EPIC: A real property investment and management company

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ABSTRACT

This case has the student assume the role of a new employee at EPIC, a privately-owned real estate investment and management company. Presented with background information and projected cash flows for a property that EPIC is considering acquiring, the student is asked to evaluate two redevelopment alternatives for the property and recommend which, if either, of the alternatives should be pursued. The subject property is a disguised version of an actual property located in a Midwestern state. The case contains information that should enable the student to conduct a rigorous financial analysis, but the results of this analysis may not be the only factor that should be considered in formulating a recommendation. This case is designed for use in a graduate or advanced undergraduate real estate course such as investing in real estate or real estate law.

Keywords: capital budgeting, deed, financial analysis, hotel, parking deck, redevelopment, zoning

INTRODUCTION

You are the newest employee at EPIC which is a privately-owned company with a forty year history of successfully investing in and managing commercial properties. The company has experience with a wide variety of property types, including: office, retail, residential, amusement, warehouse, industrial, and hotel/resort. They specialize in relatively small-scale projects located in Midwestern states. The company, originally named Edmond's Property Investment Company, was started as a one-man operation by Joseph Edmond. Today, the company is led by Josephs' son Cecil. There are 47 employees in EPICs corporate office and hundreds of others at other locations working as property managers, etc. You are eager to demonstrate your knowledge to the rest of the people at EPIC so you are excited (and a little nervous) about the inter-office memo you just received from Cecil. According to the memo, among several properties that have recently captured the interest of EPIC executives is a property located in the central business district of the central city of a top 100 MSA. Cecil wants your written input regarding this investment opportunity as soon as possible so you better get started right away.

The parcel of interest is an improved one acre rectangular-shaped parcel. It has 200 feet of street frontage and is zoned "U3, Retail Business District." This classification allows for a variety of retail, as well as a variety of other, uses. For example, the property of interest is classified as "Special Purpose," and has been the site of a church for more than a century. A fire destroyed the historic church building in 1975. The 53,000 square foot church building which is presently on site was dedicated in 1978. The three-story facility is handicap accessible with elevator access. It contains a beautiful sanctuary, large fellowship hall with a kitchen, two nurseries, several classrooms, meeting rooms and offices. Like many downtown churches the size of the congregation has declined in recent years. In its prime, the church routinely attracted a thousand worshippers to Sunday services, and many church members lived in the downtown area. By 2012, nearly all of its 250 participating members lived in the suburbs and drove downtown to attend services, and the building which housed the church provided much more room than was needed. After several years considering what should be done, the congregation decided to move their ministry from downtown to a suburban location. The downtown building is now vacant as the congregation has moved out and they will meet at a temporary location until their new building is constructed. Construction of which is not scheduled to begin until the downtown property is sold. The downtown facility is well-suited for several uses including as a church, or with some renovation as an educational facility or as office space. Apparently, however, the demand for the property with its existing improvements is low. The property is listed with a commercial broker and has been on the market for an extended period of time. The original list price was $1.95 million, but the asking price has recently been reduced to $1,000,000.

REDEVELOPMENT ALTERNATIVES

If EPIC acquires the property their plans would require demolition of the current improvements and construction of new improvements. Demolition costs are estimated to be $100,000. The acquisition team at EPIC has identified two possible uses for the redeveloped property: as a hotel, or as a multi-level parking deck. Preliminary research conducted by the acquisition team indicates that the current zoning classification of the parcel would allow either of these possibilities, and that demand for each is particularly high at the current time. A copy of the applicable portion of the local zoning ordinance is shown in the Appendix.

Both of the uses under consideration are considered average risk projects by EPICs management. Regardless of which use the property is eventually put, EPIC plans to follow their normal method of financing projects which is a combination of a 75% loan-to-value, nonrecourse, interest only, 20-year mortgage loan, and 25% equity. The fixed interest rate EPICs lender would charge on a loan backed by either of these proposals would be 10%. EPIC management requires a 20% return on equity and faces a 35% marginal income tax rate.

