

eFinancialModels

FINANCIAL MODEL CASE STUDY

Fund Buying Distressed Real Estate: Financial Model Case Study

How we developed a sophisticated financial model for a private real estate fund that buys distressed properties, assets bought below their potential value

A fund that buys a distressed property pays a discount, but the discount is not the profit: time, legal cost and works take their share, deal by deal. The financial model shows a closed investor group and its co-investing manager which deals earn their keep, what each property earns and when cash comes back, not only the fund as a whole.

KEY TAKEAWAYS

- Investor questions: what return can be expected, what can go wrong, which deals are profitable on their own, when cash comes back, and what the investors and the co-investing manager each earn.
- Business model: the fund buys at a discount, resolves the problem and sells at a fair price. The discount is not the profit, because time, legal cost, works and tax take a share.
- What mattered: returns per property, the time and cost of each route to resolve a property, net returns after costs and tax, and the manager's performance share had to come from one integrated model, so that investors could test the plan before committing capital.
- Turning point: a fund-level IRR (internal rate of return, the annual return on the cash invested) blends all deals, so the model works per property and the fund and investor views are rolled up from it.

At a glance

INDUSTRY	Real estate, fund buying distressed properties
CLIENT	Private real estate fund; a closed group of investor companies, with the manager co-investing
PURPOSE	Explain the fund's business model to investors, judge each deal on its own and show the range of returns through scenarios
MODEL SCOPE	Resolution routes, property schedules and budgets, fund and investor cash flows, multi-tier profit share, taxes, segments, scenarios
DELIVERABLES	Financial model

The situation

Distressed assets are properties that are vacant, in default, in foreclosure or in need of repair, so they can be bought below their potential value. The fund buys them for that gap: the model prices the discount to value, the cost and time to repair or resolve each asset, and the resale or rental exit. A private real estate fund, with a closed group of investor companies and a manager who co-invests, planned to buy a portfolio of residential and commercial properties whose occupiers had defaulted on their loan repayments. Each property had to be resolved, through negotiation with the occupants, arbitration, legal process or re-letting, and then sold at a fair price rather than in a fire sale. Some needed capital works first. The fund asked for a financial model.

What was at stake: What investors want to know before they commit

What return can we expect? What can go wrong, and how long until cash comes back? Which deals are profitable on their own? What does each investor earn, LP (limited partner) or GP (general partner, the manager), and when does the manager's performance share start?

How a fund makes money buying distressed real estate, and where the model comes in

The fund buys a distressed property, resolves the problem and sells. The model shows how much of the gap between purchase price and potential value is left after time, legal cost and works, so each step is a modelled assumption.

