Contents

Foreword xiii
Author’s Preface xvii
Acknowledgement xxi
About the Companion Website xxiii

1 Discounted Cash Flow Valuation: The Basic Procedures and Concepts Underlying Spreadsheet Valuation Constiute the Springboard to our Approach of Analyzing Flexibility Under Uncertainty 1
1.1 Why the Focus on the Discounted Cash Flow Model? 2
1.2 Structure of a Discounted Cash Flow Spreadsheet 3
1.3 The Cash Flow Projection 5
1.4 Discount Rate 7
1.5 Market Value and Forward-Looking (Ex-Ante) Analysis 7
1.6 Backward-Looking (Ex-Post) Analysis 9
1.7 Conclusion 9

2 Economics of the Discounted Cash Flow Valuation Model: Understanding the Discount Rate is Critical 11
2.1 Choice of Discount Rate 11
2.2 Differences between Discount Rate, Opportunity Cost of Capital, and Internal Rate of Return 13
2.3 Net Present Value 14
2.4 Relationship between Discount Rate, Growth Rate, and Income Yield 15
2.5 Relationship between Discount Rate and Risk 18
2.6 Conclusion 19

3 Future Scenarios Matter: We Need to Recognize that Future Projections are Uncertain 21
3.1 The Standard Discounted Cash Flow Model Appears to be Deterministic 21
3.2 We Live in a World of Uncertainty 23
3.3 Discounted Cash Flow Pro Forma Cash Flows Are Expectations 24
3.4 Flexibility and Options 26
3.5 Conclusion 26
4 Scenario Analysis: Future Scenarios can Significantly and Surprisingly Affect the Present Value  27
4.1 Discounted Cash Flow Scenario Analysis  27
4.2 Scenarios Affect Value  29
4.3 Flexibility Has Value  30
4.4 Conclusion  32

5 Future Outcomes Cover a Range of Possibilities: We Can Describe Uncertainties in Real Estate Using Probability Distributions of Possible Future Outcomes  33
5.1 Distribution of Future Outcomes  34
5.2 Quantifying Input Distributions  34
5.3 Distributions of Outcomes Differ from Distributions of Inputs  38
5.4 Flaw of Averages  39
5.5 Conclusion  40

6 Simulation of Outcomes: Simulation is a Practical, Efficient Way to Explore Uncertainty and to choose between Alternative Strategies for Managing it  41
6.1 Generating Scenarios  41
6.2 Real Estate Simulation in a Nutshell  42
6.3 Simulation Is an Efficient Process  43
6.4 Number of Trials  44
6.5 Conclusion  45

7 Modeling Price Dynamics: Using Pricing Factors to Model the Dynamics of Real Estate Markets  47
7.1 Pricing Factors  47
7.2 Random Walks  49
7.3 Real Estate Pricing Factor Dynamics  51
7.4 Conclusion  52

8 Interpreting Simulation Results: Target Curves and Scatterplots can be used to Graph the Distribution of the Sample Output  53
8.1 Target Curves  53
8.2 Comparing Target Curves  57
8.3 Value at Risk  57
8.4 Scatterplots  57
8.5 Conclusion  59

9 Resale Timing Decision: Analysis: Let’s See what happens when we apply the Tools of Flexibility Analysis to a Classical Investment Decision: when to sell the Property  61
9.1 The Resale Timing Problem  62
9.2 Extending the Time Horizon of the Discounted Cash Flow Model  62
9.3 IF Statements  63
9.4 Trigger Value for Stop-Gain Rule  64
9.5 Value of Example Stop-Gain Rule  64
9.6 Conclusion  68
10 Resale Timing Decision: Discussion: Let’s think about Additional Insights we can get from Simulation 69
10.1 Sensitivity Analysis 69
10.2 When to Use the Stop-Gain Rule 70
10.3 Implications of Flexibility for Property Valuation 71
10.4 Conclusion 72

11 Development Project Valuation: This Chapter Looks at Valuation of Development Projects From an Investment Perspective, Considering Uncertainty, Flexibility, and Time-to-Build 73
11.1 Time-to-Build Difference between Development Projects and Existing Assets 74
11.2 Lower Opportunity Cost of Capital for Construction Costs 75
11.3 Illustrative Example 77
11.4 Residual Value of Development Land 78
11.5 Investment Risk in Development Project 79
11.6 Conclusion 80

12 Basic Flexibility in Development Projects: The Most Basic Flexibility in Real Estate Development is the Option to Choose whether and when to Build 83
12.1 Review of Call (and Put) Options 84
12.2 Land as a Call Option on Development 85
12.3 Drivers of Option Value 85
12.4 A Practical Example of a Call (and Put) Option 86
12.5 Flexibility and Scenario Analysis for Development Projects 88
12.6 Conclusion 90

