<u>REAL 320 – Principles of Real Estate</u>
ASSIGNMENT #2 – Buy Your First Investment

1. **Please print out and turn in an excel spreadsheet, in which you have prepared a ProForma reflecting the information provided below.**

   You are considering purchasing a neighborhood location which would be perfect for an Olive Garden location. You've spoken with an Olive Garden site selection manager, who is excited about your proposed location, and now you need to determine if the purchase makes economic sense.

   You have retained Lou Galuppo of the University of San Diego, who is an expert in providing forecasting assumptions regarding your proposed site. Lou has estimated that there is a very high probability that you would earn an 11% rate of return by investing in the "Corleone Godfather Fund," which is an independent portfolio of publicly traded securities, known for extremely predictable earnings, especially in turbulent stock market conditions.

   After paying Lou's outrageous fee of $30,000.00 for his data, you sit down to decide whether you should invest in the real estate, buy the securities portfolio, or quit the business and retire by working for your relatives in Palermo.

   <u>REPORT FROM LOU GALUPPO</u>

   Dear Prospective Olive Garden Property Location Owner:

   At your request, I have completed my analysis of the market conditions for this property. At the location you are considering, an appraisal has been completed on the property, and you can purchase the property, built to Olive Garden specifications, for $6,300,000.00 ($2,300,000.00 for the land, and $4,000,000.00 for the building). At the close of escrow, you can expect to pay about 2.7% of the purchase price in closing costs.

   Because this is a commercial investment property, Pavarotti Bank Services, LLC can provide you with the best commercial loan at the lowest interest rate – a no-cost, no-points 30 year amortized loan at a fixed 6.75% interest rate. The maximum loan-to-value you can borrow is 70% of the purchase price. Loan costs are estimated at .8% of the value of the loan. You will need to personally guarantee the loan.

Additionally, Pavarotti Bank Services, LLC will require you to create a single asset California-based LLC in order to hold this property. It will cost you $3,000.00 to set up the LLC, and each year your accountant has estimated that you will pay only the $800.00 minimum California Franchise Tax Board Fee for the entity.

This property will appreciate at an annual 5% compounded rate for the term of ownership. Your closing costs at the time of sale will be 8% of the sale price at that time, inclusive of a 5.0% commission and 3.0% for other closing costs.

Olive Garden has agreed to pay annual base rent calculated as 8% of the purchase price of the property, increasing 5% each year. Additionally, Olive Garden will share its profits with you as part of the lease. Olive Garden estimates that your portion of the profits will be $75,000.00 per year, estimated to increase at 5% per year over the course of ownership. Olive Garden will be your only tenant, and they have already signed a 20 year lease, to be effective on the date construction is completed. They have guaranteed payment of both the rental and incentive payment, even if they no longer have an Olive Garden at this location.

The negotiated lease is a triple-net lease, meaning that Olive Garden will pay for taxes, insurance, and maintenance on the property. We have agreed, however, to pay for the Owners Association fee for the common area, which is $2,000.00 per month (estimated to increase at 4% per year), and the water supplied to this location, since Olive Garden’ failure to pay this utility could cause a lien to be put on the property. The estimated water bill is $2,800 per month, and we expect this cost to increase at 13% per year, given San Diego’s huge water infrastructure problems.

Depreciation is calculated over 39 years, your ordinary income tax rate is 35%, and your capital gains rate is 20%. Fortunately, you are fabulously successful, and have plenty of income to offset any loss – so any tax benefit associated with having negative income is of real value to you, since it offsets taxes on other income streams. You initially expect to hold this property 31 years.

You remember than in calculating an IRR, the initial funds are negative, since they represent funds going OUT of your pocket. If you make any additional assumptions, they should be reasonable, and clearly outlined on your paper. Do not add assumptions unless you are stuck.

2. **After completing your initial evaluation based on Lou Galuppo's forecast, you decide that additional information may help to determine the strength of your model. You should prepare additional Excel printouts detailing the differences in assumptions.**

   USD Professor Alan Gin is also a trusted advisor, and has suggested that the assumptions provided by Louis Galuppo should be adjusted as described below. Alan doesn't believe that Lou is wrong, lying or insensitive, but merely has a different view of the future economic outlook. Sensitivity Analysis should be used to test the impact on the return for the following variables:

   a. Real Estate Value Appreciation Rate: Real Estate appreciation is more likely to come in at 2% per year compounded over the next 10 years. Also, 2% is a fair amount to use for any relevant holding period.

   b. Holding Period: Perhaps the optimal time to hold this particular piece of real estate is 10 years, rather than the 31 years you initially modeled. He thinks you should also test holding periods at 5 years and 15 years.

   c. Real Estate Rental Rate Appreciation Rate: Alan Gin suggests that appreciation of the rental rate will go up only 3% over the next 10 years. Then, while he doesn't have an opinion, the 3% is a fair amount to use for any relevant holding period.

   d. Capital Gains Tax Rate: Alan Gin suggests that capital gains rates will increase to 25%. Additionally, he thinks that Capital Gains could go as high as 35%.

   e. Ordinary Income Tax Rate**:** Alan Gin believes that the ordinary tax rate (both Federal and State combined) will increase to 45% this year.

   f. Water Rate: Future water problems are likely to be extremely acute, and will result in a 40% annual increase in water costs.

   g. Interest Rate: The interest rates will drop to 4.5%

   h. Triple Net Lease: Instead of offering a triple net lease, where the tenant pays for maintenance, taxes and insurance, you should consider the economic impact of a lease where the landlord is responsible for the following costs:

   - Property Taxes at 1.1% of the total purchase price of the property
   - Fire and Hazard Insurance at $8,000.00 per year
   - Maintenance costs estimated at $15,000.00 per year

3. Please provide a 2-3 page executive summary summarizing your findings describing why or why not the investment described in this assignment should be made.

Your narrative should describe the differences between the Galuppo Assumptions and the Gin Assumptions, and should identify the five input assumptions which are most sensitive to your rate of return.

If it turns out that only the Galuppo Assumptions or the Gin Assumptions suggest you should make the investment, then you should provide an analysis as to whether you should make the investment or not. Remember, the investment can either be made, or not be made – you cannot make the investment only premised on the most favorable set of assumptions.

4. Complete the Comprehensive Peer Evaluation for yourself and your group, pursuant to the instructions in the Syllabus and on the evaluation form.