Example of case study on purchase price before renovation = $90,000,000

Business, Company

REPORT ON PURCHASE OF APARTMENT

Report to ABC Commercial Real Estate Corporation on purchase of apartment

Current average rent = $2, 000 per month

Total annual rent revenue = 400 × 2, 000 × 12 months = $9, 600, 000

Return on investment = Profitinitial cost ×100%

= 9, 600, 00090, 000, 000 ×100% = 10. 67%

Assuming a cost of capital/required rate of return of 10%, the net present value for this project can be computed as follows:

Supposing the apartment is purchased, the NPV of the project will be as follows

Cash flow for year 6 represents the cash flow the corporation will generate on sale of the apartment after 5 years. Assuming the apartment will be sold at the same price it was bought, if not renovated, the corporation will earn $90 million. If it is renovated, the corporation will earn $100 million ($90 million + $10 million for renovation).

Financing the purchase of the apartment

In raising the amount required to finance the project, the corporation should borrow 60% of the required cost. The remainder should be raised through an issue of preference shares. This will ensure that there is no loss of control in the company. Preference shareholders are not real owners of a corporation hence issuing preference shares does not lead to dilution of control of existing ordinary shareholders (Block & Hirt, 2006). In addition, issuing preference shares does not involve high floatation costs unlike issuing ordinary shares. The corporation will not be under any obligation to pay dividends to preference shareholders. Their fixed dividends are only paid if distributable profits are available and upon declaration of dividend payment by the directors.

Preference shares are suitable for this project since it is not a long term project. Preference share capital is not a permanent source of capital hence the corporation can use the matching approach to finance this project. Matching approach is where a firm uses a source of finance whose maturity period is equal to the life of a project or investment. In this case, since the project is expected to last for five years, the corporation can issue 5-year redeemable preference shares such that by the time the apartment is sold, the preference shares issued to finance its purchase are bought back by the company. This will ensure the corporation does not keep unnecessary and excessive amounts of capital.

References

Block, S. B., & Hirt, G. A. (2006). Foundations of financial management (9th ed.). Toronto: McGraw-Hill Ryerson.