13 Option Dichotomies: We Introduce a Typology of Flexibility in Development Projects 91
13.1 Three Dichotomies for Thinking Generally about Development Options 91
13.2 Defensive versus Offensive Options 92
13.3 Options “On” and “In” Projects 93
13.4 Timing Options versus Product Options 94
13.5 Conclusion 94

14 Product Options in Development: We Discuss Three types of Product Options 95
14.1 Concept of Base Plan 95
14.2 Product Expansion Flexibility 96
14.3 Product Mix Flexibility 98
14.4 Conclusion 98

15 Timing Options in Development: Now we Turn to the Types of Timing Options 99
15.1 Project Start-Timing Flexibility (The Delay Option) 99
15.2 Project Production Timing Flexibility 100
15.3 Modular Production Timing Flexibility 102
15.4 Phasing Timing Flexibility 103
## Contents

15.5 Types of Phasing  103  
15.6 Recognizing Defensive and Offensive Options in Simulation Results  104  
15.7 Conclusion  107  

16 **Garden City: An Example Multi-Asset Development Project:** We Present the  
Traditional DCF Valuation Spreadsheet Model for the Example Development Project  
We use in the Rest of Book  109  
16.1 Overview of Multi-Asset Development Project  110  
16.2 Structure of a Realistic Multi-Asset Spreadsheet Pro Forma  111  
16.3 Cash Flows for the Example Pro Forma  113  
16.4 Temporal Profile for Base Case  115  
16.5 Expected Economics of the Garden City Project  116  
16.6 Conclusion  118  

17 **Effect of Uncertainty without Flexibility in Development Project Evaluation:**  
We Re-analyze the Garden City Project by Reflecting Uncertainty  
Without Flexibility  119  
17.1 Modeling Uncertainty for the Multi-Asset Development Project  120  
17.2 Generating Random Future Scenarios  122  
17.3 Outcomes Reflecting Uncertainty for the Multi-Asset Development  123  
17.4 Effect of Different Probability Inputs Assumptions  127  
17.5 Conclusion  129  

18 **Project Start-Delay Flexibility:** We Model the Value of the Most Basic and Widely  
Available Development Project Option  131  
18.1 Project Start-Delay Option  132  
18.2 Option Exercise Decision Rule  132  
18.3 Defining “Profit” in the Decision Model  134  
18.4 Value of Start-Delay Flexibility in the Garden City Project  134  
18.5 Conclusion  138  

19 **Decision Rules and Value Implications:** We Further Explore the Option to Delay  
the Project Start  139  
19.1 Simple Myopic Delay Rule  140  
19.2 Trigger Values  140  
19.3 Value Implications of the Decision Rules  141  
19.4 Effect of Trigger Values (Start or Delay Bias)  143  
19.5 Review the Meaning of Flexibility Value  145  
19.6 Conclusion  146  

20 **Modular Production Timing Flexibility:** We Explore the Timing Option  
to Pause and Restart the Project Any Time After its Commencement  147  
20.1 Modular Production Timing Flexibility  148  
20.2 Modeling the Modular Production Option  148  
20.3 Value of Modular Production Timing Flexibility  150  
20.4 Effect of Trigger Values (Bias toward Pause or Continue)  152  
20.5 Effect of Combining Start-Delay and Modular Production Delay Flexibility  154  
20.6 Conclusion  157
21 **Product Mix Flexibility:** This Chapter Presents the Option to Change Product Mix, and Examines the Effect of Volatility on Option Value 159

21.1 Product Mix Flexibility 160
21.2 Modeling the Product Mix Option 160
21.3 Value of Product Mix Flexibility 161
21.4 Effect of Combining Product Mix Flexibility and Timing Options 165
21.5 Effect of Correlation in the Product Markets on the Value of Product Mix Flexibility 167
21.6 Effect of Volatility on the Value of Flexibility 169
21.7 Conclusion 172

22 **Project Phasing Flexibility:** We Show How to Model and Evaluate the Delay Flexibility Inherent in Project Phasing 173

22.1 Modeling the Sequential Phase Delay Option 173
22.2 Modifying the Garden City Project Plan 174
22.3 Project Economics 177
22.4 The Delay Decision Model 178
22.5 Exploring the Value of Project Phasing Flexibility 179
22.6 Conclusion 182

23 **Optimal Phasing:** We Now look at Adding Phases, Delineating Phases, and Distinguishing them from Expansion Options 183

23.1 Effect of Increasing the Number of Phases 184
23.2 Principles for Optimal Phasing 186
23.3 What Is the Difference between a Phase and an Expansion Option? 190
23.4 Conclusion 191

24 **Overall Summary:** We summarize the Main Takeaway Points from this Book 193

Appendix 197
Glossary 213
Acronyms and Symbols 219
Index 221