Angus Cartwright is tasked with producing a property investment strategy to two investors, John and Judy DeRight. These two investors are cousins who are in different life stages and, therefore, require different investment strategies. Angus is tasked with analyzing four properties across two regions to present to the DeRight cousins in fulfillment of their needs.

To begin, we want to identify the investment requirements for each of the investors and what they are looking for from the four properties.

John is a retired investor who currently receives $500K in stock dividends from his $18M investment in the sole medium-sized public company while also receiving roughly $500K in retirement and other income. He is looking to invest up to half of his $18M investment into properties. John is a retiree, and, based on his status, we can make the assumption that he wants a safe investment that will provide steady cash flows to him. John has indicated that he would like to take advantage of the tax differentials between dividend income tax and capital gains tax. He has indicated that he wants a 12% after tax return on his property investments, so these factors should be taken into account.

Judy is a president and sole stockholder of a small-sized chemical company. She has received many offers to sell her company, so we can infer that her company does well; the 1.1M after tax income she makes is desired by other investors and so she may look for more risky and rewarding investment opportunities. She has a $16M investment portfolio with which she can buy properties with. She also demands a 12% after tax return on the property investment, and this will be taken into consideration when preparing the analysis.

The four properties analyzed by Angus Cartwright included two properties in Montgomery, Maryland, and two properties in Arlington, Virginia, the hometown of many of the DeRight family members. The following are analyses on the four properties:

*The Fowler Building*

The Fowler Building is a two-story, 50,000 square foot rentable space office building in Arlington, Virginia that is currently under construction. The building’s main comparable is 900 Stony Walk, an Office Building in Montgomery, Maryland, and Ivy Terrace, a garden apartment near the Fowler Building, in Arlington, Virginia.

When comparing the Fowler Building to the other properties, based on Exhibit 6 and Exhibit 7, the Financial Analysis and the Investment Ranking, respectively, it seems to underperform in the simple return measures when compared to the other properties and has mixed performance in the discounted return measures. This initially seems to indicate that the Fowler Building may not be the best option to invest in. However, this information needs to be taken with a grain of salt; the property is subject to leases that are below market. This was done because the developers decided to lease out below-market in order to get the building rented up quickly. This action causes an effect on all the comparison figures, including the Cap. Rates, Cash-on-Cash, IRR and NPV.

To simulate the effects of proper leasing based on market conditions, we created sensitivity analyses for the property based on the price charged per s.f. as well as the final sale price of the property. The results indicate that there is a strong effect of the lease price on the NPV and the IRR. Even when taking into account a cheaper selling price, the price per s.f. has a more significant effect on the value of the investment. This can be further seen by examining exhibit 8, which indicates the breakdown of the IRR for the properties. The Fowler Building has a larger proportion of IRR resulting from the future sale of the property in comparison to the discounted cash flows, unlike the three other properties examined.

Therefore, we can conclude that the Fowler Building is misrepresented by the current leasing terms and that Cartwright needs to look deeper into how varied the price per s.f. is in comparison to what the Fowler Building is currently charging leaseholders. The Fowler Building may be more lucrative than initially represented by the information. An analysis showing how the Financial Analysis figures would vary based on the rent and futures sales price is given in the appendix and shows how impactful the below-market lease is on the value of the investment.

1. Speak about benefits of
   1. Diversification
      1. John
         1. Has stock in only one company of 18 million
            1. Highly risky as it is not diversified
         2. 500K in dividends and 500K on other income
         3. What is his tax rate?
      2. Judy
         1. Sole stockholder of company earning 1.6 million before tax and 1.1 million after tax
            1. Fairly risky
   2. Protection from Inflation
   3. Tax Advantages
      1. John
         1. We do not know his tax rate
      2. Judy
         1. Charged 5/1.6 tax rate on company revenue: 31.25% tax on revenue

* September 2003
* John makes 500k a year from dividends on 18M investment
  + Wishes to invest 9M - (9M\*.15) in real estate
* Both Judy and John want a leveraged, after-tax return of 12% on separate properties

Alison Green

* 100-unit apartment
* Montgomery, Maryland
* Completed in 2000
* 95% occupancy since initial rentup
* Moratorium meant no short-term competition, allowing the property to experience short-term rewards
* Asking price of 10M
  + Broker suggested that 9.6M was more reasonable
* Rental income before vacancy was 1,440K
  + CF before financing of 870,200
* 12% tax on gross rent roll
* Can use a 6M mortgage on the property at 6% interest
  + 10 year mortgage, 30 year amortization
* Land valued at 2.1M
* Depreciation on building would be 27.5 years straight line?

900 Stony Walk

* Nearby to Alison Green, probably in Montgomery Maryland too
* 75k s.f. with 67k s.f. rentable space
  + Rented out by professionals who rented between 5k to 7.5k each
* Completed in 1998
* Operating at 95% occupancy since initial rentup
* Asking price is 11.6M but broker says 11.5M will be accepted
* Rental income is 1,742M
  + Cf before financing is 1057200
* 8M mortgage at 6.5% interest rate
  + 10 year term with 20 year amortization
* Land valued at 3.5M
* Property depreciating on straight line over 39 years
* Real estate taxes is 12% on gross rent

Ivy Terrace

* 80 unit garden apartment
* Under construction
* 8.6M/8.4M purchase price
* Land lease of 30k annual payments
* Depreciation of 8.4M straightline over 27.5 years
* Rentals are 1296K

Assumptions by Cartwright

* CF from Ops would increase by 3% each year
  + Except for Fowler, which would increase at 4%
* Assumed that the hold period would be 10 years
* Selling prices:
  + 12.5M for Alison Green
  + 14.5M for Stony Walk
  + 10.5M for Ivy Terrace
  + 13.3M for Fowler Building
* *Predicted the highest appreciation rate since present leases were below market*
* For apartments, $250/apartment/year for potential capital needs
* For office buildings, 0.30/rentable s.f. per year for potential capital needs
* Increase the book value by the amount of reserves that were saved up over the 10 year period
* 35% ordinary tax rate, 15% capital gain tax rate
* 25% tax on the part of sale that related to depreciation

Questions to Consider

1. Reasonableness of asking price using cap rates and per-unit costs of comps
2. How to raise rents or cut expenses; how to increase CF from Ops while maintaining or enhancing future value
   1. How will owner policy need to change?
3. How can taxes affect CFs and what will future tax rates do
4. How will loan:value(leverage) be affected with construction of Fowler Building
5. Match the needs of his clients with the characteristics of the properties and the returns they offered
6. He wants to know the effects of his implicit assumptions underlying each measure
7. Does enough geographic diversity exist within the four properties
8. What priorities should he allocate his time to

Financial Analysis:

* Compared to Stony Walk, the other office building, it costs relative less
  + Depreciable base is larger than stony walk
* Has the largest capital gain on initial investment; price increases 41% over 10 years
  + Final sale price is “higher” because present leases are written below market

Things to note:

* Developer wrote leases below market rents
  + This may indicate a chance to write leases at market once the leases are up
  + Also, because it is being developed rn, there are chances to take advantage of the new building; good rents
* Where did the growth assumptions come from? Are they based on historicals? GDP growth?