

Millegan creek apartments- financial analysis assignment

Law



The Millegan Creek Apartment case is an example of a commercial loan. The parties involved in the commercial loan are JP Multifamily Inc. and Fleet Bank. Real Estate group at Fleet Bank want to find out whether or not to accept JPI's proposed \$15, 715, 000 loan for a 390-unit apartment project in Austin, Texas. The details about the each party, market and financial analysis of the project is outlined below. THE BORROWER -JP MULTIFAMILY INC. The Development Expertise JPI Multifamily Inc. (JPI) was founded in 1989 by John Carpenter and Frank Miller, who had worked together at Southland Financial.

JPI, a first class developer, was known as a " merchant builder" meaning that they developed properties with the intention of selling rather than owning them. JPI had begun seriously investigate in Austin market in 1991. They purchased their first site in early 1992, which was a " trophy property", 210-unit project, located in the Southwest part of Austin. The second property JPI purchased in Austin was located in the North Central Area which was a 342-unit project. And, finally the third apartment development in the Austin for JPI would be a 390 unit the Millegan Creek Apartments project. The investment Strategy

JPI tried to achieve at least a 150 basis point spread between the initial yield and the current market capitalization rates. JPI was seeking development opportunities which provide a going-in cap rate (or cash on cash return) of at least 10% on the total project cost. They had developed approximately 2800 apartment units and 1, 640 apartments. This record was in line their investment strategy of targeting a " holding period for development projects of two to three years. In 1994, they had eight properties with 2, 700 units
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under construction, four of which were under agreement to be sold upon completion.

THE LENDER-FLEET BANK Fleet Bank is being considered as a lender of the project. The Austin Market is a new market for Fleet Bank. Fleet wants to diversify its loan portfolio out of Northeast. Tom Hayden's (a vice president in Commercial Real Estate at Fleet Bank) assignment was to seek financial opportunities in real estate in the State of Texas. Based on Tom's research, JPI was an active developer who had survived the Texas real estate crash built a large number of apartments. SALIENT FACTS of MILLEGAN CREEK

APARTMENTS PROJECT

The Description of the Product: Jefferson at Millegan Creek Apartment would be a typical JPI luxury apartment complex. The apartment would target renters with high discretionary incomes who could probably afford a single-family home, but made a lifestyle choice to live in rental apartments. Site amenities included two swimming pools, a clubhouse, fitness center with sauna and steam rooms, and the laundry facilities. Standard features in each apartment included nine-foot ceilings, a security system, crown molding and upgrade white on white appliances.

Location: The Millegan Creek site was located in Williamson County, adjacent to the city of limits of Austin and approximately 11 miles northwest of the central business district. The site was an irregular, rectangular shape consisting of about 21.5 acres, with 904 feet of frontage along McNeil Road.

Near Highways: Parmer Lane had recently been expanded from a two lane to a six-lane road and provided excellent north-south access. McNeil Road

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brought about 15, 000 cars in an east west direction past the site each day and had recently been upgraded from a two lane to a five-lane road.

In addition, McNeil Road was being extended three miles to connect to Wells Branch Parkway. Construction financing: The loan was being reviewed by Fleet Bank because the volume of deals JPI doing, their existing lenders (NationsBank, Guaranty Federal Savings Bank (in Dallas), BankOne, General Electric Credit Corporation had reached the limit of the exposure they wanted with any borrower. Construction problem: The site was level with no significant subsurface rocks, which would not create construction problem.

Property Taxes : The site was outside the City of Austin which can provide lower property taxes and easy zoning approval. Total Project Cost: \$19, 644, 000 Loan Amount: \$15, 715, 000 Land Cost: \$1, 425, 000 The holding period: Target holding period is two to three years MARKET ANALYSIS Regional Economic Drivers Austin housing market holds a comparative advantage and this advantage exists because; -it's ranked sixth in the nation as a preferred location for a new manufacturing facility, - Austin economy had always been universities and government as the state capital.

