**FINT480 Case Study #1**

**February 2019**

**Prof. Gillen**

Congratulations!! You have been hired as an analyst for LeBow Acquisitions LLC, a major property investment and management firm.

For your first assignment, you have been asked to perform a valuation in a property that LeBow is interested in acquiring. The property is a mid-rise office building in suburban Harrisburg, PA. All of the information you will need to undertake this valuation is given in the attached offering memorandum or in this document. You will perform this valuation using the Construction Cost (aka Replacement Cost) Approach, the Comps Approach and the Income Approach (which is composed of both the Cap Rate and Discounted Cash Flow (DCF) Approaches. You will then stress test these numbers via a pessimistic scenario and an optimistic scenario, using only the DCF approach. Hence, you will compute and report 6 different valuation numbers.

Your boss has provided you with the following information:

* The structure was originally built in 1994, but was renovated in 2014. It is classified as being in “Above Average” condition.
* The property currently has three office suites, but only two of them are currently occupied. The third space is vacant.
* The current owner has offered to upgrade the finishes in the vacant suite at their own expense. Because of these upgrades, this space is expected to rent for $13.00 per square foot (hereafter, “sqft”, which is a higher rent than any of the other currently occupied spaces are being rented for. LeBow believes it will secure a tenant for this space in the fifth year after it acquires the building.
* LeBow intends to acquire the property and hold it for 10 years before selling. For the purposes of your analysis, you will assume that LeBow will begin managing the building (collecting rents and paying expenses and taxes) in year 1. LeBow will continue to operate it through year 10, at the conclusion of which it will sell the property and collect the proceeds from the sale. Hence, when you value the building via the DCF approach, you will spread your numbers out over 10 years.
* The current size of the building (total sqft) and the size of each of the three office suites (their individual sqft), is given in the offering memorandum. It also gives the lot size (in acres) and the total number of parking spots. In addition, the building has 500 square feet of common area, which is composed of a small lobby, bathrooms and janitorial storage. The common area is used by all tenants and your staff who manage the building, so it generates zero rent. Your current tenant rent roll is as follows:
  + Enterprise Holdings: $12.11/sqft
  + Trinity Pharmacy: $9.00/sqft
  + Vacant Suite: Currently, $0.00/sqft, but $13.00 sqft once leased and occupied
* For the Cost Approach, you will need the following information:
  + Land in the Harrisburg region currently is currently selling for an average price of $1.47/sqft. Improvements to vacant land (i.e. landscaping) typically cost $1.50/sqft.
  + The cost of constructing a parking space is $2.35/sqft. A typical parking space is 180 sqft.
  + The national cost of labor is $35/sqft and the national cost of materials/sqft is also $35/sqft. The local construction cost multiplier for the Harrisburg area is 1.05; i.e. both labor and material costs in Harrisburg are 5% higher than the national average. This multiplier applies only to labor and materials costs. The sum of your labor costs and your materials costs are your total hard costs. These costs apply only to the cost of constructing the building, and should not be applied to the costs of landscaping or constructing the parking spaces.
  + Soft costs (architect’s fees, legal fees, engineering, marketing, and other overhead costs) are 30% of a project’s total construction cost.
  + The total construction cost of a project is the sum of the following: site (land) acquisition cost, landscaping costs, cost of parking space construction, total hard costs and total soft costs.
* For the Comps Approach, please see the comparables info in this document. “Distance from Subject” gives how far away the comparable property is from the subject property you are valuing, in miles.
* For the Cap Rate Approach, you will need the following information:
  + The annual expense for the property’s management is $0.55/sqft.
  + The annual expense for the building’s maintenance is $1.48/sqft.
  + The annual expense for parking maintenance and landscaping is $0.07/sqft.
  + The annual expense for insurance is $0.16/sqft.
  + The annual expense for utilities is $0.35/sqft.
  + The annual expense for property taxes is $0.75/sqft.
  + The average national cap rate for suburban office space is 6.8%, but cap rates for suburban office space in the Harrisburg region have a local multiplier of 1.15.
* For the DCF Approach, you will need the following information:
  + The rent escalation rate is 3% per year; i.e. rents will grow by this much in each year after year one.
  + The OpEx escalation rate is also 3% per year; i.e. the individual line items in operating expenses will grow by this much in each year after year one. This does not include the property tax.
  + The property tax growth rate is 2% per year; i.e. the site’s property tax bill will grow by this much in each year after year one.
  + The average national cap rate for suburban office space is projected to be 7.3% ten years from now, but you should apply the same local multiplier to adjust for local conditions.
* For the pessimistic scenario, you will need the following information:
  + The rent escalation rate will be 2.75% per year, the OpEx escalation rate will be 3.25% per year, and the property tax bill’s growth rate will be 2.5% per year.
  + A tenant for the vacant space will not be secured until year 7 of the building’s operation by LeBow.
* For the optimistic scenario, you will need the following information:
  + The rent escalation rate will be 3.5% per year, the OpEx escalation rate will be 2.8% per year, and the property tax bill’s growth rate will be 1.75% per year.
  + A tenant for the vacant space will be secured in year 3 of the building’s operation by LeBow.

