access 2007.

CONTEXTUAL TABS

Certain sets of commands are only relevant when objects of a particular type are being edited. For example, the commands for editing a chart are not relevant until a chart appears in a spreadsheet and the user is focusing on modifying it. In earlier versions of Office, these commands could be difficult to find. In Office Excel 2007, clicking on a chart causes a contextual tab to appear with commands used for chart editing. Contextual tabs only appear when they are needed and make it much easier to find and use the commands needed for the operation at hand.

GALLERIES

Galleries provide users with a set of clear results to choose from when working on their document, spreadsheet, presentation, or Access database. By presenting a simple set of potential results, rather than a complex dialog box with numerous options, Galleries simplify the process of producing professional looking work. The traditional dialog boxes are still available for those wishing a greater degree of control over the result of the operation.

LIVE PREVIEW

Live Preview is a new addition that shows the results of applying an editing or formatting change as the user moves the pointer over the results pre-
sented in a Gallery. This new capability simplifies the process of laying out, editing and formatting so users can create excellent results with less time and effort.

**MIGRATION**

**Conversion**

Office 2007 uses different file formats to Office 2003 primarily owing to the switch to XML file formats as the defaults in Word, Excel, and PowerPoint. Office 2007 applications can open and work on files created in previous releases back to Office 97, and you will be able to create files in all existing Office formats. However, to take full advantage of the smaller file sizes and other benefits of Office 2007, you are forced to use the new XML formats: .docx in Word, .xlsx in Excel, and .pptx in PowerPoint. In fact, saving files in older Office formats is not possible in the ‘Save as’ dialog box; instead, you must choose Convert from the new Office button, and Convert appears on the resulting drop-down menu only when a non-XML file is open.

**1 OFFICE MENUS – HOME**

The screen below shows the difference in the menu commands starting with Home. To open, modify or print a document you click the Office icon in the top left. Home provides all cell formatting currently on the Formatting
toolbar and under Edit. The elements on the right such as conditional formatting, tables and styles are currently found under Format.

2 INSERT

This screen combines further toolbars and options: Shapes are currently on the Drawing toolbar, Pivot tables are under Data and Charts can be found on the Insert menu. These commands all insert objects on the spreadsheet so the new Office ribbon brings them together here. Where you see a triangle on the Ribbon item, further menus open out with options. When you click these buttons, they open to reveal further options. For example, inserting a column chart opens up all the variants of column charts or you can open a dialog box with all charts similar to the 2003 menus.

3 PAGE LAYOUT

The menu brings together all the layout commands from the different Excel 2003 menus. All the commands relate to the layout of individual sheets. Print comments are currently on the File menu while Custom Views are as on View. Commands such as Bring to Front are on the drawing menu.
Inserting formulas in Excel 2003 can be complex when you need to find one of the 300 different functions. This menu helps with functions arranged in categories and elements of the auditing toolbar together. Commands such as Evaluate Formula and Watch Window allow you to trace commands and understand the process of calculation and result. Currently the audit commands are hard to find; this layout tries to make them more accessible.
5 DATA

The Data menu contains some of the 2003 commands menu such as Connections and Data Validation. Sorting and Filtering is also on Data. ‘What if’ analysis such as Data Tables, Scenarios and Goal Seek is a Tools option on Excel 2003. These are key commands for risk and variance analysis in Excel. The commands for linking data and workbooks are also here since Excel works well with Access databases and other external sources.

6 REVIEW

Reviewing includes Tools options such as spelling and protection together with Comments from the Insert menu. The idea is to use this set of commands when the initial workbook has been written. Good practice includes annotating and commenting cells, together with protecting formula cells against unauthorized changes.

7 VIEW

There are a number of tools for changing the appearance of Excel such as gridlines, formula bar, etc, which can be found in Tools Options or View on earlier versions. Again, these are all the commands that stipulate the viewing of Excel, many of which are currently found under Window.
8 DEVELOPER

The Developer options are not available unless you click the box using the Options tab below. This allows you to record macros and make use of extended possibilities in Visual Basic. Macros are currently on the Tools menu or the Visual Basic toolbar and this option brings all the commands together.
You need to tick the box below and the extra option appears on the Ribbon.

