# INTRODUCTION

Diploma project represents how start-ups ecosystem is constructed and considers why this kind of business is specific compared to already established businesses. The project mostly oriented to the valuation of start-ups and shows that traditional methods of valuing do not provide so much insights. The main purpose of my diploma project to compare start-ups with other types of businesses and provide the most flexible method of valuation so that investors and owners could come to the common agreement.

To realize my main purpose I am going to use a hotel industry, which belongs to the established business, as a comparision to the start-up company. According to my plan I'm going to reflect financial information of both to excel and try to simulate their future incomes and costs. All the simulated data will be shown with the usage of tornado and spider charts. With estimated forecasts to the future cash flows, I will be able to calculate expected Net Present Value of those companies. Having financial information, I will use 2 different methods of company valuation to established business and start-up, where in the result I will get a clear comparision of different types of businesses.

The diploma project is expected to describe the following sections:

1. Research Section;
2. Theory;
3. Methods;
4. Technical implementation;
5. Economic section;
6. Occupational health and safety section.

Now I would like to briefly explain the main idea of each section that were mentioned above. In the Research section, I determine what is a start-up and its advantages and disadvantages. This part describes what kind of problems it meets and why is it important to solve them at the initial stage of start-up. Additionally, I will specify to what kind of professionals, my diploma project will be beneficial.

The next stage of my project is called theory, where I am going to introduce the basis financial aspects of company structure, investments, company valuation.

The section methods considers the ways of company valuation. In this stage I'm planning to describe what kind of traditional ways of valuation exist and focus on new approaches of valuing and distinguish their advantages compared to traditionals.

The next section called technical implementation is the most important part of diploma project. In this stage I am going to reflect the theory in real numbers and run simulations. Based on generated data, there will be constructed a graph that will show us the full picture of this diploma project. Moreover, there will be explained how simulations are working, what formulas are used.

The economic section was based on estimations of human resources exploited in the given diploma project. Creating a software product as well as any other product, must be justified also from an economic point of view. In this section I described calculation of time necessary for creation of web-platform, calculation of payroll and cost of purchased IT equipment.

The occupational health and safety section describes the system of acts of law, social and economic, organizational, technical, medical and preventive arrangements and facilities, ensuring safety, preservation of health and human performance on the job.

The last part of the project will conclude about all argument for and against start-up valuation and its importance. Additionally, based on the simulated data and other estimation, I am going to make some predictions about start-up development in Kazakhstan.

# 1 RESEARCH SECTION

## Start-up definition

The term «start-up» I heard for the first time when I studied in the 2nd course. When I studied in the 2nd course, there was an organization called «Techgarden» that help to new start-uppers to promote their prototypes and find new investors for them. After that I got interested in this direction.

In our 21st century there are a lot of companies that started from almost nothing and rapidly reached the success and become well-known companies. People throughout the world are coming with the bright ideas, work on it and deliver the final innovative product to the society, which in the result will impact on it.

Of course, it is wonderful that some unknown people create such technological products and in the result become millionares, or even billionares. Before, such people start from zero and become rich, the majority of people had an opinion that it is impossible to reach such peaks and the only to be a rich guy is to born in a family of president or in a family of billionare. However, such people proved the opposite and the popularity of such type of business captured the attention of the whole world. Communities talk about start-ups, but the only thing that they know is that it can bring million dollars and they do not understand it even briefly.

There are a lot of formulations of start-ups and each of them sounds differently. According to Timmons and Spinelli (2008) start-up companies are raw companies that have an innovaitve idea that develops into a high-growth company. The success relies on strong leadership from the main entrepreneur and on building a team with complementary talents. Giardino et al. (2014) write that startups are newly created companies with little or no history facing high volatility in technologies and markets. The start-up ecosystem is difficult to predict, because it is dynamic and every time it forces managers to make quick decisions, avoid failures and find a market where their product will be demanded. Actually start-up could be a product that can significantly impact on society and they way we live. Nowadays all start-ups refer to the high-technology sectors, but it does not have to be. According to Giardino et al, the probability of failure of start-ups in first five years of existence is more than sixty percent. On the other side, if start-up will be successful, it can gain 10 times more than it was initially invested.

10x of the investment sounds spellbinding and when people earn such amount of money, it seems that it is so easy. Unfortunately, it is not. What we see on the front-side is only the final product, we just use and do not even try to think how it is working or how it was made, but not everyone realise what is going on the backside. On the backside, programmers think about the structure of the product and try to optimize as much as it's possible, so that it will work properly without crashes. Start-up owners spend massive amount of time to find out investors, who are extremely needed for them, because only money makes money.

