Realty Cap Partners

It was 8:00pm on a Friday night. Frank Overton, Senior Managing Director of Realty Cap Partners, LLC ("RCP"), sat at his desk thinking about Monday's partner meeting. He had to make a recommendation to his partners on a fairly large real estate acquisition project he had been working on. The problem was that he hadn't had time yet to do the complete analysis. The deal had come together very quickly and he had spent significant time negotiating a contract and getting it in the title company. Monday was also the "live" date on the contract earnest money of $300,000 so a decision had to be made. He'd done a lot of research and preliminary analysis and had enough experience to know this was probably a great deal, but because RCP was attracting more sophisticated partners recently, he would have to put a presentation together that was far more explicit than explaining his "gut feel" for the deal. He had a lot of work to do this weekend to be ready.

Fortunately Frank had just hired Chris Thompson, a student intern enrolled in a top University real estate program. Chris had put together a complete proforma on the deal showing debt and equity positions. Frank had to review all these numbers and reach some conclusions over the weekend.

Realty Cap Partners

RCP had been started five years ago by Frank and four other partners. They all had substantial experience in the real estate industry. They had initially done a few small deals with "friends and family" money, but over the last year had been successful in tapping into a network of high net worth individuals. One of Frank's partners was focused on these relationships and had already found substantial interest in the subject property.

RCP eventually planned to put together a "Fund" where capital would be raised (and/or committed) in advance, and they hoped their reputation would allow them to do this in the next year or so. For the time being however, each deal had to be funded on a "one-off" basis. This meant that a specific partnership structure and equity financing arrangement would have to be negotiated at the same time they were busy with property due diligence. Without a solid equity commitment the group was wary about Monday's decisions.

RCP had also built a large enough portfolio of properties that they had taken the property management function "in house" and were actively involved in office property management.

The Real Estate and Acquisition Opportunity

RCP had a fully executed contract to acquire the Frisco Creek Building, a relatively new, 100,000 sq. ft., mixed use office building located in a rapidly growing suburban market near Dallas, TX. Buildings of this size and quality had recently sold for $200 to $250 per square foot. Frank had negotiated what he believed to be a very good price in lengthy sessions which included the original developer and lender. This price was actually below the loan amount on the real estate, but the developer had been in default and the problems had led to this opportunity.

Market Overview

The office market had been improving steadily along with general economic trends. Certain pockets in the city were clearly more popular with upscale tenants and commanded higher rents and occupancy. The Frisco Creek Building was less than three years old, fully leased and in a very strong office park area.

Debt Financing

As the deal had come together, RCP had sought out some traditional financing. Earlier in their history, RCP had used bank financing where they had excellent local relationships. However, the banks insisted on personal guarantees from the partners. While that had been appropriate in the beginning, their portfolio had grown and the partners had decided to pursue commercial mortgage lenders that would provide financing based on the security of the real estate. They had been successful in sourcing this kind of non-recourse financing and planned to continue on this route even though deals took a little longer to put together.

The commercial mortgage market was quite active for quality properties like the Frisco deal and RCP had received two mortgage financing commitments which they believed to be attractive. (See Exhibit B).

RCP Equity Financing Model

RCP had established a number of repeat investors, some with very deep pockets. They had structured a number of deals with these equity players and found a pattern in the investor structures. Deals were usually acquired in newly formed limited partnership entities with RCP acting as the general partner and the investor (sometimes more than one) acting as the limited partner.

The financial arrangement that had evolved with most of the partners required RCP to put up a small amount of the required equity, usually 5%, just so they would "have skin in the game" as the investors liked to say. The limited partner would then fund 95% of the equity requirement. The limited partner would also receive an 8% preferred return ("pref") on his money before allowing RCP to receive any cash. The basic deal was as follows:

All operating cash flows (after debt service and reserves) would be distributed
- first to satisfy the 8% pref to the limited partner (no accrual if insufficient)
- next to satisfy a similar 8% return on the equity put up by RCP
- then split 70% to limited, 30% to RCP

All net proceeds of sale or refinancing event (net of debt payoff) would be distributed:
- first to repay limited partner contribution
- next to repay RCP contribution
- next, a special distribution to limited partner to "true up" to a minimum 12% IRR
  (no similar true up on RCP funds)
- then split 70% to limited, 30% to RCP

Separate from the above allocations, RCP would earn a property management fee of 5% of EGI and a partnership management fee of 1% of invested funds (excluding RCP equity), not to exceed $25,000 annually. These were considered earned deal and administrative costs and not a distribution of cash flow or profits.

The Frisco deal had already been floated to a few of the key investors, and preliminary interest was strong. Deal sheets consistent with the above were already in circulation and the RCP partners were fairly confident a deal would crystallize. It was time to send out proformas and get an investor commitment.

Whether an investor would finally commit was usually dependent on how much risk they saw in the specific deal and if the expected return on their invested funds was adequate. This varied on a deal by deal basis given the quality of the real estate and the nature and level of debt financing (and other factors). RCP believed that the risks inherent in this deal and with their financing commitments would likely mean they would have to show the investors that they could expect a 15% internal rate of return on the deal over the expected five year holding period.

Real Estate Analysis

Frank knew he needed to put together some comprehensive spreadsheets that showed the investment and all the relevant cash flows. This meant a complete “waterfall” analysis showing what cash was available to be distributed to whom. Though he normally might do quarterly or even monthly projections, given the time constraints, he decided to do a simple annual analysis for the partner review process.

