

DOMUS DEVELOPMENTS: TO BUILD OR NOT TO BUILD?

Erica Furguele wrote this case under the supervision of Elizabeth M. A. Grasby solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

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It was October 2013, and Michael Mescia, project manager of Domus Developments (Domus), was contemplating the future of the company's next development project, the North Point Lofts (North Point). Domus had originally launched this development project in 2008, but for various reasons, it had not yet come to fruition. With most of Domus's other development projects currently near completion, Mescia wondered whether the right time had finally arrived to start work on the long-awaited North Point project.

Mescia wanted to evaluate North Point's financial outcomes, including Domus's ongoing cash position during the building process and its relevant qualitative considerations. Conversely, Mescia wondered how much the land's value had appreciated over the years and whether selling the land might be Domus's most profitable option. Mescia's decision should support Domus with its corporate goal of developing an esteemed reputation in the market.

DOMUS DEVELOPMENTS

Founded in 2000, Domus was a family-owned, residential builder that serviced southern Ontario. The company was headquartered in London, Ontario, Canada, where a majority of its developments were built and where Mescia resided.

Over the years, Domus had developed a strong reputation for innovative designs and high-quality structures. A developer who could design and construct a site that satisfied customers and sold quickly gave landowners the quickest return on their investment. This outcome was essential in the industry and had led Domus to its current level of success. In the beginning, Domus had been unable to secure Type A sites¹ because it lacked an established reputation for building development. As a result, the company often lost jobs to more experienced builders. Over time, and with a focus on quality, customer satisfaction and innovation, Domus earned a solid reputation amongst landowners, vastly improving its relationships within the industry and the community. In fact, Domus had received awards for its building development projects from both the London Home Builders' Association (LHBA) and Ontario Home Builders' Association. For example, in 2013, Domus won the London Urban Design Award for its Woodland Towns project in

¹ Developers classified land on a scale based on variables such as location and zoning classifications.

London, the LHBA award for Best Overall New Home Design for its Port Stanley, Ontario, development, and the LHBA award for Project of the Year for its River Oaks development in London. Domus currently operated a corporate website that showcased content on the company's history, awards received, current and past development projects and contact information.

LONDON, ONTARIO

With a population of over 365,000, London, Ontario, was the 15th largest city in Canada and the sixth largest city in Ontario. Situated between Toronto, Ontario (Canada's largest city), and Detroit, Michigan, in the United States, and with direct access to some of the province's major highways, London attracted a variety of different demographic groups. London was a regional centre for health care and education, and it was home to several leading hospitals, and two large well-recognized post-secondary education institutions, Western University (more than 30,000 students) and Fanshawe College (over 15,000 students). Skilled labourers in various sectors were attracted to the different industries within the city, such as General Dynamics, McCormick Canada, Labatt Breweries, Dr. Oetker, and 3M Canada. The city also hosted several prominent music and sporting events at Budweiser Gardens, a 9,000-seat sports and entertainment facility. London's downtown was anchored by Richmond row, a shopping district of over 3,200 primarily high-end businesses, including nightclubs, restaurants, higher-end clothing retailers and professional service providers.

The average Londoner was close to 40 years of age, and the median annual household income was \$74,760, slightly above the Canadian average. Many people considered London to be an ideal place to retire, and thus, baby boomers over the age of 65 made up 17 per cent of London's population. Single detached homes were the city's most popular dwelling, and 25 per cent of the population lived in apartments.²

NORTH POINT LOFTS

The Concept

After being approached by a landowner who wanted to develop a Type A site, Domus management was extremely interested in building an innovative type of home on the land. The project's concept, called North Point Lofts (North Point), would be London's first modern loft residence, inspired by the success and popularity of modern loft residences in the Toronto market.

North Point would be a four-story building constructed on five acres of highly desirable land in North London. The building would contain 51 modern lofts, each featuring high ceilings and full-height windows, and ranging in size from 1,100 to 2,000 square feet. The lofts would also be highly customizable to cater to the wants and needs of each individual buyer. See Exhibit 1 for a loft's sample floor plan. Another key feature was North Point's location in the city. The building would be constructed on a unique piece of land, on a hillside, with breathtaking views overlooking London. The building was located just a few minutes' drive from one of Northwest London's largest suburban commercial areas with a mall, a grocery store, four major banks and numerous other retailers. See Exhibits 2 and 3 for the location and an initial artist's concept design for North Point.

² Statistics Canada website, www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/famil107a-eng.htm, accessed March 13, 2015.

The Customer

North Point would be targeted at Londoners with above-average income levels. Mescia believed the development would attract empty nesters and older couples who wanted to move upon retirement. Mescia knew the top decision-making factor in any real estate purchase was location, followed by price. Preliminary research on the high-end real estate market indicated that exclusivity and customization were key to these customers. Domus's development projects had yet to cater to high-end consumers; however, Mescia saw the North Point project as an ideal growth opportunity for the company. Domus would have to expand its supplier community to sufficiently source the required high-quality building materials.