Parking Deck

In the city where the property of interest is located, downtown parking has been the subject of numerous consumer complaints about a lack of available spaces and over-aggressive meter enforcement. To address these complaints the city recently entered into a $43,000 contract for a comprehensive evaluation of the downtown parking system. One of the chief objectives of the study, which is expected to take about twenty weeks to complete, is to analyze on-street parking and determine if the current distribution of the city's meters and spaces could be improved. The consulting firm will also evaluate mobile apps that people could use to locate available parking spaces and pay for parking electronically.

Some people who frequent downtown have complained about what they perceive as a shortage of convenient on-street parking. Talks with local authorities suggest that construction of a privately owned parking deck(s) should be encouraged because city officials do not want the 20,000 people who work full-time downtown to take up on street parking spots as this discourages others from shopping at downtown retail establishments or visiting downtown offices of service providers. There are currently 1,350 downtown metered on-street parking spaces. City data shows the city collected more than $828,400 in parking meter revenue last year, and the city owns two parking decks that have a total of 2,063 parking spaces.

If EPIC decides to proceed with the parking option, they would contract to have built a multi-level, open parking structure with natural ventilation (no mechanical ventilation) containing 250 (8'6" wide) parking spaces. The precast concrete superstructure will have shallow spread footing foundations, be an all above-grade construction and contain: elevators and unenclosed stairs, basic wayfinding and signage, basic parking access and revenue control systems, and energy efficient lighting.

Table 1 (Appendix) shows the cash flows that the EPIC acquisition team put together for the proposed parking deck. EPIC assumes a ten-year holding period and sale of the property at the end of the holding period to evaluate such investment opportunities. A few assumptions were made in this process. First, to simplify the analysis, all cash flows are shown at the beginning or end of each year. Second, it was assumed that construction will require one year and the project will commence operation one year after the property is acquired. Third, it was assumed that EPIC will purchase the property for the current list price of $1,000,000. Construction costs are estimated to amount to $17,000 per parking space. Annual revenue is estimated at $6,350 per space, and annual operating expense at $2,100 per space. Construction costs will be paid throughout the first year as construction progresses, but for simplicity, one half the construction costs are assumed to occur immediately along with the land acquisition and demolition costs; with the remainder of the construction costs assumed to occur one year later. The acquisition team assumed that EPICs marginal tax rate of 35% would not change over the holding period. The annual depreciation expense shown in Table 1 (Appendix) equals the sum of construction costs and demolition costs, divided by 39. The acquisition cost was considered to be the land cost, and, therefore, is not depreciable, and, for simplicity, the team ignored the Modified Accelerated Cost Recovery System half-month convention during the first and last year of the holding period). The acquisition team was a bit conservative in assuming that annual operating revenues and expenses will remain flat over the holding period, but the reversion value imbedded in the year 11 net cash flows was estimated assuming the market value of the parking deck would grow from the total acquisition costs (purchase price, demolition and construction costs) by 3% per year once construction is complete. The two cash flows that comprise the $6,155,585 reversion value shown at year 11 are the assumed sale price of $7,189,953 less the income tax of $1,034,368 that must be paid on the gain (sale price – $4,234,615 adjusted basis).

Hotel

There has not been a full service hotel located in the central business district of the subject city for a decade. As was the case for many other Midwestern cities, decaying economic conditions in the 1980s caused many downtown hotels to cease operations, and the last in this city closed its doors during the real estate market crash in 2007. Fortunately, the city has enjoyed a rebirth by attracting new industries, and a variety of new downtown entertainment opportunities are now available. As the downtown hotels disappeared, numerous motels sprung up in the surrounding suburbs, but none are conveniently located for visitors with downtown entertainment or business plans. Preliminary analysis suggests there is now adequate demand for a modestly sized, full service hotel. If EPIC decides to redevelop the property as a hotel, they would contract to have a 220 room facility constructed at a cost of $58 million. The hotel will have an indoor pool, restaurants, cocktail lounge, fitness center, valet parking, and all the other amenities associated with a full service hotel.

