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The Condo Case

Team #19

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Project Summary

Units: There will be 27 apartments, all one-bedroom units. Higher floors will garner better prices due to less street noise and the availability of an elevator. The fourth floor will be finished first in construction, and will be used as a sales office and showroom so the broker can begin pre-selling in month 6. Marketing spend will also begin to increase at this time.

Size: All units, regardless of configuration, will be 950 square feet. The two ground units will include a small patio space.

Target Price: Range: \$342,000 (Floor 1) - \$389,500 (Floor 6). Based on local research, I estimate that apartment prices should increase by about \$10 / sq. ft. per floor.²

Amenities: Roof deck, 24-hour concierge, gym, electronic key card security system, hallway and reception furniture (ongoing upkeep after initial construction, along with general building maintenance, will be paid for by owners' condo fees). The initial costs of amenities are included in construction. Access to these amenities are included with condo purchase, and make the individual apartments higher in value. Other development opportunities that I recognize but will pursue after the initial development has stabilized are the creation of storage lockers and parking spaces which owners would be able to purchase.

Selling Date: The final estimated Stabilization Date is three years from commencement of the project. Intuitively, the expected sales timeline will resemble a right-skewed normal distribution; I have estimated about 20% pre-sell of condos by the end of year one.³ If all goes well, other sales will average out equally over years 2 and 3.

Total Costs: I have allocated costs over the construction period, according to my estimated timing as to when they will be incurred. For example, marketing costs will only ramp up when the show room and pre-sell process begins, continuing during the second year as we focus on selling finished units. I have also included a contingency cushion.

Item	Notes/Assumptions	Cost
Land	Given	\$3.6 million
Hard Costs and Construction	We assume that the cost of renovating was inclusive of all hard costs (architects, engineering, etc.) including rezoning and amenities described above	\$3.3 million
Transaction	Estimated title inspection and transfer recording	\$360,000
Borrowing	Estimated; incurred up-front	\$100,000
Insurance and Property Taxes	Paid semiannually, falling as apartments are sold; we prefer to pay more frequently so that we can take advantage of the reduction in taxes due to sales	\$196,000
Marketing	Estimated; follows S-curve distribution as units are finished	\$21,000
Development Overhead	Estimated	\$100,000
Developer's Fee	The 4% fee is of hard and soft costs; 2% paid out; the other 2% is returned to the project	\$85,000

² Based on the team's observation of a newly-built condominium complex in Old City, Philadelphia, where the increase in sale price was approximately \$10,000 per floor.

³ Based on the example of Dranoff's property, the RCA Victor in Camden, which was pre-sold about 20% before construction was completed.

Contingency Fee	For unexpected expenses	\$200,000
TOTAL COSTS	Incurred over the 3 year project life (but front loaded in yr 1)	\$8.0 million

Decision

Dear Spouse,

I have done a careful analysis of the condominium development opportunity we've been discussing and I'd like your permission to quit my job and work on it. After comprehensive study of the location, and detailed financial analysis (see attached documents), I believe there is a clear, untapped market for the type of condominium I'll be selling in this neighborhood. While this project will affect our financial situation rather dramatically, I am passionate regarding the opportunity to better our neighborhood, leave my mark on society, and set an example for our children.

Target market and positioning

A newly renovated building with a good design in a very desirable neighborhood can be expected to sell at the upper limits of the average price range. However, a 'vanilla' offering of what currently exists must compete with everything else available. Recognizing that the average size of an apartment in the area I have targeted is an enormous 1400 square feet, I propose to offer new residents a unique product – namely, smaller units at lower prices. The building will have a roof deck, gym, 24-hour concierge, and expansive lobby. The customer niche I expect to attract is an active, younger-professional group that desires to live in the neighborhood and has disposable income, but does not demand or desire the current 1400 square feet average.