September and October 2008

In early September 2008, Domus agreed to purchase the land for development at a market value of \$1 million. To secure the purchase of the land, Domus paid \$100,000 to the landowners, with the balance due upon the closing purchase date on all units. After finalizing the concept, Domus hosted its first launch party to generate excitement around the development project and to attract potential residential buyers. The party was very successful and resulted in 15 signings³ for the building that same day, based solely on the concept. While pre-sales were common occurrences in the Toronto housing market, they were new to the London market, and this early level of interest helped to build Domus's confidence in North Point's potential success as a development.

On September 15, 2008, Lehman Brothers Holdings Inc., a major financial services firm in the United States, filed for bankruptcy. This incident represented the largest bankruptcy filing in U.S. history and marked the start of what later became known as the "Global Financial Crisis." The crisis caused events never before seen in history, including a record drop in the U.S. Stock Exchange of 7 per cent in one day on September 28, 2008. Many businesses and financial institutions collapsed, global stock markets dropped dramatically and, ultimately, the world economy fell into a global recession. The global recession resulted in the loss of billions in consumer wealth and had a major impact on the housing market. The economy's future was highly uncertain, and several key economic indicators of financial stability, such as employment, declined drastically.

By October 2008, with the financial crisis underway, within a mere month of its highly successful launch party, Domus saw its initial offers on North Point slowly dissolve. People were revoking their offers due to uncertainty in the market and, it was believed, likely their own financial uncertainty. Domus's management team decided to put the project on hold and instead push forward on less expensive projects.

2009

After the 2008 recession, the Canadian government implemented incentives to encourage Canadians to buy homes, including the first-time home buyers' tax credit introduced in 2009 and structural changes made to registered retirement savings plans (RRSP), giving people the ability to use their savings for a downpayment on a house. At a later date, these funds were to be repaid to the RRSP over several years.

³ Committing to a purchase secured with signing legal sales agreements and often including an initial payment.

2010-2011

In early 2010, the subject of North Point resurfaced in company deliberations; however, through word-of-mouth discussions with real estate agents, contacts and clients, it became clear that the market conditions remained unfavourable for real estate development. The economic recession continued throughout 2011.

2012-2013

By late 2012, economic indicators were starting to show signs of a turnaround in the economy and the markets. Domus was close to completion on two large development projects, and a third project – Upper Richmond – had just sold out its first phase in less than eight weeks. These factors convinced Mescia and the management team at Domus that the residential housing market was improving. In addition, several customers who had initially shown interest in North Point had recently approached Mescia to inquire about the timing of the project's development.

DEVELOPMENT CONSIDERATIONS**Housing Market in London**

The Canadian Mortgage and Housing Corporation (CMHC) projected that new construction on development projects in London would increase by 1 per cent in 2014, amounting to 2,125 new starts. The CMHC also noted that employment numbers for those between the ages of 45 to 64 were increasing and the declining unemployment rate to 8.4 per cent in 2014 would continue to support higher-end, new home construction.⁴ See Exhibit 4 for other key trends influencing the start of construction in 2014.

The Competition

Surrounding the North Point location, several other building projects were set to take place. North London was currently the most popular development region in the city because of its undeveloped land in close proximity to multiple commercial areas and downtown London. See Exhibit 5 for a map of new developments in North London.

Costs

Mescia put North Point back on Domus's list of potential projects, but it quickly became evident that the original design was too outdated for customers in the current market. If Domus decided to relaunch the North Point project, a costly redesign would be needed, along with a reassessment of building costs, such as materials and labour. While reviewing these costs, and before commencing the work, Mescia believed it prudent to compare the cost, on a cash flow basis, of maintaining the land for another year.

Domus would have to hire a team of architects to redesign North Point, at a cost of \$500,000 in fees. The initial design had originally cost \$800,000. Once the building process commenced, it would take 14 months to complete the project.

⁴ CMHC Housing Market Outlook London Area Report Fall 2013.

The first step in the building process involved excavating the land to be developed. Excavation would cost a total of \$500,000, expensed equally between July and August of 2014. An external company would be hired to complete the task, and the price included the use of all equipment, labour and removal of the land waste from the site.

Based on past projects, Mescia could estimate the amount of labour needed for the development project. Domus hired contract labourers to complete all tasks, and they supplied their own equipment so there were no capital investments during the development phase. Fifteen labourers would be needed, each working eight hours a day, five days a week.⁵ These labourers would be hired on contract and would average a pay rate of \$15 an hour (including benefits).

The key components of building the structure included concrete, steel and exterior finishings, which included roofing. These costs would total \$1.9 million, \$2.5 million, \$1 million, respectively. In addition, windows would cost \$725,000 and interior finishings (excluding customization) would total \$5 million. Domus projected that these expenses would be paid in equal monthly installments over the 14 months of development.

Additionally, Domus incurred holding costs for the land. By law, Domus paid property tax on the land to the City of London. Annual property taxes cost approximately \$40,000 and were paid in April of each year. Domus also paid interest semi-annually to the landowners on the \$900,000 (net amount owed) on the land at an annual rate of 10 per cent. It was an industry norm that developers receive three years interest free on the land. Since Domus had already exceeded its three years, until the company could produce a return to its landowner, interest would have to be paid on the land, with payments due in February and August of each year. Mescia projected that Domus would continue to pay interest until the development phase was complete.