The hardest part of job lies on the shoulders of company owners and promouters. They need to convince investors so that they will be interested and invest into project with hope that in future it will become a huge company and they will be part of it, and earn much more money than they invested. Although investors want to put their dollars into modern project, they will not invest immediately. Investors are very smart people and they know how market is constructed and in what way cash is flowing. When they are investing they are trying to take the biggest part of the pie. Owners of a new company do not want to give the major part of equity; otherwise they will lose control over company that they were building for a long time. Such situations come to the question of company valuation, so that each side will get a fair part. This is only a tip of the iceberg, but it enough to understand how difficult start-ups are made.

## 1.2 Problem statement

As it was mentioned before start-up is a new type of business and just like other businesses, it needs financing to realize their idea into product and then it will be promouted to the market. Compared to the old and established businesses, this type of entrepreneurship gain investment from business angels or venture capitalists(risk investors) and from friends and family (Brealey et al., 2011). However, outside investment will bring only small amount of money, because there is a lack of financial history and the business idea was not tested before. At this stage we can clearly see the root of disease of all start-up companies. Most of the good start-up companies cannot rocket, because investors are scared about their money and if there is a little loss, they want to take their money back by which they do not consider future potential. The problem of all investments is that all decisions are made today and right now. Traditional methods of valuation assume that the investment is an all-or-nothing strategy and do not account for managerial flexibility, the concept that management can alter the course of an investment over time when certain aspects of the project’s uncertainty become known (Dr. Jonathan Mun, 2006). Therefore, such kind of approach makes it more risky. Consequently, with the growth of risk, the number of investors will decrease, which in the result leave potential start-ups without financing.

This problem will cause a chain of other issues like how much of equity will belong to investor, what kind of shares he will own and so on. Of course, the whole entrepreneurship is all about negotiation and trading, but in order to negotiate in a particular question both side have to have the same knowledge, otherwise they will never come to common agreement. Therefore, all financial questions about start-ups spin around the problem of valuation.

## 1.3 Target group

Actually this project will be useful for business people and employees. In this ecosystem there exist 3 types: young specialists, investors, and company owners or entrepreneurs.

Founders are first people who will find it beneficial, because compared to investors and young employees, they need to understand their business as clear as its possible. Often, potential start-ups crash because of wrong financial management. Company owners are those people who make decisions and if their business fails, it is because of their management. Therefore, founders are primary target for my diploma project.

Investors are people who are interested in success of the start-up and being part of a team so that in the result it will bring much more money than it was invested. My diploma project is also targeted to investors, because they are part of the system that I’m creating. The diploma project considers the perspective of investors very carefully, because in the result there should be created a bridge so that founders could find a common language with them. The research will include the flexibility of investments, which will positively impact to the deals.

The last category of business ecosystem is young specialists. Usually business environment consider them as labor and they are those who just should do a job, but actually they should understand what they are doing and for what purpose is this. My project will help them understand the whole business environment so that they can see what role do they play.

# 2 Theory

## 2.1 Financial statement

When people talk about any business they only know about such things like revenue, cost and profit. Actually, the financial system of any company is much more complicated. Actually this part of job fully belongs to accountant, but both investors and owners must know how do money flow. Financial statement or report is a formal record for the financial activities and position of a business. Usually financial statement consists of 4 major parts:

* Balance sheet
* Income statement
* Cash flow statement
* Statements of retained earnings or equity statement

These 4 reports reflect the whole picture of the current business. Based on this data company owners or business analysts can figure out is business works properly, if not they can find out where is the problem. Moreover, relying on this financial information and analyzing the performance of the enterpise, businessmans can make predictions for the nearest quartal or year. These statements are the lifeblood of any company and understanding them is key to finding investment opportunities. Each of them will be described futher.

According to Investopedia, which is a world’s leading source of financial content on the web, balance sheet provides an overview of assets, liabilities and stakeholders' equity as a snapshot in time. The date at the top of the balance sheet tells you when the snapshot was taken, which is generally the end of the fiscal year. The balance sheet equation is assets equals liabilities plus stockholders' equity, because assets are paid for with either liabilities, such as debt, or stockholders' equity, such as retained earnings and additional paid-in capital. Assets are listed on the balance sheet in order of liquidity. Liabilities are listed in the order in which they will be paid. Short-term or current liabilities are expected to be paid within the year, while long-term or noncurrent liabilities are debts expected to be paid after one year.