**Figure A2.13**

**Show Developer toolbar**

---

**9 ADD-INS**

On Excel 2003, you select add-ins with Tools and Add-ins. In Office 12 this is a separate option and you choose the add-ins with the options below. Tool bars open out when you select the add-ins such as Solver.

**Figure A2.14**

**Add-ins**
10 OPTIONS – PERSONALIZE

There are a number of options currently under Tools Options in the various tabs. The dialog screens are larger than current option screens in order to make the information clearer. This section is the equivalent to set up, for example, the default number of sheets in an Excel workbook. Tick the Developer tab for it to be visible on the Ribbon.

11 OPTIONS – FORMULAS

These options determine the automation of calculation and the error checking options currently in Tools Options Calculation and Error Checking.
12 OPTIONS – PROOFING

This option is common with other parts of Office 12 and chooses how proofing is carried out and how Excel seeks to correct potential errors. The AutoCorrect and dictionary options are also here.

13 OPTIONS – SAVE

Here you set up file locations, the auto-save interval and the visual appearance.
14 OPTIONS – ADVANCED

This section deals with advanced options for editing and other actions currently found in Tools Options. This includes the controls for editing options such as AutoComplete together with editing and display options.
15 OPTIONS – CUSTOMIZATION

You can customize toolbars with quick commands and this menu options allows you to select commands for the quick toolbar. The quick toolbar is visible at the top left of the Ribbon.

16 OPTIONS – TRUST CENTRE

This section on security provides tools for securing documents and privacy. In Excel 2003 these tools are scattered in the different option boxes.

17 OPTIONS – RESOURCES

This section organizes all the assistance available in Office 12 for fixing problems, getting updates and downloading updates as they become available. The Office suite contains more advanced tools for finding and fixing installation problems.
Trust Centre

Figure A2.21

Resources

Figure A2.22
Index

abandonment options 274–7
accounting format 21–2
accounting schedules 99–103
  balance sheets 99–100, 143–5, 146–7, 164–5
  income statements 99, 141, 143, 162, 163
see also cash flow
accounting standards 137
ACCRINT 221
ACCRINTM 221
accruals principle 137
accrued interest 220
add-ins 36–7, 355, 364, 376
Airbus 139
airline industry 139
Altman, E.I. 184–6
American options 239
AMORDEGRC 221
Analysis Toolpak 36, 364–5
annual reports 137
see also financial analysis; financial statements
array functions 52, 91
assets 143–4, 162, 164
  leverage 152
  turnover 152
@Risk 355
auditing 4, 50–6, 352
  pattern matching 52–3
  range testing 55–6
  stress testing 55–6
  toolbar 52
author name 16, 38–9
AVERAGE 123

balance sheets 99–100, 143–5, 146–7, 164–5
bankruptcy
  Bathory model 185
  Beaver’s model 183–4
  H-Factor model 192–3
  Logit model 189–91
  merchandising firms 188
private firms 188
ratio analysis 183–93
service firms 188
Springgate analysis 189
Z scores 186–8
see also credit risk
Basel Accords 319
Bathory model 185
Beaver’s model 183–4
beta 60–2, 208, 214–5, 216
  SLOPE function 61, 123
binomial option pricing model 261–4
Black-Scholes model 252–7, 261–3
Boeing 139
bonds 73, 219–36
  accrued interest 220
  convexity 230–3, 234, 235
  current yield 226
  duration 226–30
  Excel functions 221–2
  and interest rates 222–4
  junk bonds 338
  maturity 226–7
  modified duration 228–30, 231
  price calculations 349
  price quotations 220
  ratings agencies 191–6
  sensitivity analysis 224
  summary table 235
  terms used in bond markets 219
  yield calculations 224–6
  zero coupon bonds 227
see also credit value at risk (VaR)
borders 15, 22–3
borrowing schedule 96–8
borrowings and equity ratio 96
brain storming 70
business risk 81, 145
buttons 28–33
buy straddle 250
buy strangle 250–1
buy to let model 63–6, 124–30
call options 239, 241, 243–4
  buy and write a call 246
capital asset pricing model (CAPM) 60, 94
Index

