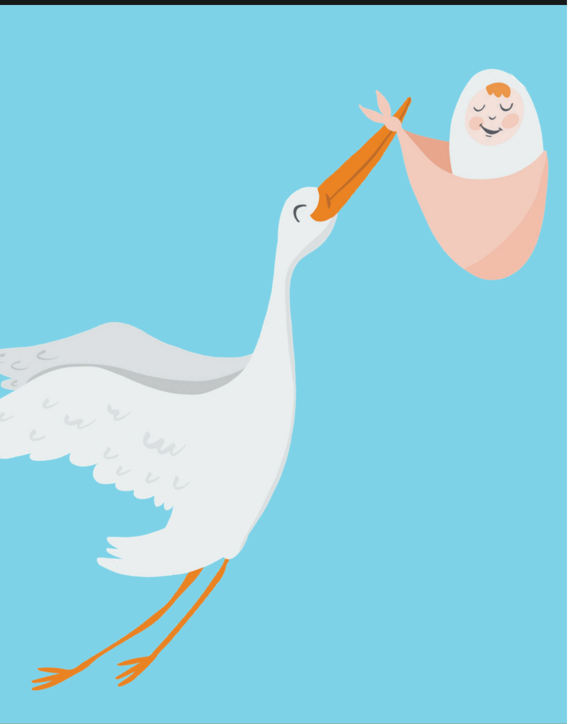
Beware the Claw



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I find newborn infants interesting. They seem to appear with little personality and a case of sheer exhaustion, presumably due to the rigors of their recent journey. They spend most of their time sleeping or crying and apparently pining for a return to the warm safe place from whence they recently emerged. As such I've previously been one of those people who finds the little ones far more appealing once they become mobile and start to develop a personality. In the case of our 3 year old granddaughter that would be very mobile and some personality indeed! We love her dearly but after a day with dear Harper the managing director seems to require more wine and valium than might otherwise be good for her. I exaggerate for effect of course......................

The recent arrival of our first grandson caused me to reassess this apparent ambivalence. Given the happy news in the middle of the night I found myself having a little cry and feeling very odd indeed. It turns out I'd been quite anxious about the whole thing and the sheer relief of knowing the little guy had landed safely made me quite emotional. Must be getting soft in my old age but I digress.

Of course, we visited the hospital the next day and there was much oohing and aahing. The MD was immediately smitten, and I must confess having a nurse was pretty special. However, there's only so much time one can spend in a hospital room before the mobile devices sneak out and it's back to work. This, of course, is an error. As soon as the MD observed that my attention was not 100% focused on the new arrival I was left in no doubt of my transgression.

"What the hell could you be doing that's more important than spending time with your new grandson? Have you no sense of the occasion? What is wrong with you?"

"Well dearest, I'm working on a deal that includes clawback and claw forward provisions and the calculation of those numbers is doing my head in. I'm just trying to write something that might help me make sense of it all."

"Claw!…I'll give you claw if you don't put that iPad away right now and pay attention to this baby."

And so, dear readers, I approach the claw with trepidation, fear, loathing and a certain sense of impending calamity. But, as one who enjoys opening Pandora's Box just to observe the mayhem here goes !

Management rights are bought on a verified net profit. That net profit is made up of a body corporate salary and income from providing letting services. The letting service income is predominantly driven by the number of units in the letting pool, the configuration of those units and the occupancy and tariff that those units can generate. This combination of occupancy and tariff is often referred to as REVPAR – Revenues per available room. It is possible to calculate exactly how much each unit in the letting pool makes for the manager. Given that calculation it is then also possible to calculate how much each of those letting appointments is worth. Or is it ? To assume that the loss of a unit from a letting pool would impact the profit by the amount that unit makes is to assume the property is running at 100% occupancy 365 days a year. Otherwise, with the exception of times when a property is in fact 100% full, the loss of a unit simply means other units enjoy higher occupancy and there is no material impact on the manager's profit. As such there is an argument that any price adjustment occasioned by the loss of a letting appointment should only reflect lost revenue during times of 100% occupancy. These calculations can be quantified using historical data that in most cases form the basis of the forensic accounting process we know as verification of net profit.

There are of course other matters that need to be taken into account. Some are quantifiable, some are not.

For example, unit configurations, particularly high demand layouts, need to be considered. Less quantifiable but equally important is what the loss of a letting appointment says about the status quo in a property. To know that an appointment has been lost is important, to know why is equally so.

There is another piece of this jigsaw puzzle that's worth thinking about but be warned, I don't have an answer. The value of a letting appointment will be impacted by future demand. In a rising demand market appointments will become more valuable, in a falling demand cycle, less so. I don't have a formula for this but if you are tossing a coin on appointment values worth thinking about.

So, I think we can establish that existing appointment values can be quantified via historical data relating to the specific lot, overlaid with considerations regarding occupancy and income loss during peak demand periods. That just leaves new appointments acquired between contract and settlement. The value of these cannot be quantified via historical performance data relating to the specific lot acquired so what to do? The easy answer is to apply the same principles to claw forward as those applied to claw backs but that's a potentially flawed approach. Here's why.

It seems implausible to me that on the one hand a forensic approach can be taken to determine the value of units lost and then to apply the same numbers to a projected and unproven hypothetical income that a new unit might derive. As such we are essentially comparing proven historical performance with a projected income and as we know multiples on projections attract discounts. My conclusion is that if a per lot value is assigned to units lost from a letting pool, then a similar methodology should be considered for units gained, but at a discount reflecting proven versus projected income.

Again, there are other considerations at play here. I would contend that in a high demand record REVPAR cycle new appointments are potentially worth the same as lost appointments. While the income on new appointments is indeed projected the risk factor in terms of filling those rooms will be low. Conversely, in a falling demand cycle where occupancy is on the wane, new appointments are potentially valueless. Once again, there's more to this than meets the eye. A new appointment signals confidence in management, support for the MLR business model and potentially diversifies the letting pool. There's a value in all of this but it is beyond me to come up with a formula.

Yes, I hear you dear readers. Mike, so much verbiage, so little solid advice! There's a reason for that. Every property is different, and every demand cycle varies. My advice is simple. Just as there is no set multiple for purchase prices, so there is no set formula for claw values. Based on all the potential variables it's a case-by-case assessment, underpinned by the considerations I've described. If in doubt I always start with E=mc2 and work backwards from there.

A word on valuations. I read a recent report where a valuer placed a value on each appointment. The pure mathematics were accurate, but the underlying methodology simply failed to consider all the variables above. I understand the need for valuers to be concise and to underpin reports with specific calculations but failing to consider variables in appointment values seems to me to be missing the point. Of more concern is that lenders rely on these reports in determining the possible drop in value of a business if it loses an appointment. A more sophisticated approach seems a fair expectation.

In closing, please take into account that I am mostly talking about short stay management rights here. Calculations relating to permanent properties are a whole lot easier and for that I do have a formula.

I'll leave you with a quote from the bloke from whom I have stolen the formula above.
"The formulation of a problem is often far more essential than its solution"
A Einstein , Genius.

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