Austin had a government workforce of over 110, 000 including state, country and city employees and plus recently added 3, 000 government sector jobs, - The location of project was close to many of Austin's high tech companies. Texas Instruments had a big campus located across the street. Others in the area included: Abbott Laboratories, Tandem Computers, 3M, and State Farm Insurance. Apple Computers had also announced plans to build a new, \$28 million, 300, 000square foot facility to house its U. S. Customer support

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Service - The other strength of Austin is that the city is filled with good universities.

Companies were attractive to Austin economy by the presence of university-based research and its very desirable climate. Market demand Austin had experienced significant population growth and local economists expected these trends to continue. The average family size would continue to be about 2.43 people per household. Job Growth Since the strength of the apartment market heavily dependent upon continued growth in the local market, local job market figures as follows; -As of September 1993, Austin's employment totaled 425,800 and its unemployment rate was at 4.%. Austin added almost 30,000 jobs in the 1992-1993 periods. -The Texas Comptroller of Public Accounts projected job growth for the next two years to continue in the 3% to 3.2% range. INVESTMENT DECISION I recommend Fleet Bank to approve the loan based on the market analysis outlined above and the attached financial analysis. The highlights of ratios listed in Exhibit 1 as follows; Cash on cash return 13.70%, IRR_e 5YR Hold 26.48%, IRR_o 5 YR Hold 16.62% and Cap Rate (in) 10.67%. In the loan calculations the interest rates is taken as 8%. Considering that institutional buyers in the region were paying cap rates in the 8% to 9% for the new apartments, JPI can achieve its investment strategy of obtaining at least 150 basis point for its investments. The debt service coverage ratio (DSCR) in commercial real estate finance refers to the primary measure to determine if a property will be able to sustain its debt based on cash flow. Typically most commercial banks require the ratio of 1.15-1.35 times (net operating income or NOI/annual debt

service) to ensure cash flow sufficient to cover loan payments is on an ongoing basis.

The requested debt coverage ratio by Fleet Bank is 1.25. Based on the calculations the Millegan Creek project has a debt coverage ratio of 1.4495. Therefore, the project meets the minimum debt coverage ratio. Loan to value ratio (LTV) examines the riskiness of the mortgage from lenders perspective. Typically, assessment with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan will generate cost the borrower more borrow or he or she will need to purchase mortgage insurance.

Loan to value ratio) is computed (the amount of mortgage/ gross purchase price) as \$15,715,000/ \$19,644,000 as 80% which does not meet the required 75% loan to value ratio by Fleet Bank. Considering that Fleet's financial goals giving in the case such as Fleet's desire to engage in real estate investment opportunities in Texas region and to reduce concentration in the franchise geographic area i. e. New England and New York, increasing average loan size in the portfolio and plus JPI's being reputable company, Fleet may want to accept an LTV of 80%.

What Does Loan To Value Ratio - LTV Ratio Mean? A lending risk assessment ratio that financial institutions and others lenders examine before approving a mortgage. Typically, assessments with high LTV ratios are generally seen as higher risk and, therefore, if the mortgage is accepted, the loan will generally cost the borrower more to borrow or he or she will need to purchase mortgage insurance. Calculated as: Investopedia explains Loan To
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Value Ratio - LTV Ratio For example, Jim needs to borrow \$92, 500 to purchase a \$100, 000 property. The

LTV ratio yields a value of about 92. 5%. Since bankers usually require a ratio at a maximum of 75% for a mortgage to be approved, it may prove difficult for Jim to get a mortgage. Similar to other lending risk assessment ratios, the LTV ratio is not comprehensive enough to be used as the only criteria in assessing mortgages. Liquidity of the property? Risk Factors The detailed financial analysis of the Millegan Creek Project is placed in EXHIBIT 1. Economic base analysis (location quotients) Calculate discounted cash flow and internal valuation.

Environmental risks ,... housing pricing bubbles 2. The project likely to be successful based on giving info about the product, the players and the pricing Estimates sales price? JPI should sign the “ Terms and Conditions” letter and send \$20, 000 deposit that would be refundable (less Fleet’s cost and expenses) if Fleet did not “ approve the loan substantially under terms of the letter. -Terms of the loan is 30 months -75% loan to value ration -1. 25 debt coverage ratio. y important date for his Millegan Creek Apartment loan.