Based on my knowledge of the market, I know that \$500,000 would be a good price for a new 1400 square foot apartment in an amenity-laden building. I've investigated comparable units in the area, and the relationship between floor space and price does not appear to be linear, which leads me to believe I can still charge prices for my smaller units within the

neighborhood's average range.⁴ I've estimated that there is more financial benefit to creating a higher number of smaller, upscale units (in addition to uniqueness of product), as the plan details, and have thus sized my apartments at 950 square feet.

Cash flow and our lifestyle

The cash flow on the condominium opportunity will be positive over its life, but it is unlikely that, even with the aggressive pre-selling I plan, we will be able to maintain our current lifestyle in which I am able to contribute \$200,000. Specifically, we'll go through a difficult time during the first 2 years.

Of course, if I did not engage in this investment, I'd be making about \$600,000 over the life of this project. Relative to my investment of cash and sweat equity, the projected returns on this condo project are far below those at my current job. However, the psychic benefits cannot compare with building something like this condo to better our neighborhood and help those who live around us. Also, becoming successful in real estate requires extensive hands on experience. I expect that this project will provide that this condo will serve as a stepping stone to other, more prosperous real estate opportunities. Furthermore, I have estimated the costs for this project as well as the pricing of the condos conservatively, and, if the economy improves as has been predicted, I will receive better prices – especially considering that I have left the most desirable top floors for last in the sales process (to be sold when the building looks its best once construction ends).

⁴ This estimate is based on our team's analysis of the relationship between floor size and price of 97 units across six different Chicago mid- and high-rise condominium buildings. Data was obtained from the Chicago brokerage firm Baird & Warner.

Appendix A – Summary of cash flows

	Year 1				Year 2				Year 3				Total over 3 years
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Number of Units Sold			3	2	2	4	5	4	3	2	1	1	27
Cash Flows													
<i>Revenue from condo sales</i>			1,111,500	741,000	722,000	1,434,500	1,748,000	1,482,000	1,149,500	779,000	389,500	389,500	9,946,500
Broker's Commission 6.0%	0	0	(66,690)	(44,460)	(43,320)	(86,070)	(104,880)	(88,920)	(68,970)	(46,740)	(23,370)	(23,370)	(596,790)
<i>Investment Cash Flows (excludes financing)</i>													
<u>Land</u>	(3,600,000)												(3,600,000)
<u>Hard Costs</u> - Construction costs ¹	(495,000)	(1,155,000)	(1,155,000)	(495,000)									(3,300,000)
<u>Soft Costs</u>													
Title - inspect / transfer 10.0%	(306,000)	(54,000)											(360,000)
Borrowing costs													
- Construction loan fee (75 bps)	(31,500)												(31,500)
- Lending inspection 0.5%	(10,500)	(10,500)											(21,000)
- Lender legal 0.5%	(10,500)	(10,500)											(21,000)
- Borrower legal 0.5%	(10,500)	(10,500)											(21,000)
Insurance 1.0%	(16,500)		(16,500)		(13,444)		(9,778)		(4,278)		(1,222)		(61,722)
Marketing 0.3%	0	(863)	(1,725)	(3,450)	(3,450)	(3,450)	(2,588)	(1,725)	(863)	(863)	(863)	(863)	(20,700)
Property taxes 2.0%	(36,000)		(36,000)		(29,333)		(21,333)		(9,333)		(2,667)		(134,667)
Develop. Overhead 3.0%	(14,850)	(34,650)	(34,650)	(14,850)									(99,000)
Contingency 2.5%	(22,500)	(52,500)	(52,500)	(22,500)	(6,250)	(6,250)	(6,250)	(6,250)	(6,250)	(6,250)	(6,250)	(6,250)	(200,000)
Developer's fee paid out (1/2 of 4%	(19,077)	(26,570)	(25,928)	(10,716)	(1,050)	(194)	(799)	(160)	(414)	(142)	(220)	(142)	(85,412)
Unlevered Free Cash Flows	(4,572,927)	(1,355,083)	(277,493)	150,024	625,153	1,338,536	1,602,372	1,384,946	1,059,392	725,005	354,909	358,875	1,393,709
Financing Cash Flows													
In-Flows													
Developer's personal investment	65,000	0	0	0	0	0	0	0	0	0	0	0	65,000
Private Equity investment	2,035,000	0	0	0	0	0	0	0	0	0	0	0	2,035,000
Mortgage (current CF - available Equity)	2,472,927	1,355,083	277,493	0	0	0	0	0	0	0	0	0	4,105,502
Shortfall - Developer makes up	0	0	0	0	0	0	0	0	0	0	0	0	0
Outflows to Debt													
Mortgage (current CF - available Equity)													
Interest	0	0	0	(73,276)	(71,963)	(62,506)	(40,690)	(13,991)	0	0	0	0	(262,426)
Principal (including capitalized interest)	0	0	0	(76,748)	(553,189)	(1,276,030)	(1,561,682)	(818,343)	0	0	0	0	(4,285,993)
Residual Cash Flows Available for Equity	0	0	0	0	0	0	0	552,612	1,059,392	725,005	354,909	358,875	