The next financial report is called income statement. Unlike the balance sheet, the income statement covers a range of time, which is a year for annual financial statements and a quarter for quarterly financial statements. This type of financial report provides an overview of revenues, expenses, net income and earnings per share. It usually provides two to three years of data for comparision. The structure of income statement is broken into several parts:

* Income from continuing operations
* Results from discounted operations (if any)
* Extraordinary items (if any)
* Cumulative effect of a change in accounting principle (if any)
* Net income
* Other comprehensive income
* Earnings per share information

The most important part of income statement is income from continuing operations, which includes sales or revenue, cost of goods sold, operating expenses, gains and losses, other revenue and expense items that are unusual or infrequent but not both, and income tax expense.

One of the important financial report is called cash flow statement. This type of financial report summarizes the amount of cash and cash equivalents entering and leaving a company (C.B.Murphy, 2018). The cash flow statement (CFS) estimates how well a company manages its cash position, which means that does company generate enough cash to pay it's debt obligations and operating expenses. In fact, this type is complementary for the balance sheet and income statement, but it is mandatory for any company's financial report. Even though it is like an addition to the previous statements, it has its own specifics. This report allows investors to understand how company's operations are running, where its money coming from, and how money is being spent. On the other hand, it can be used by creditors to determine how much cash is available (referred as liquidity) for the company to fund its operating expenses and pay its debts (C.B.Murphy, 2018). The main components of the statement are:

* Cash from operating activities
* Cash from investing activities
* Cash from financing activities
* Diclosure of noncash activities

Usually the last activity is sometimes included when prepared under the generally accepted accounting principles, or GAAP. Compared to balance sheet and income statement, cash flow statement's specifity is that it does not include the amount of future incoming and outgoing cash that has been recorded on credit (C.B.Murphy, 2018). For example, if somebody bought your product partly, which costs $200, and paid only $100 in income statement it will be recorded as $200, whereas in cash flow it will be recorded as $100. Therefore, this statement is called cash flow statement, because with cash the person paid only $100.

The last part of financial report is statement of retained earnings or equity statement. Equity statement outlines the changes in retained earning for a specified period. It reconciles the begining and ending retained earnings for the period, using information such as net income from the other financial statements. Retained earnings can refer to any any profits made by an organization that it decides to keep for internal use. Additionally, it can be referred to as retained profit, accumulated earnings or accumulated retained earnings. The main purpose of this financial report is to improve market and investor confidence in the organization. It is used like a marker to help analyze the health of the organization.

## 2.2 Investment decision and its valuation

The background of any company are their real assets, which can be used to provide goods and services that are sold to the customers. In our 21st century the bright example is a computer, which is used by different kinds of specialists to print the documents, send emails, create websites and so on. In this ecosystem the decision to purchase a real asset is usually called investment decision. When the company makes many investment decisions to buy real assets during the period is called capital budgetting or capital expenditure (CAPEX) decisions (O.A.Leskisenoja, 2015).

All real assets have their costs and in order to get them, companies finance their investments through financial assets or securities. For instance, it can be bank loans, corporate bonds or stocks to stockholders. With money that has been gathered from investment, company can buy either tangible assets – things that we can see and touch – or intangible assets – for example, company can spend money to do research and development (R&D) (O.A.Leskisenoja, 2015, p.13). The bright example of R&D is a biochemical company's decision to figure out possible results and after that make final decision. Such investment decisions are also included into capital budgetting.

There should be a difference between investment decision and financing decision. Investment and financing decisions are similar to strategy and tactics. In this case, investment decision is a strategy that is for looking for the long-term period purposes, whereas financing decisions are tactics, which is part of strategy and it answers to question how to and they are done in short periods. For instance, investment decision is to buy computers, then to do it company need money and they find it by borrow money from banks (debt financing) or raise money from present or future stockholders (equity financing), which is a financing decision.

However, when money come from outside they are not free and any company has to repay those money to banks, bondholders or as dividend or stock repurchase to stockholders at certain period of time. When company get money it will be spent on financing for the investment decision, but the future income may come one year or even later. It is obvious that to realize the investment to earn money need some time. Therefore, manageres have to plan the financing so that the company remains viable in the period between investment and revenue (O.A.Leskisenoja, 2015, p.13). If this part will be managed wrongly, the company will have delays in paying salaries or buy resources for productions. In wrost case, the company can bankrupt and all the investments will not realized. The consequences of managers' decisions may be crucial, which means that they to come to this problem responsibly and seriously. These people should think whether the is asset is necessary and how effective it will be for production.

The main purpose of any entrepreneurship of any size is to generate profits as much as it is possible. Company owners are trying to steer the company so that the return on equity (ROE) is as high as possible in both the short and long term. Therefore, to reach this they have to invest in real assets that are worth more than they cost. (Brealey et al., 2011). As it was mentioned asset can worth, not cost. However, there is a question what is the value of those assets.