capital structure 206–10

cash conversion cycle 147–8

cash flow 82, 201, 200, 205–6, 207
  analysis 154–8, 165–6
  and credit risk 176
  free cash flow 158, 176, 201, 200
  net operating cash flow (NOCF) 154, 156–7, 171, 174
  ratio analysis 159
  statements 100, 101

cell formulas vs formulas

central limit theorem 115–19

correlation 285–6, 326–8
  CORREL function 285, 328
  cost of capital 94–5, 103, 104, 206–10
  COUNTIF 123, 358–9
  COUPDAYSNC 221
  COUPNCD 221
  COUPNUM 221
  COUPPCD 221

credit distribution 339

credit risk 177–99
  bankruptcy predictions 183–93
  cash flow 176
  loan cover ratios 176–80
  ratings agencies 191–6
  sustainability of growth 180–3

credit spreads 338

credit value at risk (VaR) 337–61
  audit trail 352
  components 339–40
  credit quality correlations 347–8
  estimating exposure amounts 341
  estimating quality migrations 341–4, 350
  outputs 340, 346–7, 352–3
  portfolio risk calculation 347–8
  portfolio values 350–1
  simulation 355–61
  single asset model 341–8
  transition matrix 342–3, 345
  two-asset portfolio 348–54
  volatility calculations/derivation 340

cronditor days 146

Crystal Ball 355

CUMIPMT 221

CUMPRINC 221

cumulative charts 44

current ratio 150

current yield 226

custom formats 16, 21, 22

data Analysis 7–8

data tables 9, 46–8, 96

data validation 15, 25–8

dates 14
  EDATE 37

debtor days 146

decimal places 16, 20

decision trees 9, 71–2

delay options 271–4

deLphi technique 70

delta 255–7

demographics 138

dependants 52, 53

depreciation 137

Descriptive Statistics 7–8

design of models 13–56
  borders 15, 22–3
  colour 15, 24–5
  comments 17, 41–2
  controls 28–33
Index

data tables 9, 46–8, 96

data validation 15, 25–8
documentation 18, 38–9, 41–2
ersors in design 15–18
labels 14, 17, 37–8
lines 22–3
objectives 13–14
patterns 24
scenarios 9, 49–50, 69–72, 91, 113
see also formatting; graphs
deterministic models 6
dialog boxes, Excel 2003 in 2007 370
Add-ins 376
AutoCorrect 378
Calculation 377
Error Checking 377
Options 374, 377–81
Save 378–9
Security 380
Spelling 378
dirty bond prices 220
diversification 60, 283–4, 326
documentation 18, 38
names table 40–1
Du Pont ratios 148, 150–2
duration 226–30
DURATION function 221, 227
dynamic graphs 44–6
dynamic labels 17
easyJet 139
EBIT interest coverage 193, 195–6
EBITDA 155, 156, 176
interest coverage 193, 195–6
ecology 138
economic capital 305–9
economic risks 137
EDATE 37
EFFECT 287–8
efficient frontier 298–9
efficient portfolios 285
ENPV (expected net present value) 270
environmental analysis 137–8
equities 283–300
comparison charts 291–2
correlation matrix 285–6
efficient frontier 298–9
efficient portfolios 285
expected returns 283–4
optimum portfolio calculation 294–300
portfolio theory 60, 283
returns summary 286–92
Sharpe ratio 294, 295, 298, 299–300
simulation 292–4
US stock returns 284–5
equity funding 203–4
ers 54, 113
chart errors 114
in design 15–18
FIND for hidden errors 54–5
ISERROR 150
see also auditing
European options 239
Excel 2007 introduction 369–81
see also commands; dialog boxes; menus;
toolbars
exit multiples 200, 211–2
expansion options 277–80
expected net present value (ENPV) 270
expected returns 65–6, 283–4
file formats 371
finance leases 138
financial analysis 135–71
accounting standards 137
balance sheets 143–5, 146–7, 164–5
cash flow 154–58, 165–6
comparing accounts 137
environment 137–8
financial structure 148, 149–50
financial weakness 175
forecasts 158–7
framework 135
industry factors 139–40
management analysis 167–8
management summary 167–8
model structure 141, 142
operating efficiency 145–8
performance measures 135, 136
process 137
profit and loss statements 141–3, 162, 163
profitability 148–9, 172
sources of risk 136, 147
STEEPV model 137
trend analysis 152–4
value chains 140
see also ratio analysis; valuation models
financial forecasting 158–67
financial risk 81
financial statements 140–1, 271
balance sheets 99–100, 143–5, 146–7, 164–5
income statements 99, 141, 143, 162, 163
see also cash flow
financial structure 148, 149–50
ratio analysis 148, 149–50
financial weakness 175
FIND for hidden errors 54–5
five forces model 139
flexibility value of projects 269
fonts and typefaces 20, 25
forecasts 158–67
Index