Unique to the London market, customers were unaccustomed to buying a property without seeing a physical model; consequently, Mescia projected that only 14 units of the building would be sold in the pre-sale phase (two months prior to commencement of the building phase). Throughout the building phase, Mescia estimated that 28 more units would be sold, and the remaining units sold within 12 months after completion of the development. Sales would be sporadic within these time periods, so Mescia assumed that no more than two purchases would occur in a single month. To secure their purchases, customers would have to pay a 10 per cent deposit (up-front) on the loft. Mescia believed the average loft selling price would be \$500,000.

The customization and upgrade option was another key selling feature of the lofts. Mescia knew all customers would want to customize and upgrade basic features and that each customer would differ on the amount spent. Some customers would spend as little as \$5,000 in upgrades, while others would spend closer to \$50,000. Mescia projected each customer's spending would average an additional \$15,000 for customization and upgrades. Fees for all upgrades would be included with their deposit when buyers signed their initial purchase and sale agreement. No profit was made on upgrades.

Mescia also considered the impact the North Point project would have on his administrator's workload. He estimated two hours a day would need to be allocated to the project. The current administrator earned \$42,000 annually, including benefits.

⁵ Mescia assumed 23 working days per month.

Finally, should additional expenses arise, Mescia budgeted \$500,000 in other costs in order to ensure that the development progressed on schedule without delays. Mescia believed this expense would be incurred evenly throughout the two years.

As soon as all of the North Point lofts were sold and ownership was transferred, Domus expected to net a 20 per cent profit on the entire project. Mescia projected this value to be approximately \$25.5 million based on the average selling price per unit.

Because the project had been on hold for so long, Mescia, as the landholder, wondered whether the most profitable option would be to arrange the sale of the land to a competitor. Mescia estimated that the value of the land had appreciated by approximately 50 per cent over the past five years.

If Domus decided to move forward with the project, construction would begin in July 2014. In May, Mescia would begin marketing the development. He anticipated the marketing mix to include signage erected on the site, a feature section on the company website, print advertising in the local newspaper and in the London Home Builders' Association directory, as well as a model home. See Exhibit 6 for an advertisement from the London Home Builders' Association directory. Mescia's marketing budget was \$375,000 and would be spent over 24 months.

CONCLUSION

It had been five years since the introduction of North Point, and the Domus team still faced a lot of work to successfully build the development project. Analyzing both qualitative and quantitative factors, Mescia was keen on evaluating Domus's ongoing cash position while building North Point, in addition to assessing the project's financial outcomes and its relevant qualitative considerations. Was developing North Point the right move for Domus Developments?

EXHIBIT 1: SAMPLE LOFT FLOOR PLAN



Source: Domus Developments.

EXHIBIT 2: LOCATION OF NORTH POINT LOFTS



Source: Google Maps — My Maps.

EXHIBIT 3: NORTH POINT CONCEPT DESIGN



Source: Domus Developments.

EXHIBIT 4 : KEY TRENDS IN LONDON

Key Factors and their Effects on Housing Starts	
Employment	Employment in London will increase by just over 1.5 per cent in 2014 after a flat profile in 2013. Growth will come in both services and manufacturing to drive a lower unemployment rate.
Income	Average incomes fell slightly in 2013 and will resume growth in 2014.
Population	Population growth will continue to come from immigration and inter and intra-provincial migration supported by a stronger employment outlook.
Resale Market	Sales will grow by two per cent in 2014 to 8,210 over the 2013 forecast of 8,050. Both the high-end and the more affordable markets will continue to do well in 2014.
Mortgage Rates	Short term mortgage rates are expected to remain at historical low levels which will continue to support housing demand.

Source: CMHC Housing Market Outlook Fall 2013. March 13, 2015.


EXHIBIT 5: NEW DEVELOPMENTS IN LONDON



Source: www.buzzbuzzhome.com/listview/lat_43.0183/lng_-81.2949/zoom_13/seed_784, accessed March 13, 2015.

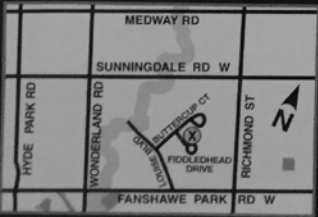
EXHIBIT 6: ADVERTISEMENT FROM LONDON HOME BUILDERS' ASSOCIATION DIRECTORY

NORTH POINT modern loft condos




51 customizable boutique condos offering the finest luxurious interior finishes. Gas service for stove, fireplace, furnace & BBQ. 10 & 12 ft ceilings, oversized balconies up to 500 sq ft, custom cabinets and granite countertops, curtain wall glass windows, 8 ft doors and underground parking

Open daily 1 - 5 (closed Fridays)
located at 1705 Fiddlehead Place, off richmond and fanshawe



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www.domusdev.com
2013 London urban design award winning builder



Source: London Home Builders' Association Directory, January 2015.