Joanne McClatchy, the Senior Credit Officer, had asked Tom Hayden to prepare a brief presentation and answer a few questions about his proposed McClatchy indicated that because it was a new market, a new developer and a large loan without a takeout, she wanted to get additional information before the project was submitted for credit committee approval.

Study Questions: 1. Would you recommend that Fleet Bank make this loan on the terms negotiated? What are Fleet’s risks? 2. Is this project likely to be

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successful? What do you think of the location, the product, the player, and the pricing? 3.

Of the market information provided, how would you analyze market demand and supply and affordability at the proposed rental rates? 4. How much profit can the developer expect to receive from this project? What are JPI's biggest risks? What are the terms of the loan? Describe take out commitments ? Tom was sent preliminary deal packages for JPI's apartment projects had take out commitments from General Electric Corporation -JPI wanted to Fleet to finance 100% of the cost of its projects which was contrary to Fleet's credit policy of requiring developers invest equity equal to 10% to 20% of the total project.

Considering that JPI had take out commitments for a couple of apartment from General Electric Corporation, JPI had strength to ask for 100% financing.

Fleet also agreed to drop its its loan rate by a quarter of a percent (0. 25%)

COMMERCIAL REAL ESTATE FINANCIAL RATIOS NET OPERATING INCOME

(NOI) Net operating income (NOI) is the net cash generated before mortgage payments and taxes. NOI is calculated by adding the property's gross rental income to any other income (such as late fees or parking income) and then subtracting vacancies and rental expenses. DEBT COVERAGE RATIO (DCR)

Debt Coverage Ration (DCR) is also known as the Debt Service Coverage Ratio (DSCR). The DCR measures your ability to pay the property's monthly mortgage payments from the cash generated by the rental property.

Bankers and lenders use this ratio as a guide to determine whether the property will generate enough cash to pay rental expenses and whether

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there will be enough money remaining to pay back the money borrowed. The DCR is calculated by dividing the property's annual net operating income (NOI) by the property's annual debt service. Annual debt service is the annual total of all mortgage payments (i. e. he principal and accrued interest but not escrow payments). EXAMPLE: Assume a net operating income of \$40,000 and debt payments of \$30,000. The DCR is 1.33 ($\$40,000 \div \$30,000 = 1.33$). A debt coverage ratio of less than one (e. g. .75) indicates that there is not enough cash flow to pay the property's rental expenses and have enough money left over to pay the mortgage payments. This means that the borrower has negative cash flow and will have to subsidize the difference in order to pay the lender. Obviously, a lender will not be willing to loan you money to purchase a property that does not generate enough cash to pay him/her back.

In the above example, the DCR of 1.33 means that the property will generate 1.33 times (33%) more cash required than what is required to pay the mortgage. CASH ON CASH RETURN Cash on Cash Return is probably the most important ratio needed when evaluating the long-term performance of a rental property. Cash on Cash Return is the property's annual net cash flow divided by the net investment, expressed as a percentage. EXAMPLE: If the net cash flow from a property is \$40,000 and the cash invested in the property is \$200,000, the Cash on Cash return is calculated to be 20% ($\$40,000 \div \$200,000$).

The net investment in the property is the cost of the property minus the amount borrowed. One way to understand the ratio is to compare it to a

return on a certificate of deposit. If the bank pays you an annual return of, say 5%, the 5% is the Cash on Cash return on the deposit. However, unless the property is owned free and clear, this is not a totally true comparison. The return you get is AFTER the mortgage and all other expenses have been paid. It can therefore fluctuate wildly. Whereas, if you put \$200, 000 in the bank in a CD you can be certain that you will get the return you expected.

Please note that the Cash on Cash return does not include property appreciation which is a non-cash flow item until the year of sale. Therefore, if you are evaluating a property on a long-term basis, you need to focus more on the annual cash flow as it relates to your investment and focus less on property appreciation. CAPITALIZATION RATE (CAP RATE) The Cap Rate is a ratio that places a value on a property based on the net operating income (NOI) it generates which allows for a comparison of properties with different Fair Market Values (FMV). The Cap Rate is computed by taking the rental NOI and dividing it by the property's FMV.

