**A2 – One Leather Street**

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The case outlines the acquisition and construction process set out by the Smith brothers. Harry wanted to get an understanding of the progress of the property and wanted some numbers indicating the financial situation of the investment. We have outlined the issues pertaining to the strategy and actions of Eric and Redstone.

Office Location

The office location selected by the brothers was a good place for their type of operations, but not ideal. As described Laclede’s Landing is located near two major highways and its proximity to popular spots provides a good amount of foot traffic. In addition, the building was located near the financial district and although not yet ready for top firms the location could be a great opportunity for the up and coming. Yes, it was near highways and yes, they were blocks away from the financial district, but because there were undesirable places nearby the property, the desirability for rent space by high-priority clients was less than it would have been blocks away in the financial district. It might be a good investment for long term as there is possibility for the area to be similar to the financial district in the future, as space in the financial district diminishes with new entrants of renters. Yet, at the moment, its less-than-ideal, although it could work.

Price Increases

The price increase to $15 seemed reasonable at first but , seeing that others were charging more (see next analysis) would become worrisome in the long run seeing that the brothers intent on keeping tenants on during construction. It might be beneficial to reconsider a drop in prices to combat vacancy issues during these times. We also need to consider that leasing and renting in commercial buildings to companies is different that residential areas. Where it may be normal for leases to be scattered in residential properties, companies may prefer to have structured leasing agreements that correlate with their fiscal periods or operational fluctuations.

Issues Pertaining to Vacancy

In exhibit 2 of the brother’s analysis, they prematurely estimate that, within 2 years, they would be able to fill their vacancies and raise all the existing and new tenant’s rents to $15. This estimate was made despite their absorption analysis which indicated an added 2,000,000 s.f. of vacant buildings added to the market as well as an added 700,000 s.f. of recently vacated offices by banks moving operations.

Although it is true that that the target rent of $15 is below the $25-$30 office rent in the *financial district*, and below the $20-$25 rent in the *suburbs*, the brothers failed to calculate for the event that these prices are ultimately driven down by the record-high 13% office vacancy and 20% vacancy in the suburbs. An important and neglected analysis would be to produce a sensitivity analysis for best case and worst case scenarios.

Below you may find the best case and worst case scenarios for the tenant rents ($15/$13)



|  |  |
| --- | --- |
| best case cashflow after Financing | worst case cashflow after Financing |
| $ 278,703 | $ 158,160 |

This would mean the above difference in cash flow after financing.

This different in income would then drastically have a difference on the future projections and the syndicator Analysis. It is important to keep in mind the possibility that the brothers will not be able to get the tenants to the desired price range. In this cae they must act according to have some breathing gap for their finances. It would be ill advised to base everything on this projection.

Revoking the Purchase

Having some doubt about the amount of risk that they have taken on, the brothers had been nervous about the level of risk that they had undertaken and had decided to reconsider going forwards with the project. At the same time seeking to get out of their contract, they discovered that the seller also wanted to buy back their agreement, seeking to give $100,000 in profit. At the time the brothers decided against going for this option and moved boldly forwards with their project. This however in this analysis was a bad decision. At the time the brothers were given the opportunity to make a 100% on their investment with absolutely no risk, instantly.

Below is an illustration of the IRR on the profit of selling of their contract.

|  |  |
| --- | --- |
| Feb 1987 | May 1987 |
| -$100,000 | +$200,000 |

IRR = 100%

The brothers would have to be expecting to beat this IRR on their investment for them to go for the project (similar risk project which it is not). Again, since this is a risk free return their project must show substantial returns over this deal for them to consider it, specially considering how risky the project is.

Crimson Group – Deal Breakdown

Upon initial search for equity syndicators, it was clear that investors were not interested to invest in the project, given the circumstances and characteristics of the project. This was, however, not enough to deter the Crimson Group from wanting to invest, and we should question why. The Crimson Group has managed to leverage our position in a multitude of ways.

