

## **Private Practice (A)**

It wasn't the first time. It was Friday afternoon and Duna Wright wished his classmates well as they again departed without him. Last Saturday it was to the Head of the Charles regatta followed by the Miracle of Science for burgers and beers. This weekend a rented SUV would guide the spirited group of budding real estate entrepreneurs to the brilliant fall foliage in northern New England. It was only a month ago that the offer of a (significantly reduced) weekly paycheck and full health benefits seemed too good to pass up. Yet Duna Wright was now starting to wish he'd never agreed to continue to help analyze investment deals for Ottathe Money Managers once he had left for graduate school in Cambridge.

On Monday morning Duna would need to email bids on three potential acquisition opportunities to his former boss, N.P. Venter. Duna had previously prepared a preliminary bid on one of the properties, Pace Place. But Venter had just informed him that, on behalf of one of their private clients, Ottathe Money Managers was a finalist in the bidding to acquire that property as well as two others that had recently been identified. Revising his previous bid for Pace Place would be relatively easy; it was preparing bids on two new properties, Ciller Centre and Rowe House, which concerned Duna the most.

N.P. Venter was notoriously impatient, and she was starting to get a bit concerned about Duna turning the new analyses around by Monday.

### **Pace Place**

Pace Place is a 7-year-old multi-tenanted office building. It contains 200,000 square feet of net rentable area and is about 98% leased to more than a dozen tenants. The property is well located within its competitive market area and is considered desirable by office tenants.

Since Duna's preparation of the preliminary bid, an additional lease was signed with an existing tenant to expand into the balance of the floor it occupies. The tenant will pay a gross market rental rate of \$25 per square foot and has agreed to accept the additional space in as-is condition. Leases in that market are generally written for a term of five years, although longer leases from larger tenants are also quite common. An updated projection of property cash flow prepared by one of Ottathe's junior analysts, Cameron Rogers, is presented in Exhibit 1.

## **Ciller Centre**

Ciller Centre is a very well-located 12-year-old distribution building leased to two national firms. The leases are structured as “triple net” (NNN), meaning that, in addition to the annual base rent payable to the landlord, each tenant is responsible for the payment of its pro rata share of the property’s operating expenses and real estate taxes, which currently total \$3.00 per rentable square foot. A reserve for the replacement of base building components has been estimated at \$0.25 per square foot per year by Ottathe’s independent engineers, which, under the terms of the leases, cannot be passed through to the tenants.

Di Carlo Discounters occupies 60,000 rentable square feet in the building. It has three years remaining on its lease and is paying an annual NNN rent of \$6.00 per rentable square foot. Di Carlo Discounters has been a tenant in the building since the day it was completed. It is in its second 5-year lease renewal term, and has two additional 5-year lease renewal options at 90% of fair market rental value.

Weikal Widgets occupies the remaining 40,000 square feet of net rentable area. It entered into a 7-year lease two years ago. It is currently paying an annual rent per square foot of \$6.75 NNN. Weikal Widgets has two 5-year renewal options at 90% of fair market rental value.

Clayton Nash, a local commercial real estate broker, estimated for Venter that the current fair market NNN rent for the building was about \$7.00 per rentable square foot. Nash also suggested that the 2% historic average annual rate of growth in market rents would be a prudent estimate of future market rent growth. Under the terms of the renewal options contained in each lease, any required expenditures for tenant improvements and/or leasing commissions would be the responsibility of the tenant.

Nash further advised that the probability of renewal for each tenant was somewhere between 50% and 100%. In the event of non-renewal, however, Nash felt that a replacement tenant could be identified and put under lease within 6 months of the termination of either of the existing leases, due to the early notification requirements contained therein. In such a situation, expenditures for landlord-funded tenant improvements and leasing commissions would arise. Current market allowances for such items were \$5 PSF and \$2 PSF, respectively, and were expected to escalate over time at a rate consistent with property operating expenses and taxes (about 2% per year).

Both Di Carlo Discounters and Weikal Widgets enjoy investment grade credit ratings of BBB-, implying that their corporate bondholders would expect to earn a return of about 6.5% if either firm issued 5-year bonds.

## **Rowe House**

Rowe House is a newly-constructed 100-unit mixed income apartment complex. Upon full lease-up, 80 of the units will be rented at average market rents of \$1,500 per month,

and the remaining 20 affordable units will be rented at average low-income rents of \$500 per month. The initial lease-up should be completed by the closing of the acquisition.

In exchange for contracting with his management subsidiary to manage the property for a market-based management fee, the developer has personally guaranteed that the property will generate annual effective gross income of at least \$1,500,000 during the first two years of operations. The long-run average vacancy rate for market-rate units in the submarket in which the property is located has been about 6%; for affordable units, the long-run average vacancy rate has been about 2%.

According to N.P. Venter, rental rates on the 80 market-rate units can be expected to increase by about 2% per year, while rental rates on the 20 affordable units can be expected to increase by only about half as much. Annual operating expenses<sup>1</sup> and property taxes are budgeted at \$4,500 per unit per year and can be expected to increase by about 3% per year. The standard tenant lease is for one year and does not permit the landlord to pass through increases in operating expenses or property taxes.

### **Due Diligence**

Before laying out the relevant cash flows to analyze, Duna Wright took a moment to consider some of the broader assumptions he would use to generate such cash flows. Specifically, he assumed that:

- Investment decisions would generally be made on the basis of 10-year discounted cash flow analyses;
- In recognition of the high degree of uncertainty associated with forecasting future asset values, estimates of future sales prices would be based on eleventh year projected net operating incomes capitalized at a rates consistent with currently applicable discount rates minus the projected compound average annual change in property before-tax cash flow over the 10-year holding period;
- Costs of sale would be 2% of the estimated future sales prices;
- Projected annual capital (replacement) reserve funding would be expended on each property in the year funded; and
- Due diligence and legal fees paid to third-parties would be approximately \$100,000 if Ottathe Money Managers were selected as the preferred buyer (i.e., “awarded” the deal).