They expected to hold the property for 5 years and believed the market would be sufficiently liquid that they’d be able to sell the property. Office “cap rates” for this class of building were about 7.0% and they believed that would hold true when they were looking to sell the property except that they should probably add 50 basis points for the additional age of the building 5 years from now. Expected commissions and selling expenses would likely total 4% of proceeds.

Partner Return Analysis and Cash Distributions

The equity partners were always concerned about when “they” would receive cash. RCP had to manage the cash position of the partnership and knew that, once distributed, it was difficult to “call” for additional cash from the limited partners. For this reason they had adopted a practice of reserving some of the cash flow (beyond their capex expectations) for emergencies. For this deal, they decided they’d like to maintain a cash position of at least $50,000. At closing, they’d reserve $25,000 and then build to the $50,000 figure from operating cash flows.

After meeting these needs, RCP would distribute cash in accordance with the partnership agreement that would be along the lines discussed above.

Tax Considerations

The limited partnership entity used to hold legal title of the real estate would not be a tax paying entity. For this reason, there was no need to calculate taxes payable or due in the proforma exercise. However, the partners understood that this entity is a “flow-through” for tax purposes. Thus any taxable income or loss would be allocated to them annually when the K-1 tax forms were sent out. Further they all understood that tax allocations could vary substantially from actual cash distributions and this provided endless tax planning headaches for the partners. For this reason investors typically asked for a projection of taxable income allocations by year along with the proforma information. This would be done later.

The Decision

A decision had to be made by Monday – at least with respect to the $300,000 earnest money contract. Frank had asked for an extension, but had been denied as apparently there were other buyers waiting in line. Investor interest was high, but actually getting a commitment by Monday was probably impossible. They would have to make a decision based on their confidence level that they could attract the investor. They believed this could be easily done – if they could show a believable and acceptable IRR to investors.

Can we meet our investor expectations? Should we allow our contract to go “live”?

Exhibit A - Property Information

Contract Purchase Price:	$19,400,000
Terms:	All cash
Earnest Money:	$300,000 (also: Liquidated damages if buyer fails to close)
Closing:	60 days after expiration of inspection period with option at that date for 30 additional days in return for $200,000 additional earnest money deposit at that time.
Inspection Period	60 days from Date of Contract. Buyer may terminate and receive full refund of Earnest Money
Building Name:	Frisco Creek Building
Size:	101,350 sq. ft. gross 96,500 sq. ft. rentable

Leases – per review of individual leases – all are 5 years lease deals

SUMMARY LEASE INFORMATION Year 1							
Tenant	**Sq. ft.**	**Base Rent per s.f.**	**Base Rent**	**Remaining term (yrs)**	**Expense stop per s.f.**		**CPI adjustment % of actual**
Tenant 1	20,000	$29.25	$585,000	3	$12.00		None
Tenant 2	15,000	$29.50	442,500	4	12.25		None
Tenant 3	15,000	**$31.75**	476,250	5	13.30		None
Tenant 4	9,000	$30.75	276,750	4	12.50		None
Tenant 5	16,000	**$32.00**	512,000	5	13.30		None
Tenant 6	21,500	**$31.75**	682,625	5	13.30		None
Total	96,500		2,975,125				

Leases with rents shown in **BOLD** are new leases.

Expenses – Summarized from review of previous financials along with experience assumptions

Summary Expense Information - Estimates for Year 1					
	Dollars	**per s.f.**			
Property tax	$425,000	4.40	increase	3.00%	per year
Insurance	194,000	2.01	increase	2.50%	per year
Utilities	260,000	2.69	increase	3.50%	per year
Janitorial	164,500	1.70	increase	3.00%	per year
Maintenance	240,000	2.49	increase	2.50%	per year
Subtotal (reimbursable)	1,283,500	13.30			
Management fee* (estimated using base rent)	$148,756	1.54	5.00%	of EGI	
Total	$1,432,256	$14.84			

* Treated as non-reimbursable costs for these leases (practices may vary)

Exhibit B - Financing offers available

Loan A – Regions Insurance Company

Min Debt Service Coverage	1.25
Max LTV	88%
Interest Rate:	7.0%
Amortization	30 years
Term:	10 years
Points and closing fees:	2.5% @ closing

Loan B – National Assurance Co.

Min Debt Service Coverage	1.40
Max LTV	72%
Interest Rate:	6.5%
Amortization	30 years
Term:	10 years
Points and closing fees:	1.5% @ closing

Exhibit C – Additional Assumptions

Estimated closing costs (excluding financing points)	1% of purchase price (capitalized for tax)*
Estimated annual capital expenditures:	1% of NOI (ignore depr’n for tax*)
Current Market rate for this market:	$32 per rentable sq. ft.
Projected annual increase in market rents:	2.8%
Projected increase in CPI annually: (may not be needed)	2.5%
Base case Vacancy Rate Assumptions:	
- Year 1 – 3	0%
- Year 4	5%
- Year 5 and subseq.	8%
Expected Book Tax Differences (advanced analysis only)*	
Depreciation (80% of Purchase Price)	39 year life
Lender points	life of loan

* Assumptions provided here relating to tax aspects of deal are not required. Students interested in a detailed analysis including full tax allocations may contact instructor or review the optional Tax Accounting Advanced worksheet.

Exhibit D – A Comment on Equity Financing Model

This case uses a specific equity model similar to the one developed in the Brueggeman/Fisher text. Though one could argue it is reasonable and fair, it should be noted that there is no “standard” methodology for this. There are many different ways that investors and managers can share cash flows and economic risks/benefits of a deal. A somewhat standard, but different approach was developed in the private equity industry and is now migrating into real estate deal structures. This may be discussed further as part of this course.