Comps (Comparables) Info: See subsequent pages.



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| **Property #1** |  |  |  |  |
| **Property Info** |  |  | **Sale Information** |  |
| Site Area (Acres) | 2.2 |  | Sale Date | 1/12/2019 |
| Building Size (SqFt) | 22,000 |  | Sale Price | $3,400,000 |
| Net Rentable Area (SqFt) | 22,000 |  | Condition of Sale | Arms-Length |
| Year Built | 1989 |  | NOI | $284,920 |
| Last Renovation | 2018 |  | Buying Entity | Investor |
| Condition | Good |  |  |  |
| Number of Buildings | 1 |  | **Location Information** |  |
| Number of Stories | 2 |  | Location | Harrisburg, PA |
| Number of Parking Spaces | 35 |  | Distance from Subject | 0.7 miles |
| Tenancy Type | Single-Tenant |  |  |  |

**Comments:** The property was originally marketed for sale at a price of $3.65 million. Shortly before the sale, the existing tenant renewed with a 7-year lease. Thelease operates on a gross plus janitorial and utility basis with year 1 rent of 15.22 per square foot. The lease has 2.5 percent annual increases starting

in year 3. The building was renovated in 2018. Renovations included exterior upgrades such as re-flashing and painting. In addition, the parking lot wasresurfaced and new parking lot lighting was installed. Interior finishes were also updated. The roof had 7-years of warranty remaining on it and was ingood condition. The buyer is an investor and operator of office product in the region.



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| **Property #2** |  |  |  |  |
| **Property Info** |  |  | **Sale Information** |  |
| Site Area (Acres) | 1.7 |  | Sale Date | 6/17/2017 |
| Building Size (SqFt) | 43,161 |  | Sale Price | $6,648,743 |
| Net Rentable Area (SqFt) | 43,161 |  | Condition of Sale | Arms-Length |
| Year Built | 1988 |  | NOI | $598,387 |
| Last Renovation | 2004 |  | Buying Entity | Investor |
| Condition | Average |  |  |  |
| Number of Buildings | 1 |  | **Location Information** |  |
| Number of Stories | 2 |  | Location | Camp Hill, PA |
| Number of Parking Spaces | 178 |  | Distance from Subject | 4.7 |
| Tenancy Type | Multi-Tenant |  |  |  |

**Comments:**This is the sale of an approximately 43,000 square foot office building built in 1988. The building is located in the Harrisburg West Market. The building was occupiedby three tenants at the time of sale. In-Place NOI was reported as being around $600,000. The major tenants included Urology of Central PA leasing17,000/SF through 11/2026 and Marshall Dennehey leasing 21,728/SF through 12/2023. Market rent for this building was reported at $19.50 FullService.



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| **Property #3** |  |  |  |  |
| **Property Info** |  |  | **Sale Information** |  |
| Site Area (Acres) | 1.1 |  | Sale Date | 5/25/2017 |
| Building Size (SqFt) | 64,169 |  | Sale Price | $5,240,000 |
| Net Rentable Area (SqFt) | 64,169 |  | Condition of Sale | Arms-Length |
| Year Built | 1980 |  | NOI | $520,856 |
| Last Renovation | 2012 |  | Buying Entity | Investor |
| Condition | Average |  |  |  |
| Number of Buildings | 1 |  | **Location Information** |  |
| Number of Stories | 1 |  | Location | Harrisburg, PA |
| Number of Parking Spaces | 100 |  | Distance from Subject | 0.27 |
| Tenancy Type | Multi-Tenant |  |  |  |

**Comments:** This is a sale of a fully leased medical office building/fitness center. The building is leased to the Orthopedic Institute of PA and Central PennsylvaniaFitness Center. The initial asking price was $5,950,000 and the property was on the market for 4 months.