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<sup>1</sup> Consistent with multi-family industry practice, such operating expenses include Wheeler’s estimate of required annual replacement reserve funding of \$300 per unit per year (escalated at 3% per annum) as an expense in calculating Net Operating Income.

## **Required Investment Returns and Bid Prices**

Venter had earlier instructed Duna to establish appropriate bid prices for each property using unlevered pre-tax cash flows in conjunction with pre-tax discount rates that were consistent with the expected total returns for unlevered fully-leased institutional quality properties.

That was a big help, thought Duna.

Duna knew, however, that prevailing market capitalization rates<sup>2</sup> in the institutional property markets were in the 6% to 8% range, and that realistic growth expectations for operating cash flows and asset values were typically about 1% or so less than the expected rate of inflation. Duna also knew that the current yield on the 10-year U.S. Treasury Note was about 4.75% and the yield on the 10-year U.S. Inflation-Indexed Treasury Note was about 2.25%, which indicated to him that the U.S. debt markets expected an average annual rate of inflation of around 2.5% over the next ten years.

Duna understood that both the projected investment returns and bid prices applicable to each property would need to be presented in a summary matrix as part of a summary investment memorandum, which was not to exceed 3 pages of text. Included in the summary memorandum would be a discussion of (i) the projected annual net investment flows associated with investing in such properties, (ii) projected investment return performance attribution, (iii) suggested rank-ordering of preference for the three properties based on the client's stated need to enhance its ability to service its increasing long-term (as opposed to near-term) annual financial obligations, and (iv) any specific risk factors or other issues worthy of mention. Supporting financial analyses would be attached as exhibits.

## **Due Process**

It was Friday night. The phone rang. It was Venter. She was anxious.

The client had called late in the afternoon to say it really wanted to get money invested quickly in good properties that could be acquired at prices that would deliver fair risk-adjusted investment returns. Based on the potential acquisition and investment management fees payable to Ottathe Money Managers in connection with such acquisitions, Venter wanted to get the client's money invested quickly, too.

Venter made a point of thanking Duna again for all his help and, in her typically pretentious fashion, made a point to confirm that their new compensation and benefits agreement was comforting to Duna during his quest for higher education. You know, that they both really valued the commitment the other had made, and all that sort of stuff. Duna flinched a little on the other end of the phone, but politely agreed. It wasn't the first time.

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<sup>2</sup> Based on the first year's projected net operating income.

## Exhibit 1

### Projection of Property Before-Tax Cash Flow

#### Pace Place

	Year <u>1</u>	Year <u>2</u>	Year <u>3</u>	Year <u>4</u>	Year <u>5</u>	Year <u>6</u>	Year <u>7</u>	Year <u>8</u>	Year <u>9</u>	Year <u>10</u>	Year <u>11</u>
Gross Rental Revenues	\$4,323,000	\$4,467,000	\$4,512,000	\$4,876,000	\$4,912,000	\$4,995,000	\$5,147,000	\$5,209,000	\$5,536,000	\$5,662,000	\$5,988,000
Less Vacancy	(88,000)	(90,000)	(94,000)	(602,000)	(123,000)	(136,000)	(147,000)	(160,000)	(685,000)	(303,000)	(189,000)
Plus Expense Reimbursements	<u>287,000</u>	<u>311,000</u>	<u>336,000</u>	<u>175,000</u>	<u>201,000</u>	<u>228,000</u>	<u>256,000</u>	<u>285,000</u>	<u>156,000</u>	<u>186,000</u>	<u>217,000</u>
<b>Effective Gross Income</b>	4,522,000	4,688,000	4,754,000	4,449,000	4,990,000	5,087,000	5,256,000	5,334,000	5,007,000	5,545,000	6,016,000
Less Operating Expenses	(1,300,000)	(1,339,000)	(1,379,000)	(1,391,000)	(1,463,000)	(1,507,000)	(1,552,000)	(1,599,000)	(1,615,000)	(1,696,000)	(1,747,000)
Less Property Taxes	<u>(800,000)</u>	<u>(824,000)</u>	<u>(849,000)</u>	<u>(874,000)</u>	<u>(900,000)</u>	<u>(927,000)</u>	<u>(955,000)</u>	<u>(984,000)</u>	<u>(1,014,000)</u>	<u>(1,044,000)</u>	<u>(1,075,000)</u>
<b>Net Operating Income</b>	<b>2,422,000</b>	<b>2,525,000</b>	<b>2,526,000</b>	<b>2,184,000</b>	<b>2,627,000</b>	<b>2,653,000</b>	<b>2,749,000</b>	<b>2,751,000</b>	<b>2,378,000</b>	<b>2,805,000</b>	<b>3,194,000</b>
Less Tenant Improvements	0	0	0	(456,000)	0	0	0	0	(613,000)	0	0
Less Leasing Commissions	0	0	0	(98,000)	0	0	0	0	(141,000)	0	0
Less Capital Reserve Funding	<u>(100,000)</u>										
<b>Property Before-Tax Cash Flow</b>	<b><u>\$2,322,000</u></b>	<b><u>\$2,425,000</u></b>	<b><u>\$2,426,000</u></b>	<b><u>\$1,530,000</u></b>	<b><u>\$2,527,000</u></b>	<b><u>\$2,553,000</u></b>	<b><u>\$2,649,000</u></b>	<b><u>\$2,651,000</u></b>	<b><u>\$1,524,000</u></b>	<b><u>\$2,705,000</u></b>	<b><u>\$2,705,000</u></b>