

Feasibility, Underwriting, and Due Diligence

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Feasibility Defined

- capable of being done or carried out <a *feasible* plan
 - capable of being used or dealt with successfully :
suitable, reasonable, likely
 - Kohlhepp: When the benefits exceed the costs.
- Starts with Market Data
 - Prices
 - Rents
 - Cap Rates
 - Development Costs

Feasibility Analysis

(Can you do it in your head?)

- What's the Spread Between Cap Rates?
 - Return on Total Costs (Going In)
 - Selling Cap Rate (Going out) Also Called Market Cap Rate
- Direct Capitalization
 - Value = Income/Cap Rate
 - Property Value = NOI/Overall Cap Rate
 - Land Value = Land Income/Land Cap Rate
- BOTE
 - Examples Please
- Threshold Returns (On What?)
 - Stabilized Returns
 - Annual Returns
 - Time Weighted Returns
 - Traditional IRRs
 - IRR with Specified Reinvestment Rate

Underwriting Defined

- to write under or at the end of something else
- to set one's name to (an insurance policy) for the purpose of thereby becoming answerable for a designated loss or damage on consideration of receiving a premium percent : insure on life or property; *also* : to assume liability for (a sum or risk) as an insurer
- to subscribe to : agree to
- to agree to purchase (as security issue) usually on a fixed date at a fixed price with a view to public distribution **b** : to guarantee financial support of
- Kohlhepp: To bet your assets that this deal will work

Underwriting Analysis

- Sensitivity
- Robustness
- Back Door
- Critical Assumptions
- Conditions to Fund

Due Diligence Defined

- the care that a reasonable person exercises under the circumstances to avoid harm to other persons or their property
 - Prudent Man Principle
 - Prudent Expert Principle
 - Prudent Woman Principle
- Kohlhepp Seller's Due Diligence:
 - What do we have
 - What is it worth?
 - Who wants to buy it?
 - How do we affect a sale?

Buyer's Due Diligence

– Kohlhepp Buyer's Due Diligence:

- All things considered, is there a reasonable possibility that this investment will meet or exceed the buyer's investment objectives?
- No limiting assumptions (unlike appraisals or accounting projections).
- No excuses, e.g. not my field
- Use appropriate experts
- Use a "second set of eyes"

– **Know thyself:**

- What price can be paid and what risks can be assumed for the specified investment opportunity to achieve the buyer's objectives?
- If you don't know where you are going, any road will get you there.

Potomac Yard Example

- What the Seller Represented
- Crescent's Critical Issues
- Crescent's Quantification
- The Deal
- Actual vs Predicted (Errors of Estimation)