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| **Property #4** |  |  |  |  |
| **Property Info** |  |  | **Sale Information** |  |
| Site Area (Acres) | 2.8 |  | Sale Date | 2/20/2018 |
| Building Size (SqFt) | 11,250 |  | Sale Price | $1,450,000 |
| Net Rentable Area (SqFt) | 11,250 |  | Condition of Sale | Arms-Length |
| Year Built | 1980 |  | NOI | $116,000 |
| Last Renovation | 2012 |  | Buying Entity | Investor |
| Condition | Average |  |  |  |
| Number of Buildings | 1 |  | **Location Information** |  |
| Number of Stories | 3 |  | Location | Camp Hill, PA |
| Number of Parking Spaces | 40 |  | Distance from Subject | 4.6 |
| Tenancy Type | Multi-Tenant |  |  |  |

**Comments:**The building was occupied by five tenants at the time of purchase, with a 1,500 square foot suite available on the third floor. The roof was replaced inMay of 2002. The building underwent considerable renovations in 2012. At the time of sale the HVAC and mechanical systems were inspected andreported to be in good and functioning order. These components were serviced on a regular quarterly maintenance schedule.

Note: I highly recommend entering all the assumptions and inputs into a spreadsheet, and then create a separate worksheet tab for each valuation approach. That way, you will only be entering the input data once.

**Question 1:** Value the property using the Cost Approach. You will do this by computing each entry in the following construction budget’s line items and summing them:

|  |  |  |
| --- | --- | --- |
| **Item** | **National $Amount** | **Local $Amount** |
| Site (Land) Acquisition Cost |  |  |
| Landscaping Costs |  |  |
| Cost of Parking Space Const. |  |  |
| Total Hard Costs |  |  |
| Total Soft Costs |  |  |
| **Total Construction Costs** |  |  |

**Question 2:** What is the total value of land as a percent of the total project’s value (i.e. total cost of construction)?

**Question 3:** Our guests from MAI said that land is typically 20-30% of value in a balanced market. Is the % allocation of value to land under the cost approach significantly different from this? If so, what does this tell you?

**Question 4:** Value the property using the Comps Approach You will do this by taking a weighted average of the value of the four comparables, where the weights reflect how similar (i.e. “comparable”) they are to the subject property. For value, you can use their sale price or sale price/sqft. You are also free to only use subset of the four comparables if you believe that one or two of them are not good ones. Present and show your work. Be aware that the comps approach is more art than science: there is no one “correct” answer. Rather, you will be graded on this component by how well you show your work and how well you argue your reasoning for the final number you arrive at.

**Question 5:**Which particular comp did you think was the most comparable and why?

**Question 6:**Which particular comp did you think was the least comparable and why?

**Question 5:**Value the property using the Cap Rate version of the Income Approach. You will do this by computing each entry in the following table and the using those numbers to compute the Estimated Price. (Note: you may wish to set up a more detailed version of the table, where each tenant’s rent and each individual operating expense is broken out separately.)

|  |  |
| --- | --- |
| **Item** | **Year 1** |
| Total Annual Rent |  |
| -Total Operating Expenses |  |
| =Net Operating Income |  |
| Cap Rate |  |
| Estimated Price (=NOI/Cap Rate) |  |

**Question 6:**What percent of total annual rental income is operating expenses? Does this percent seem reasonable to you? (Hint: google around to find what percent of gross income that operating expenses should be.)

**Question 7:**Value the property using the DCF version of the Income Approach. You will do this by computing each entry in the following table and the using those numbers to compute the Estimated Price.



Note that this is conceptually the same as the Cap Rate Approach, but with two key differences:

1. The cash flows are spread out over 10 years.
2. In the final year that you are holding the building, you will apply the appropriate cap rate to that year’s NOI to obtain a predicted sales price. You will then add this sales price to your year 10 NOI before computing the NPV of all your cash flows.

**Question 8:**Value the property using the DCF version of the Income Approach, but for the pessimistic scenario.

**Question 9:**Value the property using the DCF version of the Income Approach, but for the optimistic scenario.

**Question 10:**Summarize your valuation results by completing the following table:

|  |  |  |
| --- | --- | --- |
| **Approach** | **Estimated $Value** | **Estimated $Value/SqFt** |
| Cost Approach |  |  |
| Comps Approach |  |  |
| Cap Rate Approach |  |  |
| DCF-Baseline |  |  |
| DCF-Pessimistic |  |  |
| DCF-Optimistic |  |  |
| Asking Price |  |  |

**Question 11:**Which approach do you think is the most appropriate one for this case study, and why? Which approach do you think is the leastappropriate one for this case study, and why?

**Question 12:** What is your final, best estimate of the property’s current market value? (It is fine to blend the values from different approaches). Describe your reasoning why you think this is the most accurate value. Compare your value to the property’s current list price and discuss why you think there may be any significant difference.