The net cash flows prepared by the acquisition team for the hotel option are shown in Table 2 (Appendix). Several assumptions made for the parking deck option were also applied here (i.e., all cash flows are shown at the beginning or end of each year, construction will require one year and the project will commence operation one year after the property is acquired, that EPIC will pay the current list price for the property, and the income tax rate will not change over the holding period). Construction costs will be paid throughout the first year as construction progresses, but for analysis purposes, just as was done for the parking deck option, these expenditures are bifurcated. In Table 2 (Appendix), the initial cash outflow consists of half the estimated construction costs, the purchase price of the property, and demolition costs, while the outflow at the end of the first year consists of half the construction costs and an additional $3 million for the purchase of hotel fixtures. The acquisition team used the recent experience of similar hotels in comparable cities and the results of a preliminary marketing study to estimate the average room rates and occupancy ratios shown in Table 2 (Appendix). Annual food and other income is predicted to equal 55% of room income over the holding period, and the operating expense ratio is equal to 40% of total income. Depreciation expense for each year of the 10-year holding period includes 1/39 of total acquisition costs (purchase price, demolition and construction costs) as well as 1/7 of the cost of fixtures during the first seven years of the operating period. It was estimated that annual revenues and operating expenses as well as the value of the redeveloped property would increase by 3% per year. Therefore, the $69,718,082 inflow shown at year 11 is the predicted sale price of $83,457,207 less the income tax of

$13,739,125 that will be due because the hotel is anticipated to sell at a gain (sale price – $44,202,564 adjusted basis). Note that no transaction costs (e.g., legal, brokerage) are included in the cash flows for either the parking deck or hotel option. This is because EPIC has the staff qualified to perform tasks that other investors frequently have to pay outsiders to perform. EPIC classifies such cost as general administrative expenditures rather than assign them to a particular project.

As a part of their due diligence, the EPIC acquisition team obtained a copy of the hand-written deed on file at the County Recorder's Office which indicates that the church was granted title to the parcel in 1846. The hand-writing style of the 1800s makes reading the deed today difficult for most people and impossible for some. So EPIC hired an expert to transcribe the hand-written original into the typed copy shown in the Appendix. Interestingly, the deed does not specifically mention the amount of land to which title was conveyed, but the current property owners recently had a survey conducted which verified the property boundaries and lot size.

APPENDIX

Local zoning code - retail business districts - class U3

A. Class U3 Uses (Retail Business) are subdivided and permitted as follows:

1. Retail store; wholesale sales office or sample room; catalog sales office; office; church or place of public worship; bank or financial institution; studio; telephone exchange; retail laundry, provided the use is not offensive by reason of emission of noxious smoke, dust, or noise and the total combined capacity of all washing machines is limited to four hundred pounds; laundromat; funeral home, laboratory; data processing center; off-street parking of motor vehicles;
2. Restaurant; cafe; lunch counter; cocktail lounge; bar; taverns; trade or shop for custom work or for a service customarily performed for the residents of a locality, including barbering and cosmetology and including the making of articles to be sold on the premises to the ultimate consumer, provided that not more than five skilled workers are engaged on the premises; retail dry cleaning establishment, provided the use is not offensive by reason of emission of noxious fumes, smoke, dust, or noise and the total combined capacity of all machines is limited to fifty pounds; catering, provided that not over three panel trucks are used; coin-operated dry cleaning; child day care business center.

B. Additional Uses in Class U3 (Retail Business), which are permitted within those portions of a Class U3 District that are also within a Class A3, A4, or A5 District are subdivided and permitted as follows:

1. All uses permitted under subsection A of this section;
2. Any use not included in any other classification of uses (except the prohibited use class), provided that such use is consistent with uses enumerated in this section and is not noxious or offensive by reason of the emission of odor, dust, smoke, gas, or noise;
3. Hotel; motel; newspaper printing; job printing; commercial school or college; public and semipublic buildings not specified in other classes or uses; dance hall; skating rink; motor vehicle sales; theater; veterinarian's office not including surgical work, boarding, or breeding; ambulance service; arcade; and Gasoline service station;

