

Advanced Real Estate Finance Study Project 2011
Graduate School of Banking at LSU

Investment Opportunity: One of your clients has approached you to obtain debt financing for the acquisition of an office building located in a rapidly growing suburban submarket. The building is priced at \$7,500,000 and includes 30,000 rentable square feet and 25,000 usable square feet of space. Existing tenants occupy 92% of the building at an average annual lease rate of \$23.00 per square foot triple net and all of these tenants have at least seven years of term remaining on their leases. All of the leases additionally include escalation clauses that increase the rental rates by 2% each year. Operating expenses and capital expenses for office buildings in the submarket are approximately \$6.00 and \$.50 per square foot respectively and both have historically increased by 3% per year. Vending machines located in the building generate approximately \$5,000 in income each year and a cellular phone tower located on the roof generates \$12,000 per year in income, both of which are anticipated to remain constant over time.

Capital Market Considerations: Investors acquiring similar office buildings in the submarket typically require an annual unlevered rate of return of 10% and currently use a terminal capitalization rate of 7.5% to estimate the value of such buildings at the end of a five year holding period. The cost of selling a building at the end of a five year holding period is expected to be approximately 4% of the gross sale price. Debt financing is generally available from your bank for this type of asset at a 70% LTV ratio and an annual interest rate of 6.5%, with a 20 year amortization period and a five year maturity. Based on these assumptions, your client has asked you to help evaluate the property and estimate its value. Please complete a financial analysis in EXCEL to assist your client and answer the following questions:

- 1) What is the going-in capitalization rate for this investment if it is acquired for \$7,500,000?
- 2) What is the most your client should be willing to pay for the asset based on a discounted cash flow analysis if the client plans to hold the property for five years?
- 3) What are the unlevered NPV and IRR of the investment if it is acquired for \$7,500,000 and performs as expected over the five year holding period?
- 4) What is an appropriate levered discount rate for this investment based on the leverage ratio and other information provided above?
- 5) What are the levered NPV and IRR for this investment over a five year holding period if it is acquired for \$7,500,000 and a loan is obtained on the terms described above?
- 6) What is the debt coverage ratio, breakeven ratio and cash-on-cash return generated by the investment in the first year of the holding period if it performs as expected?
- 7) What is the load factor of the building and what information does it provide the investors?
- 8) Would you be willing to make the loan described above based on the results of your financial analysis and the market information provided above?