1 Buy
The fund buys a distressed property, priced below its potential value for the problem it carries.

2 Resolve
Negotiation or settlement with the occupant, arbitration or legal process, each with its own time and cost.

3 Re-let or improve
Some properties are re-let; some need capital works before they can be sold.

4 Sell at a fair price
Waiting avoids a fire sale, but running costs and tax keep accruing.

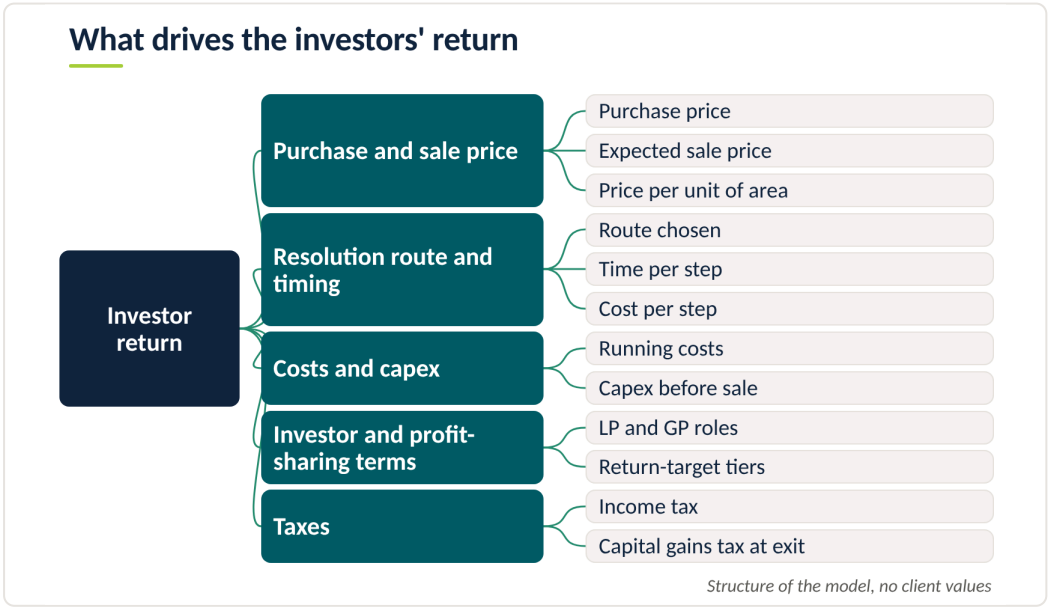
5 Share the profit
Cash after costs and tax is paid out; the manager earns a performance share by return targets.



Illustrative schematic: how a fund makes money buying distressed real estate (no client figures).

What drives the value?

Five driver groups decide what investors receive from a deal in a distressed property: purchase and sale price, resolution route and timing, costs and capex (capex), investor and profit-sharing terms, and taxes. The groups are not ranked. Price sets the starting discount, the route and its timing set how long capital is tied up, costs and capex reduce the gap, the investor terms split what is left, and taxes apply at the property and at exit.



Driver tree of the investors' return: five driver groups, not ranked (no client values).

What made it hard to model?

1 Profit and return for every property

DIFFICULTY "What return can investors expect, deal by deal?" A fund-level IRR blends all deals, so strong deals mask weak ones.

OUR SOLUTION We built a schedule per property for rent, costs and sale, giving profit and return per deal, then summed to the fund.

2 Pricing each route to resolve a property

DIFFICULTY "How long and how costly is each route, and what can go wrong?" Negotiation rounds with the occupants, arbitration and legal process each take time, cost and legal risk.

OUR SOLUTION We gave each step of the management process its own timing and cost, feeding the property's cash flow.

3 Settle, re-let, improve or sell

DIFFICULTY "What is the fallback if the preferred route fails?" Each route has its own assumptions and costs, and some properties need capital works (capex) first.

OUR SOLUTION We built each strategy with its own assumptions, costs and optional works in one property structure, so routes and the fallback compare on one basis.

4 Costs and taxes, property to fund

DIFFICULTY "What is left for investors after running costs and taxes?" Property costs, fund management costs, income tax and capital gains tax at exit arise at different points.

OUR SOLUTION We modelled each where it arises, per property or for the fund, so returns show after costs and tax.

5 Investor roles and the manager's share

DIFFICULTY "What does each investor earn, and when? What if one joins only selected deals?" The manager co-invests, with own money at risk, and earns a performance share when return targets are met.

OUR SOLUTION We separated LP and GP investors, routed each property's cash to the investors in that deal, and built a multi-tier profit share by return targets.

6 Market rates, portfolio mix and budget control

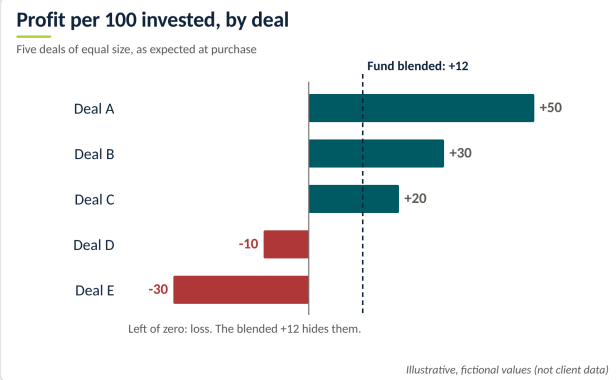
DIFFICULTY "Are prices in line with the market, and is each property on budget?" Properties differ in size and type, and overruns show early only with a budget per property.