*Contingency*

The Crimson Group is being risky and inconsiderate with the terms set for contingency allocation. They have determined that there will be limited reserves for capital contingencies in order to ensure that the return to investors are higher. This means that potential renters of the property will have less money to spend on altering the space for their needs, which is an effective way of turning away potential renters. Capital cost contingencies have direct effects on the demand for property, and, will have a material impact on the vacancy rate of the property, given the already all-time-high vacancy rate of 13%.

*Debt Levels*

The Crimson Group has agreed to provide $1,939,000 of equity investment to the Smith brothers, however, is unable to give the money up-front, and will secure the loan through investor notes. These investor notes would then be charging interest across the full partnership and not just the Crimson Group, which would effectively increase the riskiness of the cash flows produced by the property. Not only is the Crimson Group structuring the materials of the deal to be in favour of their investors, they are also spreading their own leverage risk across the partnership, which will ultimately make the project more risky and prone to cash flow issues.

*Issues with time*

The equity syndication planned by the Crimson Group had first commenced in the beginning of April. Unlike how the brothers were accustomed to, the syndication process of the commercial property was going to take up to three months, meaning that the equity funding would be delayed and that Redstone would have to find a way to pay for all the expenses upfront using another loan or had to pause operations until the equity was syndicated by the Crimson Group. This is problematic because the extra three month delay will either cause the brothers to take on more interest expense or to incur expenses associated with the inability to charge leasers for a full three months.

Some other issues dealing with agreement specifics include:

1. Tax Losses

The Crimson Group has done a good job of covering their back through the fine-print of the agreement. Amongst the myriad of details, the Crimson Group has written into the contract that 99% of the tax losses will go to the investors. In other words, rebates from the government thanks to losses will be handed over to the investors of the syndicated equity issued by the Crimson Group. Essentially, the losses incurred will hurt twice as much because the Smith brothers will only be able to use 1% of the tax refund that the government pays out to the commercial property.

1. Investor recoupment

Another aspect of the Crimson contract is that the investor is to get their investment back first in the case of the sales/profit. This would mean that even at a profit of (principle + interest) the brothers would lose all their equity investment as they Crimson Group would be the first to recoup their money.

1. Cash Flow split

The cashflow split is rather well reflective of the equity investment of each partner in the project, the brothers having invested around 1.8 million dollars of their own equity into the project, will receive 50% of the profits after investor recoupment of investment. The other 50% would be going to the investors (Pre-tax). However, it would have been better for the broterhs to push for a higher % split as they are doing all the work and the other investors and simply financing them.

Which architect would be the better option?

When considering the different architects that the brothers could have chosen, the tradeoff is quite simple. Where Gary Grant and Associates provide a cost-effective job which was more suited for smaller renovations of warehouses near the river, Elizabeth Andrews and Associates provides a relatively expensive, award-winning and reliable renovation job that is more suited to the office property being dealt with.

In the end, the brothers chose to move forwards with Elizabeth Andrews and Associates, despite their estimate of $40,000, a $25,000 premium in comparison to Gary Grant and Associates. This move was ultimately ill advised as Elizabeth had specifically said that the construction costs were set to go way above the budget. Working with Gary would have also been better in line with the brother’s overall policy of renovating an old building and turning it into a B/B+. Although with this project as stated the brothers sought a B+/A- rating which is a bit of an overreach in their proven method. Also working with Elizabeth and going based on her promises to try to keep the budget in check is an enormous risk that assumes nothing in the construction will go over budget. A fact that must always be accounted for. Throughout this process the brothers considered the best-case-scenario for their budgeting, a bad decision as they were constantly over-expecting the results of the property. Sticking with Grant would have further allowed the brothers to maintain a certain allowance for any unexpected costs that arose during production. The brothers would also have been more able to stay within the requirement of the deal brokered with the Crimson Group where additional funding was not an option.

Contractor

On choosing the contractor the brothers decided to go with the 2 smaller contractors which they have worked with in the past in exchange for a larger contractor who had completed similar work nationwide. This seemed to be the correct move as the contractors both had a good past of working with the brothers and they stayed within their budget estimates in comparison to the American Syndicate. However, it was important for the brothers to also ensure that the contractors had the licensing to go forth with this bigger project. This proved an issue when it was discovered that the contractor only had a Class C license and could only supervise smaller jobs. This is a critical aspect of the due-diligence that the brother did not due. It is very important for the brothers to understand that not every contractor is fit for every job and that it is the responsibility of the developer to ensure that the contractor is fit for the job. Taking this into consideration the brothers would have immediately went with the American Syndicate option, be it more costly, they would have assurances that nothing goes wrong.