The question of valuation is extremely important. Today we have different kind of products like gold, silver, paper, pencil and etc., which have own price that can be taken directly from existing markets. Unfortunately, such intangibles like research and development or company equipment, which can bring much more money than it costs, is another story. When company is operating there arise a lot of questions, whose answers are only partial with some probability. Mostly, those questions are more futuristic like: how many people will purchase our product in a year, will there be a devaluation of dollar or not, will the costs of salaries change in nearest five years or not? An investment valuation has to be carefully considered to answer questions that are written above. Of course, it is impossible to calculate the valuation in exact numbers, because things are changing everyday and anything could happen, but there should be an approximate evaluation of investment’s worth.

# 3 Methods

## 3.1 Traditional methods

Looking from financial perspective, value is defined as the single time-value discounted number that representative of all future net profitability. Economists distinguish the terms «value» and «market price», and they are not the same. Market price of an asset may or may not be equal to its value. The idea of valuation is to determine the price that closely resembles the true value of an asset (Dr. J. Mun, 2006). There are a lot physical, non-physical, intrinsic, or intangible aspects that can influence on the true value of an asset. Traditionally, there distinguish 3 methods of valuation, which are:

* Market approach;
* Income approach;
* Cost approach.

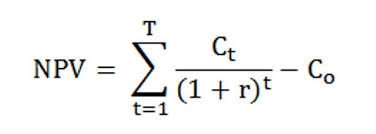
First approach considers the comparable asset in the marketplace and its prices. This method is called market approach, because the value of the asset will be determined by the supply and demand. So that by the law of supply and demand the value of the asset will be force to the equilibrium. It is further assumed that the market price is also the fair market value after adjusting for transaction costs and risk differentials. Sometimes a market-adjustment is warranted to bring the comparables closer to the operating structure of the firm whose asset is being valued. These approaches could include common-sizing the comparable firms, such as performing quantitative screening using criteria that closely resemble the firm’s industry, operations, size, revenues, functions, profitability levels, operational efficiency, competition, market, and risks (Dr. J. Mun, 2006).

The next method is called income approach. Proceeding from the name of the approach, this method focuses at the future potential profit or free cash flow generating potential of the asset and attempts to quantify, forecast, and discount these net free cash flows to a present value. The cost of implementation, acquisition, and development of the asset is then deducted from this present value of cash flows to generate a net present value. Often, the cash flow stream is discounted at a firm- specified hurdle rate, at the weighted average cost of capital, or at a risk-adjusted discount rate based on the perceived project-specific risk, historical firm risk, or overall business risk.

The last method called cost approach, works similarly to the income approach. The key word is a “cost”, therefore this way of valuation consider the cost a firm that would incur if it were to replace or reproduce the asset’s future profitability potential including the cost of its strategic intangibles, if the asset were to be created from the ground up. Although the financial theories underlying these approaches are sound in the more traditional deterministic view, they cannot be reasonably used in isolation when analyzing the true strategic flexibility value of a firm, project, or asset.

## 3.2 Discounted cash flow

The traditional valuation methodologies that were described above are based on the Discounted cash flow (DCF) method. It is used to estimate the attractiveness of the investment opportunity. According to the information provided by Investopedia, DCF analyses use future free cash flow projections and discounts them, using a required annual rate, to arrive at present value estimates. A present value estimate is then used to evaluate the potential for investment. The difference between present value and investment is called Net Present Value (NPV), and if NPV is positive, then it means that there may be a good opportunity. The formula for NPV is futher:



Where: t – year, Ct – is cash flow for year t, C0 – initial investment, r – discount rate.

The main purpose of DCF analysis is to figure out will investor gain money from his investment, adjusted for time value of money. The reason for discounting future money for the present time is that value of money devaluate over time. The time value of money is the assumption that a dollar today is worth more than a dollar tomorrow, because prices of goods and services increase and so on. Knowing this information, we can consider a simple example. Suppose that we have 2 choices:

1. Get 100000 dollars today
2. Wait 5 years and get 150000

Fortunately, we know the formula and let's consider the discount rate about 10%.

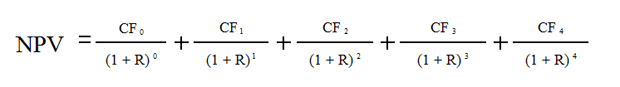
150000/ (1+0.1)5 = $ 93135, which is less than $ 100000.

Therefore, choice A is much better, because 150000 after 5 year will worth only 93135. That was the basic concept of discounting and for investment it work in the same way.