Notes and Assumptions

- 1 Assumed to include engineering, architect, and any other "hard" costs.
- 2 Interest accrues at 6.8% APR compounded and payable monthly (See debt schedule)

Appendix B - Summary of Returns

Project's Unleveraged IRR	Year 1				Year 2				Year 3				Total over 3 years
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	
Dates used for calculating IRR	1/1/2004	4/1/2004	7/1/2004	10/1/2004	1/1/2005	4/1/2005	7/1/2005	10/1/2005	1/1/2006	4/1/2006	7/1/2006	10/1/2006	
Unlevered Free Cash Flows (from above)	(4,572,927)	(1,355,083)	(277,493)	150,024	625,153	1,338,536	1,602,372	1,384,946	1,059,392	725,005	354,909	358,875	
Project's cumulative IRR * (using Excel's XIRR function)				-99.8%	-91.1%	-63.6%	-34.2%	-13.5%	-0.5%	7.1%	10.4%	13.5%	13.5%
* Cash flows are assumed to occur on the first day of the quarter.													
Equity IRR													
<u>Equity investments</u>													
Private Equity fund's investment	(2,035,000)	0	0	0	0	0	0	0	0	0	0	0	(2,035,000)
Personal investment of Developer	(65,000)	0	0	0	0	0	0	0	0	0	0	0	0
Shortfall made up by Developer	0	0	0	0	0	0	0	0	0	0	0	0	0
Investment of Developer Fee	(19,077)	(26,570)	(25,928)	(10,716)	(1,050)	(194)	(799)	(160)	(414)	(142)	(220)	(142)	(150,412)
Operating cash flows to available to Equity (from	0	0	0	0	0	0	0	552,612	1,059,392	725,005	354,909	358,875	
Cash flows Available to Equity	(2,119,077)	(26,570)	(25,928)	(10,716)	(1,050)	(194)	(799)	552,452	1,058,977	724,863	354,689	358,733	
Equity's cumulative IRR (using Excel's XIRR function)								-54.8%	-14.8%	3.4%	10.6%	16.9%	16.9%
Developer's Return													
Cash invested	(65,000)	0	0	0	0	0	0	0	0	0	0	0	
Return received													
Developer fee	38,154	53,141	51,855	21,432	2,099	388	1,598	319	829	285	440	285	
less fee re-invested (Sweat equity)	(19,077)	(26,570)	(25,928)	(10,716)	(1,050)	(194)	(799)	(160)	(414)	(142)	(220)	(142)	
Recovery of subordinated equity position	0	0	0	0	0	0	0	0	0	85,050	220	142	
Receipt of Carry	0	0	0	0	0	0	0	0	0	0	0	62,679	
Share of residual equity cash flows	0	0	0	0	0	0	0	0	0	14,850	24,375	20,366	
Developer's cash flows	(45,923)	26,570	25,928	10,716	1,050	194	799	160	414	100,041	24,815	83,330	228,094
Developer's IRR (using Excel XIRR function)													267.4%