

Case Study – Domus Developments: To build or not to build?

(This case study is adapted from <https://cb.hbsp.harvard.edu/cbmp/access/43420441>)

Introduction

It was October 2013 and Michael Mescia, a project manager of Domus Developments (Domus), was contemplating to relaunch the North Point Lofts (North Point) development project that had not yet come to fruition in 2008. 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 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

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

Domus had developed a strong reputation for innovative designs and high-quality structures. Domus could design and construct a site that satisfied customers and sold quickly which led Domus to its current level of success. In the beginning, Domus had been unable to secure Type A sites (a land classification based on location and zoning) 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.

North Point Lofts

North Point would be a four-storey 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. 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 Exhibit 1 for an initial artist's concept design for North Point.

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 of all units.

Development Considerations

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.

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 was 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 of 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.

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. 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 cost 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 has been 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 purposes, 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 sales 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.

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.

Mescia projected total revenue from the sale of the North Point lofts to be \$25.5 million based on the average selling price per unit. 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.

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 model home. See Exhibit 3 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, 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.

Required:

- a) Prepare a 24-month cash budget for building North Point, starting in May 2014. (Cash budget template will be provided.)
- b) Should Domus build North Point or sell the land? Support your decisions considering both qualitative and quantitative factors.

EXHIBIT 1: NORTH POINT CONCEPT DESIGN




Source: Domus Developments.

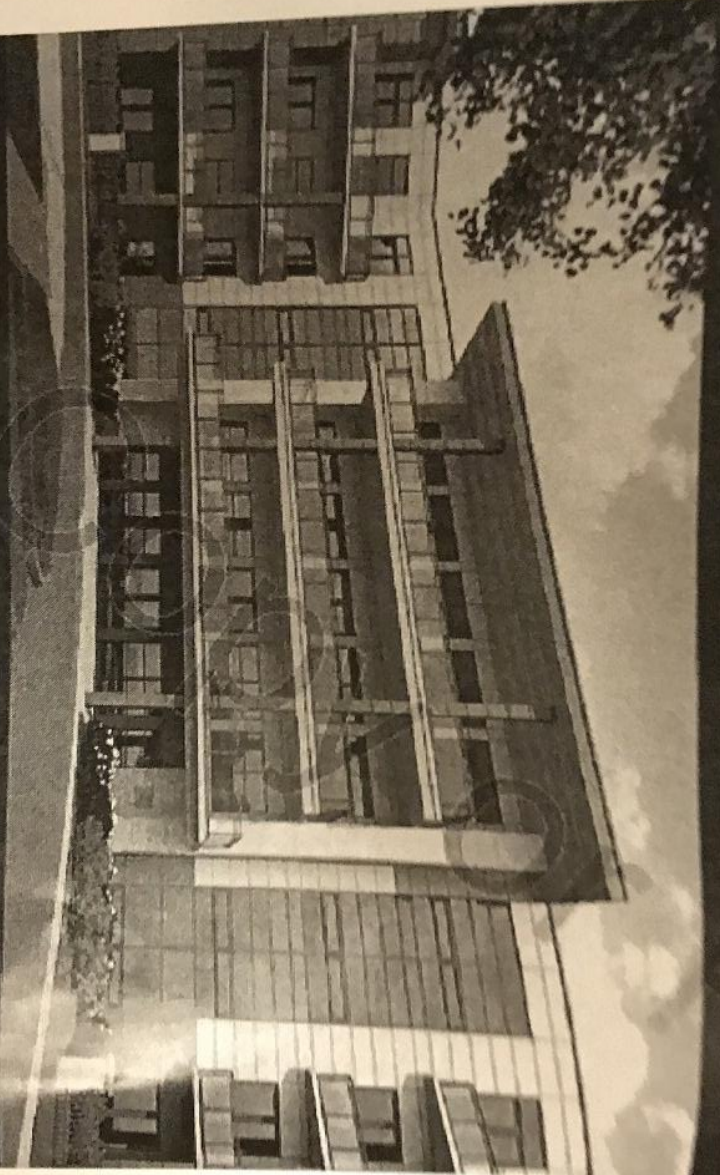
EXHIBIT 2: KEY TRENDS IN LONDON

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.



EXHIBIT 3: ADVERTISEMENT FROM LONDON HOME BUILDERS ASSOCIATION ORGANIZATION

NORTH POINT  **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

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