The concept of NPV is also going to be explained with the following example. For instance, we have 2 different projects and their future cash flows look like this:

|  |  |  |
| --- | --- | --- |
| Year | Project A | Project B |
| 0 | (10'000) | (10'000) |
| 1 | 5'000 | 1'000 |
| 2 | 4'000 | 3'000 |
| 3 | 3'000 | 4'000 |
| 4 | 1'000 | 6'000 |

Numbers in square brackets are our investments and we consider them as negative income. Here come the question: Which of this projects is more attractive. If we sum up all future incomes of both projects, we can notice that project B's revenues is greater by 1'000, but the question is which of them is more attractive for investors. What can do is to use the NPV formula and figure out which of these projects is more attractive.



Project A:

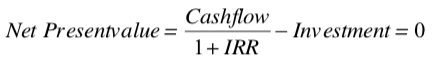
NPVA = 788,2

Project B:

NPVB = 491.5

We see that Net Present value of both projects are positive, which means that investors can invest on both of them, but it is more attractive to invest into project A, because it’s NPV is higher. Initially we saw that future cash flows of project B was greater by 1’000, but at this time we didn’t consider the fact that denominator’s power is increasing over the time. That’s why the sum of discounted cash flows of project B was less.

Of course, there used only final numbers and with them it is much easier to put everything into formula and get the answer. The main problem is to find those final numbers or estimate it as close as it is possible. NPV approach is widely used throughout the world and 75% of firms confirm it. The additional part of NPV is called Internal Rate of Return (IRR). The formula of IRR looks like this:



Mathematically, it is the same formula for NPV, but in this case the unknown variable become discount rate, which in this example is called Internal Rate of Return (IRR). Actually, IRR is rate at which all future cash flows will be equal to initial investment and NPV will be equal to zero.

## 3.3 Real options valuation

Even though discounted cash flow approach is relatively simple, widely taught, widely accepted, it has some several problems. Traditional methodologies based on the discounted cash flow approach does not get at some of the intrinsic attributes of the asset or investment opportunity. According to the criticism of Dr. Jonathan Mun is that traditional methods of valuation assume that the investment is all-or-nothing strategy and do not consider the managerial flexibility. Those methods work properly if the whole business is carefully planned so that business people considered all possible outcomes and the plan is perfect. Unfortunately, nobody cannot predict the exact prices of shares of Apple for tomorrow not to mention far five years.

Of course, there are mature businesses that come from old times and the pratice showed all possibles outcomes so that it became much easier to predict and estimate. The bright examples of such entrepreneurships are hotels, restaurants, cafes, grocery stores and so on. As these businesses exist for a long period of time, there made many researches so that people learned how to perform it. However, the world does not stay in the same place, it is chaning and there creating different invention, which in the result create new businesses and new jobs. There are many industries, which require different researches to create new product. They are:

* Automobile and manufacturing
* Computers
* Airline
* Oil and Gas
* Pharmaceutical Research and Development Industry
* High-tech and e-Business

The main point is that these industries are new and modern. Of course, we can learn from practice by making mistakes and only then understand, but the fact is that these mistakes will cost huge amount of money and we don't have it. These industries researchs refer to the VUCA model. VUCA is the abbreviatioin, where:

V – volatility is the quality of being subject to frequent, rapid and significant change. In a volatile market, for example, the prices of commodities can rise or fall considerably in a short period of time, and the direction of a trend may reverse suddenly

U – uncertainty is a component of that situation, in which events and outcomes are unpredictable.

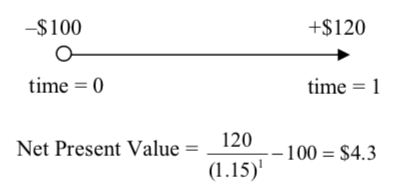
C – complexity involves a multiplicity of issues and factors, some of which may be intricately interconnected. (Some models also include chaotic, making the acronym VUCCA.)

A – ambiguity is manifested in a lack of clarity and the difficulty of understanding exactly what the situation is.