formatting 16, 20–2
  accounting format 21–2
  colour 15, 24–5
  conditional 17, 33, 34, 209–11, 216, 275
  custom formats 16, 21, 22
  fonts and typefaces 20, 25
  highlighting cells 20, 25
  number formats 16, 20–2
  toolbar 22
  zeros 21
  see also design of models
formulas 13, 17
  errors 54
  mixing with numbers 16
  names for 39–41
  Show Formulas 20, 51, 52
  see also auditing
free cash flow 158, 176, 200, 201
FREQUENCY 7, 123, 128, 129, 288
Fulmer, John G. 192
functions 17, 33–7
  add-ins 36–7, 355, 364
  Analysis Toolpak 36, 364–5
  array functions 48, 91
  AVERAGE 123
  bond functions 221–2
  CHOOSE 71
  COMBIN 262
  CORREL 285, 327–8
  COUNTIF 125, 358–9
  EDATE 37
  EFFECT 287–8
  FREQUENCY 7, 123, 128, 129, 288
  help on 36
  IF 38
  ISERROR 148
  KURT 123
  LOOKUP 71
  MATCH 195, 269, 347
  MAX 102, 123
  MEDIAN 123
  MIN 102, 123, 179
  MMULT 330–1
  NORMINV 121, 308
  NORMSDIST 272, 321, 326
  NORMSINV 321, 322, 346, 355
  NPV 33–6
  OFFSET 30–1, 45, 71, 92, 195, 231, 356
  PERCENTRANK 294, 295
  PMT 17
  RAND 115, 123, 308, 353
  RANDBETWEEN 115, 123, 286, 292
  RATE 287–8
  ROUNDDUP 195
  ROW 143
  RSQ 123
  security-related functions 221–2
  SKEW 123
  SLOPE 61, 123
  SUMPRODUCT 189, 292, 332
  TEXT 143
  TRANSPOSE 91
  XNPV 37
  funding gap 146

GAAP (Generally Accepted Accounting Principles) 137
  gamma 255
  gearing 147, 150
  go to special 53, 54
  going concern principle 137
  graphs 14, 17, 42–6, 168–9, 212
  and auditing 55
  chart errors 114
  chart types 42–3
  cumulative charts 44
  dynamic graphs 44–6
  percentiles chart 125
  probability charts 64–5
  quartiles chart 130
  scatter plots 60, 62, 122, 129, 298–9
  source data 43
  green issues 138
  Greenpeace 138
  Greiner model 180–1
  growth model 180–3
  H-Factor model 192–3
  hard coding 14
  hedging strategies 245–52
  help on functions 36
  highlighting cells 22
  IF 38
  impact-likelihood matrix 8–9, 10, 84–5
  income statements 99, 141, 143, 162, 163
  incremental values 28–33
  industry analysis 139–40
  input-calculation-output models 6
  inputs 13, 15
  colours 13, 15, 24–5
  controls 28–33
  data validation 15, 25–8
  incremental values 28–33
  insolvency see bankruptcy
  installation of software 363–7
  interest coverage 193, 195–6
  interest rates 222–4, 287–8
interim variables 13
internal rate of return (IRR) 201, 210
inventories 145, 147
ISERROR 148