CRYSTAL
CITY

NATIONAL
AIRPORT

POTOMAC YARDS

Potomac Yard Example

North Tract

Reagan National Airport



Arlington

Retail Center

Alexandria

Aerial of Potomac Yard Arlington Before Construction



Aerial of Potomac Yard Alexandria Before Construction

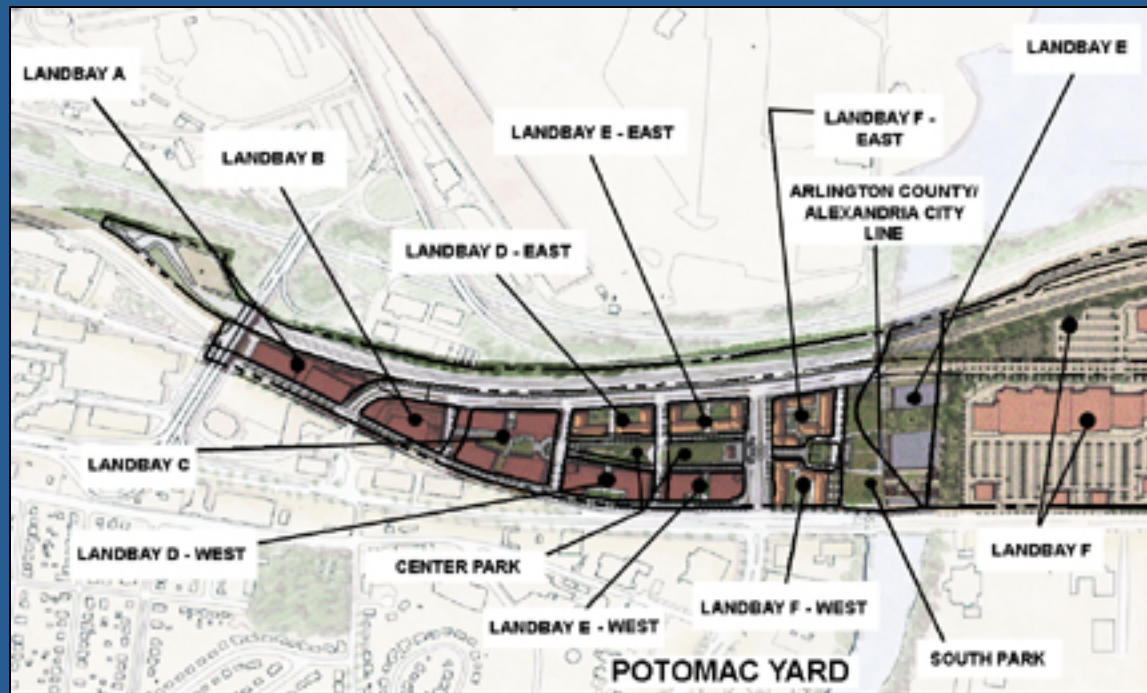


North Tract Transfer

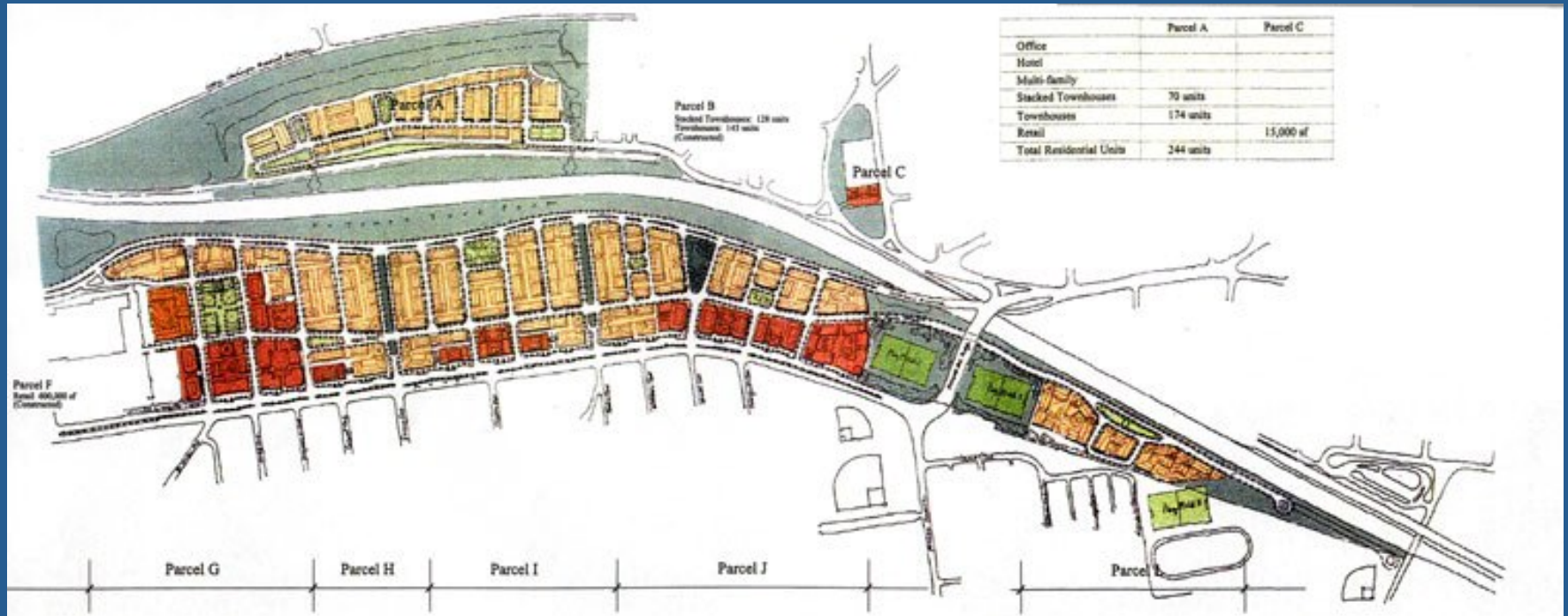
Arlington Necessary Condition



Land Bays at Potomac Yard Arlington



Land Bays at Potomac Yard Alexandria



What the Seller Said

- Physical Conditions
 - 369 acres
 - Former RF&P Rail Yard
 - Partially developed
- Environmental conditions
 - “Extent of Contamination Study” completed May 24, 1995 (Approved by EPA September 19, 1995)
 - “Human Risk Assessment and On-Site Ecological Risk Assessment” completed October 13, 1995 (approved by EPA October 13, 1995)
 - Remediation Underway at former Central Operations area
 - “No further action” letter expected
 - 16 boxes of studies
 - [http\\:loggerhead.epa.gov\arweb\public\advanced_search.jsp](http://loggerhead.epa.gov/arweb/public/advanced_search.jsp)

Seller Said

- Entitlements
 - » Coordinated Development District approved in Alexandria in September 1999.
 - Development conditions
 - Urban Design Guidelines
 - » Phased Development Site Plan Zoning being negotiated in Arlington
 - Development Conditions
 - Urban Design Guidelines
 - » Smith Litigation is baseless

Seller Said:

	Arlington South Tract PDSP	Alexandria CDD	Existing Retail Center	Total
Office	2,880,000	1,900,000	0	4,780,000
Residential	1,000,000	2,953,000	0	3,953,000
Neighborhood Retail	60,000	135,000	0	195,000
Hotel	468,750	468,750	0	937,500
Retail Center	0	0	600,000	600,000
Total Building Area	4,408,750	5,456,750	600,000	10,465,500

Crescent Critical Issues

- Real estate market forecasts in 1999 and 2000
 - Office -- Strong
 - Retail -- Weak
 - Residential -- Weak
 - Hotel -- Strong
- Infrastructure
 - Off-site
 - Onsite

Crescent Critical Issues