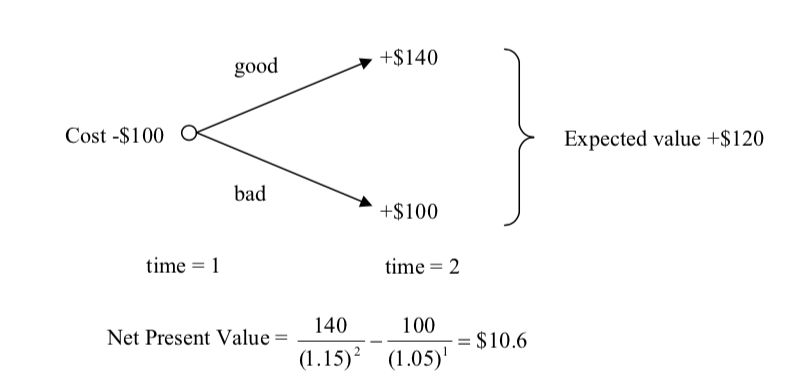
In entrepreneurship survive those who are ready for changes and have a flexible business model. Managerial flexibility, that were mentioned above, can change the course of investment if something goes wrong in initial plan by which reduces the risk of waste of the money. When old methods are not working we need a new generation of strategic decision analytics, namely **Real options** analysis.

First thing that we need to mention is that this approach is not an equation or a set of equations. In fact, 50% of the value of real option is simply thinking about it, 25% is about generating models and the last 25% is explaining the results and insights to senior management. Additionally, new approaches come from the olds. Therefore, it does not mean that traditional approaches are wrong. Actually, they are not complete, because it does not work on all types of the businesses. This new way of analytics uses the same NPV equations, but it just makes it more flexible. The key word of this type of valuation is an “option”. Option is a financial instrument, which you the right, but not the obligation to buy or sell financial assets like stocks or bonds. Compared to just an option, real option considers the real project, which is called underlying asset. As it was mentioned before, with traditional discounted cash flow approaches investor makes a single decision with fixed outcomes, and everything made in the beginning so that there is no ability to change or develop over time. The strategy of real options is different, because it takes into account multiple decision pathways. Over the development of the project there can be added some corrections if the initial plan start going in wrong direction. Multidimentional dynamic series of decision provide a flexible management, which helps to the project to adapt a change in the entrepreneurship ecosystem.

Let's consider some example, suppose that there is a project which requires $100 of investment and there is a prediction that after one year future cash flow will be $120. Let's suppose that weighted average cost of capital (WACC) is 15% and it will be used as a discount rate for this example.



We see that NPV is positive and the project is likely to be good (used DCF method). Let's suppose that these prediction is correct, but there was a probability that income could be less than even $120. If we put all $100 at initial time and after one year cash flow become about $100, then the NPV would be negative, which means that project does not have a future. If we had an option to wait and gather data about market and demand, then the risk of losing money will be a little.



During this period of waiting, investor made a research and after one year it become clear that demand was high, then the investor can put his money into project. Notice that now time stars from 1, which means that the investment provided after one year. Moreover, the value of NPV this is higher than it was before at t0. However, for this option invetors has to pay some amount money, which is called cost of the option. In this case investor buy a call option for waiting one year and if the demand will be as it was predicted before, then he has a right to put money into this project. Also, we can notice that $100 investment is discounting at 5%, which is usually accounted as risk-free rate. Usually, it is not considered because investments are made at time zero so that (1.05)0 gives one. Theoretically, risk-free rate is some kind of safe investment. In the example with options it is accounted, because investor waited a year and made some research by which he reduced the risk of losing money. Also, he is investing at t = 1, and when in formulate it will be used. Because of the discounting of investment by 5%, 100 becomes about 95, which in the result increased the Net present value by these 5 dollars. Actually, each percent plays an important role when it comes to its absolute values. For 100 dollars 5% is like drop of water, but when it comes to millions or even billions, even 0.1 percent can bring a lot of money.

# 4 Business modulation and simulation

## 4.1 Established business case

### Real estate business description

Now we are moving to the details of the theory that was introduced above. As an example of a established business, I am going to consider the business model of Real estate. The principle of this type of the business is the simpliest, it is about of buying, selling or renting real property. Actually this business is the most popular way of earning money, because it takes less risks. Less risks doesn't mean that this way of earning is a guaranteed method, because any kind of business is all about taking risk into account. However, compared to such businesses like start-ups, things are more predictable. Logically if risks are low, it means that profits are respectively less. Therefore, to make a lot of money people focus on the quantity, so that they are buying or selling many real properties. If we look from the relative perspective, from one property they make only little amount money, but increase in its quantity will bring much profit.

There are several reasons for putting money in real estate:

1. The most obvious reason is when buy a home or flat at right time for right place is some kind of leveraged investment. For long-term period price of your property will increase and in return you will much more than your invested.
2. For people who own a home they get a tremendous tax advantage. Tax is a cost, and if costs are low, it leads to the maximization of profit.
3. For people who plan properly and own home or flat and rent it, for them their costs of living will be canceled by those who were paying for this rent.