OUR SOLUTION We compared price per unit of area with market rates, tagged each property by segment, and built a budget per property with actual costs, rolled up to the fund plan.

THE TURNING POINT

From one fund figure to a return per deal

A fund-level IRR can be calculated, but it blends every deal and does not show which deals are profitable on their own. The model therefore works per property, each with its own schedule, budget and return. Fund and investor views are rolled up from these, so each deal is judged on its own and only likely-profitable deals are added.



Illustrative, fictional values (not client data): profit per 100 invested in five equal deals.

What the scenarios can show: a weaker, a planned and a stronger path for a property

Weaker path, for example
Settlement fails; the legal route and a longer hold add time and cost. Once resolved, the property is re-let and sold at a fair price, not in a fire sale.

Planned path, for example
The expected route and timing hold; returns show per property, for the fund and for each investor.

Stronger path, for example
Settlement comes sooner, rent starts earlier and the sale follows sooner; less time and cost leave more of the discount as profit.

Why time matters as much as price

The discount does not decide the return alone. The same sale price, reached two years later after a larger legal cost, can cut IRR from about 15% to about 3% in our illustrative example. Carrying time and cost per route shows investors this before they commit.

What we built

INPUTS

- Purchase and expected sale prices
- Resolution routes: timing and cost
- Rent, costs and capex per property
- Investor roles and profit-share terms
- Tax and fund cost assumptions

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CALCULATION MODULES

- Resolution steps per property
- Property schedules and budgets
- Fund cash flow and costs
- Investor layer and profit share
- Taxes, segments and scenarios

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OUTPUTS

- Profit and return per property
- Fund and investor cash flows
- Budget against actual
- Portfolio split by segment

How we worked together

Step 1

Discussion

We analysed the fund's strategy, the route from purchase to sale and the investor structure, then discussed the questions investors will ask.

Step 2

Plan

We set the structure: a schedule per property, with fund and investor layers rolled up from it, and scenarios run through them.

Step 3

Build the model

Built the property schedules and fund layer, then the LP and GP investors, co-investment and multi-tier profit share.

Step 4

Scenarios and reporting

Added taxes, budget against actual, segments, scenarios and reporting.

What came out of it?

The investor group and the manager can show the range of returns to expect, judge each deal on its own, see the time and cost of each route to resolve a property, and read each investor's cash flows and the manager's share.

- Scenarios across property, fund and investor levels, set up to show the range of returns to expect.
- The time and cost of each route to resolve a property, set as assumptions per property.
- Each property's actual costs against budget, and prices per unit of area against market rates.
- Profit and return per property, rolled up to the fund, so that only deals likely to be profitable need be added.
- Cash flows and returns for each investor, LP or GP, in all or selected deals, and the manager's multi-tier performance share tied to return targets.

Lessons for funds that buy distressed real estate

1. Start from the smallest unit a decision is made on. A fund return averages deals; a property schedule shows each one.
2. Show the range, not one number. Scenarios tell investors what can go wrong before they commit.
3. Choose depth or reading speed. Full statements give more ratios; a direct cash-flow view reads faster. This client preferred the direct view.

Questions your model must answer

1. What return can investors expect, and how wide is the range?
2. What can go wrong, and what is the fallback if a settlement fails?
3. Which deals are profitable on their own, and which should not be added?
4. How is the money deployed, and when does cash come back to investors?
5. How long and how costly is each route to resolve a property?
6. What is left after running costs, fund costs and taxes?
7. What does each investor earn, LP or GP, and when does the manager's share start?
8. Is each property on budget, and are prices in line with the market?

Client details are anonymised to protect confidentiality. Charts, schematics and worked examples are illustrative and contain no client data.

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