- Environmental Risks
 - Reviewed Documents
 - » Duke Scientists
 - » Third-party Consultants
 - » Environmental Attorneys
 - Phase II Analysis (tests)
 - Phase III Remediation
 - Insurance
-
- Entitlements and Municipal Conditions
 - Alexandria Necessary Condition - Trunk sewer completion
 - Arlington necessary Condition - North Tract Transfer
 - Existing Litigation over alleged NEPA violations

Crescent Critical Issues

- Neighbors
 - CSX Railroad
 - WMAA (Reagan National Airport)
 - WAMTA (metro)
 - VDDOT)
 - Army Corps of Engineers
 - National Park Service
 - Neighborhood Associations

Crescent Critical Issues

- Political Conditions
 - Arlington
 - Alexandria
- Capital Requirements
 - Return Expectations
 - Acceptable Risks
 - 1031 Trade Dollars
 - » Closing date is important
 - » Use of Trade Dollars is critical



Crescent Quantifications

- Land Sales Projections
- Interim Income and Holding Costs
- Infrastructure
- Time –Weighted Measures for Evaluation
 - Land Residual Analysis: How much can we pay for the land and still achieve a target rate of return?
 - Internal Rate of Return: If we pay this much for the land, what will our rate of return be?

The Deal

– **Negotiations: Three Rounds of Bidding**

- Everything, Real Estate Only, Undeveloped Land Only

– **Approvals**

- Duke Updates (2), Crescent Resources, Lazard Feres, Duke

– **Transaction**

- Retail Option and ROFO Agreement
- Title, Survey, and Cost Allocations
- 1031 Trade
 - Buyer had 16 trades into the deal
 - Seller had 4 trades out of the deal

Predicted versus Actual

	Pre	Pre	Pre	Act	Act	Act	% Diff	% Diff	% Diff
	Arlington	Alexandria	Total	Arlington	Alexandria	Total	Arlington	Alexandria	
Sales	170.7	295.3	466.0	150.2	140.9	291.1	-12.0	-52.3	-37.5
Infrastructure	30.9	84.2	115.1	34.3	13.0	47.3	11.0	-84.6	-58.9
Land	73.1	49.7	122.8	78.6	51.2	127.8	7.5	3.0	4.1
Cash Flow	66.7	131.4	198.1	39.3	78.6	115.9	-41.1	-40.2	-41.5
Time (years)	12	13	13	4.5	3.25	4.5	-62.5	-75.0	-65.4