



Making the right decision



Stephen Aldridge

With banks recapitalising their balance sheets and investors being spooked by potential Euro debt contagion, how can you improve the chances of your deal to completing? Stephen Aldridge believes increased confidence amongst investors and lenders can be achieved with a professional financial model

Hindsight is a wonderful thing. It enables us to see whether our decisions were good or bad. Wouldn't it be useful if we could opt for the occasional Groundhog Day (or month) where we could re-run things a few times until we got it right? Well until we get the hang of time travel, we'll just have to make do with

another approach. Admittedly, claiming that financial modelling is second best to time travel is a bit of a stretch; but it does allow us to try out different versions of what the future might look like, evaluate the options and choose the best one.

I've seen hundreds of financial models and most of them fall short

of this vision, to the extent that I'm surprised when I see one that even comes close. That might explain why a common response to mentioning financial models is a sigh, slumped shoulders and memories of long nights sitting next to an 'Excel wiz' trying to make the figures stack up.

It doesn't have to be that way. Part of the problem is that it often falls to the 'Excel wiz' to do the modelling and whilst they may have a good mastery of functions, most of the techniques and disciplines needed to build a robust, fit-for-purpose model are not taught during accountancy training, MBA courses or technical spreadsheet courses.

The assumption that someone with good technical Excel skills can

build a useful model is fatally flawed. There is a tendency to 'show off' and try to build clever complex formulae. This not only secures their position as the only person who can use their model, it increases the risk that the model contains errors and could give you the wrong answer. A model like this is going to cause nagging doubt about the numbers it produces in the minds of managers, investors and bankers alike.

So what does a professional modeller do differently? A professional will always have an eye on the risk of error and take steps to avoid it. This does include employing techniques and principles about the way calculations are structured, but there is more to it than that, it's a whole mind set. First of all an acceptance of our own fallibility is important. Most people have a strong optimism bias regarding their spreadsheets, but experience and research show that human endeavour of all kinds is prone to errors, so a continuous suspicion that what we have just built might be wrong is important.

Building each section of calculation in a modular fashion allows it to be tested with dummy data, representing all circumstances the model is expected to deal with, before it is connected to the rest of the model with its base case numbers. Thorough and independent testing of the spreadsheet is also important to identify and correct errors.

Visibility is often proposed as the solution to dealing with complex, uncertain issues and this applies equally well to modelling. Simple, clearly laid out calculations, with well labelled input areas that any financially literate user can understand should be the objective. Clear thinking before starting to build a model about the way it will be used and what questions it will have to answer will avoid too many changes along the way. Changes to existing models are much more likely to cause error than changes to a specification before construction has started. If you intend to use the model after the deal is done,

perhaps for budgeting purposes, this should be planned for before commencing as it will influence the design of the model.

So you have found a professional modeller and held a workshop to think about what you want your forecast to tell you. Your modeller has built a flexible, simple to understand model and it's been tested to eliminate errors. What can you expect it to do for you?

It should enable you to make assumptions about the drivers of the business it represents and translate operational and activity based assumptions into financial forecasts of profit and loss, balance sheet and cash flow. These, along with other metrics, allow you to test ratios in the business and see how they are impacted by changes to your operational assumptions. You can demonstrate to banks and investors that the step change in the business your deal will bring about will not adversely affect its profitability and that if the economy takes another turn for the worse, you can intervene to make sure the business will still prosper. If you can't demonstrate this using the model, you should probably re-think the deal and potentially save yourself the ignominy of staking your reputation on a deal that goes sour.

So a model that represents a business well can provide confidence it will survive and prosper, or allow you to test alternatives – perhaps modifying the business model, the expansion plans or the timing of events, in order that the business can adapt to the ever changing world. We don't get a second chance to get it right in the real world, but using a model, you can have as many Groundhog days as you need to get your business plan right. **DM**

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