Transcribed deed by which current property owner obtained title

Whereas Simon Perkins, late of Warren, deceased, did on the 26 day of May, 1843, by deed recorded in Mercer County records, book 6, page 297, convey to Rufsell Abbey the others, trustees of the 1st Congregational Society of Summit, Mercer County, Ohio, for certain purposes and upon certain conditions recited in said deed, lot number five in Block Eighteen of the plot of Summit, which was surveyed and numbered by Mallison surveyor and recoded in Portage County records, and whereas said 1st Congregational Society has suffered said premises to be sold at Sheriff's sale, and are thereby supposed to have forfeited their interest in said premises, so that the same have already reverted or will revert to the undersigned heirs at law and devisees of the said Simon Perkins, deceased, and whereas the present holders of said premises are disposed to waive whatever rights they have or claim to have in said premises, to the 1st Society of Disciples in said Summit, now therefore know ye that we, Simon Perkins of Summit aforesaid, Joseph Perkins, Jacob Perkins, and Henry B. Perkins, as heirs at law and devisees and the first three as executors of the will of the said Simon Perkins deceased, and Frederick Kinsman of Warren, as an executor of the will aforesaid, in consideration of goodwill and of one dollar received to our full satisfaction of John Gilchrist, Jonah Allen and Levi Allen, the aforesaid lot number 5 in block number eighteen (18) of the plat aforesaid to be held by them in trust for the sole use of members of the 1st Society of Disciples of Summit aforesaid, according to the rules which may from time to time be adopted by said Society for the preaching and expounding of God's holy word upon said premises and for no other purpose whatsoever. Provided however, that if the trustees, or their successors in said office, shall at any future day decline or neglect for more than two and a half years together to keep and continue on the premises a house of worship for the 1st Society of Disciples of Summit, or if they shall permit the house now erected or houses hereafter to be erected on the said lot to be devoted to other purposes than the worship of God by the denomination of Christians known as Disciples, then and in either of these events, this deed shall be void, and the lot shall revert to the aforesaid heirs at law and devisees of the said Simon Perkins, deceased, or their heirs or assigns.

And we, Grace I. Perkins, wife of the said Simon Perkins, and Martha E. Perkins, wife of the said Joseph Perkins, for the purposes and upon the conditions hereinbefore recited, do hereby remise, release, and forever quit claim to the grantees aforesaid our respective rights of dower in and to the premises aforesaid. Witness the hands and seals of the parties severally, the said Simon Perkins and Grace I. Perkins at Summit and others at Warren, this third day of April, A.D. 1846.

Here follow the signatures of Frederick Kinsman, Jacob Perkins, H.B. Perkins, Joseph Perkins, Martha E. Perkins, Simon Perkins and Grace I. Perkins. (signatures)
Signed and sealed in the presence of William Herst and Zalmon Fitch, Mary I.T. Evans and H.W. King (witnesses to Mrs. G.I. Perkins) and I.D. Taylor and H.W. King (witnesses to Simon Perkins).
(Then follows a statement of Zalmon Fitch, Justice of the Peace)

Before the undersigned, a justice of the peace within and for said county, personally came the aforesaid Joseph Perkins, Jacob Perkins, Henry B. Perkins and Frederick Kinsman and acknowledged the foregoing instrument to be their free act and deed. Also Martha E. Perkins, wife of the said Joseph Perkins, who, being examined by me separate and apart from her said husband, and having had the contents of said deed to her explained by me did acknowledge the same to be her voluntary act and deed, and that she signed, sealed and acknowledged the same without compulsion from her said husband and is still satisfied therewith. Witness my hand at Warren this 3rd day of April, 1846. (Signed Zalmon Fitch).

Before the undersigned, a Notary Public within and for the said county, personally appeared Simon Perkins and acknowledged the within to be his free act and deed for the purposes therein named. Also personally appeared Grace I. Perkins, his wife, and having been examined by me separate and apart from her said husband, acknowledges that she did voluntarily sign, seal and acknowledge the same to be her voluntary act and deed, without compulsion from her said husband, and that she is still satisfied therewith. Witness my hand and seal this 20th day of April 1846. (Signed by H.W. King, Notary Public).