The fact things are predictable is very attractive espesially for people who millions or even billions. For investors this business offer a stable source of profit. The majority of profit comes from leasing the property, which is less volatile than capital returns. Historically this type of the business showed relatively strong returns for investors.

People are following simple principle «buy low, sell high» and the difference is your profit. If we look back in 20 years, there was a time when flats cost for $5000 dollars or even less. Today on average those appartments cost for $90000 depending its location and meter squares. If we move back to 20 years and buy more than 10 flats at $5000 and sell them today. We would earn 18 times more than we invested and here we didn't account that during this period of time we could rent those appartments. Accounting the rent plus having a job, we would secure ourself for the next 20 years taking into account inflation rate and currency devaluations. Additionally, to start such business is not so difficult. Of course, there is a question: “Where can we find investment?” This question can be answered and the major part of investment is leveraged. About 80% of the price property is financed with debt.

The advantage of this type of the business is that its financial structure is also simple. We need to know such few things like income, expenses and cash flow.

As it was said before with real property we can sell, rent or buy. Actually we can money only from selling and renting it. For example, we have a rental house, which we rent for $1000 per month and 25$ for garage. Our income per month is $1025. Expenses are things that cost money from our house. For instance, it could be the loan from bank, paying for garbage, electricity, water, and gas. Of course, there listed not all possible expenses, but actually it is clear that expenses are cost to produce a house so that it will be demanded. Cash flow is the same as profit; it is the money that left after all expenses subtracted.

Above was a basic example of real estate so that it will be easy to understand the principle. However, not only individuals operate in this business. Considering this from the perspective of a company, this business becomes more complicated when it comes to the financial indicators. Here we have an example of real estate, which operate in big amounts. The main purpose of this example is to calculate the valuation of соmmеrciаl prоpеrtу аnd tо dеtеrminе thе finаnciаl fеаsibility оf аn investmеnt in thе subjесt property fоr a 10-yеаr hоlding pеriоd. In analysis, here made some assumptions and the impоrtant of them are Net Operating Income assumptions, such as annual gross rent, vacany and collection losss factor and operating expenses and the capital rate at purchase. Valuation of real estate uses 2 factors, which are net operating income (NOI) and the capital rate. NOI is equal to the gross rent roll minus vacancy and collection losses and operating expenses. Cap rate is the division of NOI to the sale price. We can see it on the formula

In table we can see the following assumptions for the project:

|  |  |
| --- | --- |
| Assumptions | |
| Annuаl grоss rеnt, first yеаr | 182400 |
| Vаcаncу аnd cоllеctiоn fаctоr | 5% |
| Оpеrаting еxpеnsеs, first yеаr | 55540 |
| Annual % in change in rent | 3% |
| Annual % in change in expenses | 3% |
| Loan to Value ratio | 75% |
| Stated annual interest rate | 6% |
| Loan term years | 25 |
| Percent of price in improvements | 85% |
| CPI Annual Increase | 3% |
| After tax, Real Discount rate | 8% |
| Cap rate assumed at date of sale | 8% |
| Transaction costs as % of sales price | 9% |

From those assumptions, we are going to calculate economic values such as loan amount, equity required, and mortrage loan constant. The important factor is cash flow for 10 years. In example, there provided a cash flow for 10 years, where year 0 is negative, because it is accounted as an initial investment. Initial investment is the difference between property valuation and loan amount. It is mostly referred to the balance sheet, where initial investment is equity, loan amount is liability and in sum it gives propert valuation, which is an assets.

As our project is about valuation, the important financial term is Net present value of real cash flow. Fortunately, this business shows a positive NPV, which means that this business has future.

The example was not complete, because there is no any simulations, what-if and sensitivity analisys. What I have done next, for input variables I divided into 3, which are low, base and high. It is done in this way, because usually such variables like loan to value ratio, discount rate, gross rent and others can vary. All this variables will be simulated with beta-distribution. Beta distribution requires only 3 inputs, which are in our case low, base and high. In order to make simulation, we need to make that inputs could vary randomly in some range between its low and high values. Formulas for beta distribution are following:

The most important of them to calculate beta distribution are alpha and beta. In excel, we have a ready formula that can compute the results for beta distribution. From beta distribution we can get the transformed estimate value of an input, which varies from its low and high values.