joint probabilities 351–2
JP Morgan 319
junk bonds 338

key drivers 159–61
knowledge management 83
kurtosis 123, 358

labels 14, 17, 37
   dynamic labels 17
   updated labels 37–8
law of large numbers 115
layouts 13, 14, 21
   see also design of models
leases 138
leverage 152, 303, 305
liabilities 143, 145, 163, 165
licence 365–7
lines 22–3
links between workbooks 40
liquidity 146
loans
   cover ratios 176–80
   credit distribution 339
   repayment 77
   risk adjusted return on capital (RAROC) 309–15
   see also credit value at risk (VaR)
Logit model 189–91
long butterfly 249
LOOKUP 71

macros in Excel 2007 375
maintenance of models 14
management analysis 103–11, 167–8
management information systems 83
management reporting 18, 70–1
management skills 82
management summaries see summaries
Manhattan Project 113
manual scenarios 71
mapping risk 67–8
market ratios 152, 153
market risk 60, 333–4, 338–9
Markowitz, Harry 283
MATCH 197, 271, 347
matching principle 137
matrices 330–1
maturity of bonds 226–7
MAX 102, 123
MDURATION 221
mean 114–15
median 123, 357
mental mapping 70
menu systems 17, 90, 91
menus, Excel 2003 in 2007 370
   Data 372, 374
   Edit 372
   File 371, 372
   Format 372
   Help 380
   Insert 374
   Tools 374, 375, 376, 377–81
   View 372, 374
   Window 374
Merck 138
merchandising firms 188
Microsoft Office 2007 introduction 369–81
   see also commands; dialog boxes; menus; toolbars
MIN 102, 123, 179
MMULT 330–1
mode 357
modified duration 228–30, 231
Monte Carlo simulation see simulation
multi-discriminant analysis 186

names
   for formulas 39–41
   for key variables 15
table 40–1
net operating cash flow (NOCF) 154, 156–7, 171, 174
net present value (NPV) 18, 33–6, 203, 267, 269
normal distribution 7, 114–16, 283–4, 320–1, 326
NORMINV 121, 308
NORMSDIST 272, 321, 326
NORMSINV 321, 322, 346, 355
Norsk Hydro 138
NPV (net present value) 18, 33–6, 201, 267, 269
number formats 16, 20–2

objectives
   of model design 13–14
   of modelling 5, 6–9
ODDFPRICE 221
ODDFYIELD 221
ODDLPRICE 221
ODDLYIELD 221
Office 12 introduction 369–81
   see also commands; dialog boxes; menus; toolbars
OFFSET 30–1, 45, 71, 92, 195, 229, 356
operating efficiency 145–8
  ratio analysis 146–7, 148
opportunity costs 267
optimization techniques 9
optimum portfolio calculation 294–300
options 239–264
  American options 239
  buy straddle 250
  buy strangle 250–1
  call options 239, 241, 243–4
  buy and write a call 246
delta 255–7
European options 239
gamma 255
hedging strategies 245–52
long butterfly 249
pay-off diagrams 240–1, 243–4, 268, 275
pricing
  binomial model 261–4
  Black-Scholes model 252–7, 263
  simulation method 257–60
  variables 239–40
put options 239, 241, 243–4
  buy and write a put 247
sell straddle 247, 248
sell strangle 247–8
short butterfly 251–2
theta 255–6
vega 255–6
see also real options
options to abandon 246–7
options to delay 271–4
options to expand 277–80
output colours 15, 24–5
overtrading 180–1