It should also be noted that in the end the revised costs on October 1987 came out to being 150,000 a floor (4 floors) and higher storefront costs, (due to the issues that became present). This price totals to 881,000 a price that is almost the exact same as the 150,000 per floor.

Below you will find the financials if they had gone with the American Syndicate

($150,000 per floor) ($900,000 instead of $525,000 which turned out to be $881,000).

On this model the 1989 vacancy would be the normal 5% because the construction is done

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
|  | **1987** | **1988** | **1989** | **Total** |
| **Total sources** | $ (181,500) | $ 479,937 | $ 1,076,134 |  |
|  |  |  |  |  |
| **Uses** |  |  |  |  |
| Leasing fees | $ 25,000 | $ 25,000 | $ 12,500 | $ 62,500 |
| Cap improvements | $ 450,000 | $ 450,000 |  | $ 900,000 |
| Investor note |  | $ 504,000 | $ 910,000 |  |
| Surplus/ Deficit | $ (656,500) | $ (499,063) | $ 153,634 |  |
| **Culminative Balance** | $ 67,500 | $ (431,563) | $ (277,929) |  |
| **Cash Flow** |  |  |  |  |
| Gross Rent | $ 187,704 | $ 405,545 | $ 768,735 |  |
| Vacancy | $ 9,385 | $ 116,175 | $ 38,437 |  |
| **Net rent** | $ 178,319 | $ 289,370 | $ 730,298 |  |
| Operating cashflow | $ 56,969 | $ 376,137 | $ 492,084 |  |
| Total interest | $ 238,469 | $ 400,200 | $ 345,600 |  |
| **Cashflow after financing** | $ (181,500) | $ (24,063) | $ 166,134 |  |

As displayed in the analysis above on the 1989 the brothers would be cash positive $154,634 as opposed to the chosen contractors which came in at -$41,016. However, in general they would be slightly less in debt at the end of the 1989 fiscal cycles. The monetary cost of the two contractors turns out to be the same. However, with this second contractor the brothers would not be dealing with the licensing situations that they are now.

**What to do in current situation?**

The brothers are placed in a though situation right now. As it currently stands within their projections, they are set to lose $270,000 by the end of 1989. This is due to a few different aspects, mainly, floor vacancy and increased capital improvements costs. The best option for the brothers right now would be to take a step back from everything and re-assess their situation and their entire plan of action. Firstly, they must handle the most immediate problem for them, that is the licensing issue. They are currently being asked to do somewhat of an un-ethical “cozying up to” the construction supervisor, so that he does not shut down their operations. However, the best approach for the brother right now is to take a step back and allow the inspector to shut down operations for the next two months.

While the shut down in underway the brother will have a few different decisions to make. Firstly, the current designs for the building are set to be too costly, a change from $525,000 to $821,000, that is almost $300,000 over their pervious estimations of cost. The brothers will have to redesign their buildings to cut the previous costs and stick to their original moto of a simple redesign. This restructuring will have to be much like the first architect that they visited. This would be period were the architects would have time to consider how to move forwards with the construction already done but avoid heavy future construction.

Over the hold period the brothers would also ask the original general contractor of the building to obtain his Class B licensing and avoid hiring Williams as the site supervisor, this would not only cut on the costs that he has demanded but also allow the brothers air to breath without him holding his license over their head. It is already apparent that Williams is ready to go to unethical grounds to get what he wants, it would be best for the brothers to not place themselves at the mercy of this man.

Another issue present to the brothers is the rental vacancy that seems to have caught them by surprise. Initially the estimated a 5% vacancy but due to their university rent fall through the brothers are suffering extensively on the source of income that they were supposed to have. Losing $116,000 in 1988 and $58,000 in 1989.