The higher the Cap Rate, the better the property is said to be performing. Note that the Cap Rate is not a computation of an investment return but rather a way of understanding how a property will generate NOI so it can be compared to other properties. Cap Rate - Practical Use #1 You can use the Cap Rate to value your property. Let's say that your property generates \$30, 000 of annual net operating income. Your real estate agent tells you that the Capitalization Rate in your area is approximately 10%. That would mean that the approximate fair market value of your property is \$300, 000 ($\$30,000 \div 0.10$).

Cap Rate - Practical Use #2 Assume that you are comparing two properties. The first property has a projected NOI of \$20, 000 and an asking price of \$500, 000. The second property has a NOI of only \$10, 000 with an asking price of \$110, 000. Which one would the Cap Rate suggest is a better investment? The Cap Rate would suggest that the second property is a better investment since the Cap Rate is 9% ($\$10,000 \div \$110,000$) versus 4% ($\$20,000 \div \$500,000$). LOAN TO VALUE RATIO (LTV or LVR) The Loan-to-Value Ratio is the amount of a secured loan or mortgage divided by the fair market value of the property.

For example, if your property is worth \$100, 000 and you have a mortgage balance of \$50, 000, the Loan-to-Value ratio on your home would be 50%. The LVR helps you quickly determine how leveraged your property is based on the fair market value of the property versus your cost. You can also use the LVR to determine the amount of your equity. If you have more than one loan secured against your property, add together the outstanding value of each loan in order to calculate the Loan-to-Value ratio. For example, if your home is worth \$100, 000 and you have a mortgage balance of \$50, 000, the Loan-to-Value ratio on your home would be 50%.

However, if you also have a second secured loan on your home for \$25, 000, the Loan-to-Value ratio on your home would be 75% ($(\$50,000 + \$25,000) \div \$100,000$). GROSS RENT MULTIPLIER (GRM) The Gross Rent Multiplier (GRM) is another way to value and compare properties. Used mostly in the apartment industry, the GRM is much like the Capitalization Rate except the gross rental income rather than the net operating income

(NOI) is used to determine the value of a property. The GRM is calculated by dividing the fair market value of the property by the monthly gross rental income. EXAMPLE:

If the sales price for a property is \$200,000 and the monthly gross rental income for a property is \$2,500, the GRM is equal to 80 ($\$200,000 \div \$2,500$). INTERNAL RATE OF RETURN (IRR) When an investment creates differing amounts of annual cash flow, a rate of return can be determined by calculating the Internal Rate of Return (IRR). The formula for computing the IRR is very complicated but essentially an IRR is the rate needed to convert (or discount) the future uneven cash flow to equal your initial investment or down payment. EXAMPLE: Assume a cash flow of \$100 in the second year.

Also, assume that in order to generate that \$100, you had to invest \$500. In this example, you have an outflow of \$500 the first year and an inflow of \$600 in the second year (\$100 earnings plus the \$500 return of your initial investment). To convert or discount the \$600 back to today's dollars to equal your initial investment of \$500, a discount rate of 20% is required. Thus, your IRR is 20%. In other words, IRR is the discount rate at which the "net" present value of all future cash flow is zero (discounted future cash flows = starting investment amount). The "net" meaning you subtract your initial investment.

Leveraged vs. Unleveraged IRR When you use debt to purchase a property, you are using leverage. The program computes your IRR based on how debt impacts your cash flow. As a result, you can compare the leveraged and unleveraged IRR to determine how debt is helping or hurting your

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investment results. MODIFIED INTERNAL RATE OF RETURN (MIRR) The Modified Internal Rate of Return (MIRR) is used to correct a significant inherent problem with the IRR calculation. The IRR formula assumes that you are reinvesting the annual cash flow at the same rate as calculated by the IRR.

As a result, when you have a property that generates significant cash flow, the calculated IRR will overstate the likely financial return of the property. The MIRR allows you to enter a different rate that is applied to the property's annual cash flow. Using the MIRR will more closely mimic the real rate of return since operating cash flow is rarely invested at a higher rate than a bank savings rate. The finance rate is the annual interest rate paid to borrow money during years the property experiences a negative cash flow. The reinvestment rate is the rate of return earned on the excess cash flow that is generated by the property.