pattern matching 52–5
patterns 24
pay-off diagrams 240–1, 243–4, 268, 275
payback 44
percent of sales forecasting 159–61
percentiles 123–4, 125, 126
PERCENTRANK 294, 295
performance measures 135, 136
performance risk 81
PMT 17
Porter, Michael 139
portfolio theory 60, 283, 326–8
see also equities
portfolio VaR 328–30
portfolios of loans see credit value at risk (VaR)
position limits 323
PRAT model 183, 184
precedents 52, 53
present value 211–12
PRICE 221, 222, 223–4
PRICEDISC 221
PRICEMAT 221
printing 17
private firms 188
probabilities 64–5, 283–4
  joint probabilities 351–2
probability distributions 114–19, 288–9
  normal distribution 7, 114–16, 283–4,
  320–1, 326
probability modelling 113
profit and loss statements 99, 141, 143, 162,
  163
profitability analysis 148–9, 170
project finance 77–111
  accounting schedules 99–103
  advantages 79
  borrowing schedule 96–8
  borrowings and equity ratio 96
  choice of project vehicle 81
  construction schedule 96–7
  contracts 78, 83
  cost of capital 94–6, 103, 104
  design of the model 86–8, 89
  elements to be modelled 79–84
  inputs 87, 88–94
  loan repayments 77
  management analysis 103–11
  outputs 96–8
  ratio analysis 82, 87, 101–3, 110
risks
  analysis 84–5
  mitigation 85
  sources 79–84
  sensitivity analysis 94–6, 105
STEEPV model 79–81
structure of projects 78
summaries 103–11
see also real options
property investment, buy to let model 63–6,
  124–30
prudence principle 137
Psion 138
put options 239, 241, 243–4
  buy and write a put 247
quartiles 132, 290
quick ratio 150
r-squared values 123
random events 66
random numbers 115, 286
  RAND 115, 121, 308, 355
  RANDBETWEEN 115, 121, 286, 292
Index

stock days 146
stress testing 55–6, 85
Strong law of large numbers 115
summaries 14, 18, 93
bonds 237
financial analysis 167–8
project finance 103–11
real options 272, 279, 281
valuation models 214–5
SUMPRODUCT 185, 294, 332
sustainability of growth 178–
system requirements 363
tables
composite tables 48
data tables 9, 46–8, 96
TBILLEQ 224
TBILLPRICE 224
TBILLYIELD 224
technology 138
terms used in bond markets 221
TEXT 143
labels 14, 17, 37–8
and number formats 21

see also formatting
theta 255–6
three asset model 330–4
toolbars (Excel 2007)
auditing 52
formatting 22
quick 380
toolbars, Excel 2003 in 2007 370

Drawing 372
Formatting 371–2
Visual Basic 375
trade credit 140
TRANSPOSE 91
trend analysis 152–4
turnover of assets 152
turnover ratio 146
two-asset models 324–30, 348–54
Ulam, Stanislaw 113
uncertainty 8, 9, 66
United States stock returns 284–5
updated labels 37–8
user inputs see inputs
validation 15, 16, 25–8
valuation models 201–16
and capital structure 206–10
and cash flow 198, 200, 205–6, 207
exit multiples 200, 213–14
inputs 201–5
internal rate of return (IRR) 201, 210
management summary 214–5
net present value (NPV) 18, 33–6, 201, 267, 269
options
binomial model 261–4
Black-Scholes model 252–7, 263
simulation method 257–60
variables 239–40
and returns 210–11
sensitivity analysis 212–4
value at risk (VaR) 319–34
and correlation 326–8
definitions 319
and market risk 333–4
and portfolio theory 326–8
portfolio VaR 328–30
position limits 323
sensitivity chart 323–4
single asset model 320–4
two asset model 324–30
three asset model 330–4
and volatility 334
see also credit value at risk (VaR)
value chains 140
value of flexibility 267
variables
in financial forecasting 160, 161
interim variables 13
names for key variables 15
in option pricing 239–40
variance see standard deviation
vega 257–8
version numbers 15–16, 38–9
Visual Basic in Excel 2007
volatility 334
von Neumann, John 113
WACC (weighted average cost of capital) 94–6, 211
what if analysis 9
working capital 150, 156
turnover ratio 146
XNPV 37
XY scatter plots see scatter plots
yield calculations 224–6
Z scores 186–88
zero coupon bonds 229
zeros 21