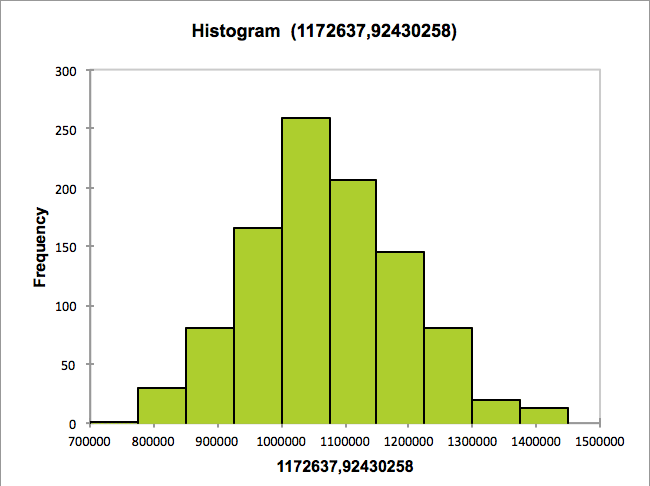
When values are changeable, it means that our output, which is Net Present Value will vary also. From these we can run it for 1000 times and get 1000 possible outcomes for NPV of this project, which is our simulation. From 1000 outcomes of NPV we can see how things are changing and in what way. The simulation of NPV is done the usage of analysis tool in Excel. With its usage we can get the descriptive statistics, which will get all the outcomes and from them calculates all the results of the normal distribution such as mean, standard deviation, range, minimum value, maximum value, relative frequency and so on. Moreover, data analysis tool in Excel can provide a diagram for these outcomes of NPV. It can create a historam of the norlam distribution and cumulative dataset. This tool is good, because analyst can visually see the distribution and the range of Net present values. These are the values that I got:

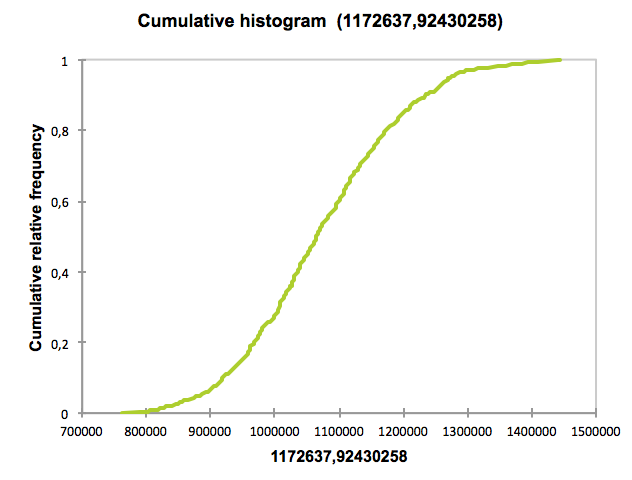
* From Descriptive statistics:

|  |  |
| --- | --- |
| # Of observations | 999 |
| Minimum | 763 497,45 |
| Maximum | 1 445 343,48 |
| Range | 681 846,03 |
| 1st Quartile | 985 581,47 |
| Median | 1 064 603,10 |
| 3rd Quartile | 1 152 772,66 |
| Sum | 1 070 969 276,10 |
| Mean | 1 072 041,32 |
| Variance (n) | 14 556 727 965,67 |
| Variance (n-1) | 14 571 313 865,44 |
| Standard deviation | 120 651,27 |
| Standard deviation (n-1) | 120 711,70 |

* From histogram:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Lower bound | Upper bound | Frequency | Relative frequency | Density |
| 700000 | 775000 | 1 | 0,100% | 0,000 |
| 775000 | 850000 | 29 | 2,903% | 0,000 |
| 850000 | 925000 | 81 | 8,108% | 0,000 |
| 925000 | 1000000 | 166 | 16,617% | 0,000 |
| 1000000 | 1075000 | 259 | 25,926% | 0,000 |
| 1075000 | 1150000 | 206 | 20,621% | 0,000 |
| 1150000 | 1225000 | 145 | 14,515% | 0,000 |
| 1225000 | 1300000 | 81 | 8,108% | 0,000 |
| 1300000 | 1375000 | 19 | 1,902% | 0,000 |
| 1375000 | 1450000 | 12 | 1,201% | 0,000 |
|  |  |  |  |  |





That was a part of running simulations, which is also not enough. The next part of the analysis is to see how sensitive outcome for a slight change in some variable. This part of the analysis is called sensitivity analysis. This analysis considers two diagrams, which are tornado and spider charts.

Below we can see the tornado chart, which was computed with usage of SensIt 1.40 tool. This chart represents how change in variables are effect on the the outcome of Net Present Value.

After sentivity analysis we can start the valuation part. As it was mentioned before, we have 2 approaches of valuation, which are Discounted Cash Flow (DCF) and Real options. DCF is already done by calculations, which means that we don’t need it there. The most important part of the project is to consider the Real Options.

In project, I am going to use an option to wait one year and see how the demand is going to change.