

RE 618 / Fin 618 – Real Estate Investment Analysis

Homework – Disposition Analysis

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- 1) Five years ago, Bob the Builder developed a 15,000 square foot shopping center for \$1.8 million. This property generated NOI of \$180,000 in the first two years and \$200,000 in the next three years. The annual debt service on his mortgage is \$117,000. His original loan amount was \$1.35 million and his current loan balance is \$1.24 million.

Recently, Bob has received an offer from an investor willing to purchase the building for \$2.15 million. If he sells, Bob expects to incur transaction costs equal to 4 percent of the sale price.

Alternatively, Bob could continue to hold the property for another five years. He believes NOI will be \$225,000 for the foreseeable future. At the end of five more years, Bob believes he can sell the property at a 9.5 percent terminal cap rate. At that time, his mortgage balance will be \$1.07 million.

Bob's required return on this investment is 16 percent.

- a) Conduct an historical (retrospective analysis) of this investment. Over the past 5 years what has been Bob's internal rate of return from this investment? What does this analysis have to say about whether Bob should keep or sell the property today?
- b) Do a prospective analysis of the keep vs. sell decision. Should Bob sell the property or keep it?
- c) If Bob keeps this property he has the opportunity to improve the property at a cost of \$900,000 (cash). Doing so will raise the expected future NOI to \$300,000 per year. Calculate the differential cash flows from renovating instead of keeping the property as is. Should Bob make this investment?
- d) The reason Bob has considered selling this property is that he would like to get back some of his equity to purchase another property. Alternatively, Bob could refinance his mortgage, taking out \$700,000 in equity and raising his annual debt service to \$193,000. If he does so, his mortgage balance will be \$1.74 million after five more years. Calculate the differential cash flows from refinancing vs. keeping the property as it is. Should Bob refinance his loan?
- e) Which of the four options (selling the property, keeping it as is, renovating it, or refinancing it) should Bob choose?