Table 1

Projected Net Cash Flows - Parking Deck

Year	0	1	2	3	4	5	6	7	8	9	10	11
Car spaces			250	250	250	250	250	250	250	250	250	250
Annual per space revenue			6,350	6,350	6,350	6,350	6,350	6,350	6,350	6,350	6,350	6,350
Annual per space op. exp.			2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100	2,100
Total revenue			1,587,500	1,587,500	1,587,500	1,587,500	1,587,500	1,587,500	1,587,500	1,587,500	1,587,500	1,587,500
- Operating expenses			525,000	525,000	525,000	525,000	525,000	525,000	525,000	525,000	525,000	525,000
Net operating income			1,062,500	1,062,500	1,062,500	1,062,500	1,062,500	1,062,500	1,062,500	1,062,500	1,062,500	1,062,500
- Depreciation			111,538	111,538	111,538	111,538	111,538	111,538	111,538	111,538	111,538	111,538
Taxable income			950,962	950,962	950,962	950,962	950,962	950,962	950,962	950,962	950,962	950,962
Income tax			332,837	332,837	332,837	332,837	332,837	332,837	332,837	332,837	332,837	332,837
Net income			618,125	618,125	618,125	618,125	618,125	618,125	618,125	618,125	618,125	618,125
+ Depreciation			111,538	111,538	111,538	111,538	111,538	111,538	111,538	111,538	111,538	111,538
Net operating cash flow			729,663	729,663	729,663	729,663	729,663	729,663	729,663	729,663	729,663	729,663
Development/Sale	(3,225,000)	(2,125,000)										6,155,585
Net cash flow	(3,225,000)	(2,125,000)	729,663	729,663	729,663	729,663	729,663	729,663	729,663	729,663	729,663	6,885,248

Table 2

Projected Net Cash Flows - Hotel

Year	0	1	2	3	4	5	6	7	8	9	10	11
Rooms			220	220	220	220	220	220	220	220	220	220
Occupancy			0.70	0.70	0.71	0.71	0.72	0.72	0.73	0.73	0.74	0.74
Ave room rate			150	155	159	164	169	174	179	184	190	196
Room income			8,431,500	8,684,445	9,072,764	9,344,947	9,760,863	10,053,688	10,499,123	10,814,096	11,291,102	11,629,835
Food/beverage/other income			4,637,325	4,776,445	4,990,020	5,139,721	5,368,474	5,529,529	5,774,518	5,947,753	6,210,106	6,396,409
Total income			13,068,825	13,460,890	14,062,784	14,484,667	15,129,337	15,583,217	16,273,640	16,761,849	17,501,208	18,026,244
- Operating expenses			5,227,530	5,384,356	5,625,114	5,793,867	6,051,735	6,233,287	6,509,456	6,704,740	7,000,483	7,210,498
Net operating income			7,841,295	8,076,534	8,437,670	8,690,800	9,077,602	9,349,930	9,764,184	10,057,110	10,500,725	10,815,746
- Depreciation			1,918,315	1,918,315	1,918,315	1,918,315	1,918,315	1,918,315	1,918,315	1,489,744	1,489,744	1,489,744
Taxable income			5,922,980	6,158,219	6,519,355	6,772,485	7,159,287	7,431,615	7,845,869	8,567,366	9,010,981	9,326,003
- Income tax			2,073,043	2,155,377	2,281,774	2,370,370	2,505,751	2,601,065	2,746,054	2,998,578	3,153,843	3,264,101
Net income			3,849,937	4,002,842	4,237,581	4,402,115	4,653,537	4,830,550	5,099,815	5,568,788	5,857,138	6,061,902
+ Depreciation			1,918,315	1,918,315	1,918,315	1,918,315	1,918,315	1,918,315	1,918,315	1,489,744	1,489,744	1,489,744
Net operating cash flow			5,768,252	5,921,157	6,155,896	6,320,431	6,571,852	6,748,865	7,018,130	7,058,532	7,346,881	7,551,645
Development/Sale	(30,100,000)	(32,000,000)										69,718,082
Net cash flow	(30,100,000)	(32,000,000)	5,768,252	5,921,157	6,155,896	6,320,431	6,571,852	6,748,865	7,018,130	7,058,532	7,346,881	77,269,727

Teaching notes may be obtained by contacting the case author at: james.larsen@wright.edu