South Bridge Student Case Response

By Josh Kroll - 1st year Program in Real Estate Student

TO: Jean DuSable – Chairman of Jean DuSable Company
FROM: Josh Kroll – Associate
Re: South Bridge Project

I originally believed that the Chicago market could support any mixed use project. Following my initial impression, I felt that the South Bridge Redevelopment Project should have roughly equal proportions of leasable area designated for retail, office, and hotel. Furthermore, I saw the inclusion of a hotel facility as necessary, even though the associated risks are quite high. The market fundamentals seemed to be strong, but as you will see, the financial conclusions were in disagreement with my initial instincts. The following text will explain in further detail.

Market Feasibility:

Retail

Ground level retail rents are very high in the area, as evidenced by the Northern Realty Group's research results that have indicated attainable rental rates of $150-$200/sf in the Magnificent Mile area. Similarly, vacancy rates in this area were found to be a mere 1.3%, as determined by S. Realty Group, Ltd.

The rapid retail growth in the area indicates that foot traffic is here to stay. Stores such as Polo and Tiffany attract the upscale customers whereas Marshall's and Linens N' Things attract the bargain shoppers. High achievable rents and a diverse customer base support my belief that retail should compose a sizeable portion of the lower floors of this project. Furthermore, the lower capitalization rates for retail assets illustrate that functional obsolescence, and thus value loss, is less of an issue than it is with hotel assets.

Office

Office properties are abundant in the Magnificent Mile area of Chicago. Despite the competition, the somewhat favorable going-out cap rates (8.6% - 9.1%) projected by the Cushman & Wakefield study indicate that a portion of this project should be devoted to office use. Certain design approaches can be taken to distinguish this property from the many others nearby, and thus capture rental and occupancy rates at levels above market norms. Such approaches include designing floors with vast amounts of contiguous open space, and integrating green architecture into the building design. This portion of the project will likely generate the lowest returns, but will have the lowest volatility.

Hotel

The market is flooded with flagged hotels. This further affirms the desirability of this market and the affluence of the consumers within it. The existing competition, among other factors, raises uncertainties about the stability of future hotel revenues. The volatility of these revenues poses both problems and opportunities for the project at hand

Hotels are thought to be poor investments because of their short-term leases, which increases their risk and sensitivity to the economy. This reason, coupled with the intricacies of efficiently operating a luxury hotel property, are the main reasons why hotel investments are thought to be risky.

In contrast, hotels, unlike office and retail, are capable of passing on to their guests the expenses caused by short-term inflationary increases. In this respect, hotels can be seen as adding diversity to the project cash flows. In addition, the hotel mantra: "New, new, new," reminds us that the best hotel investments tend to be the newest properties. There are only three truly comparable properties in this market (Ritz Carlton, Four Seasons, and the Park Hyatt), and only the Park Hyatt is new. This means that only 200 of the 2000 new rooms being constructed in Chicago are in direct competition with this project.

It would be a mistake not to capitalize on the uniqueness of this historic property by omitting this uniquely performing asset from the mix. A new hotel will most certainly erode the revenues of the aging competition, and attain sufficient occupancy levels and ADR's to make for positive NPV's. Any losses in hotel revenues will be short in duration, and will not drastically affect the profitability over the 10-year holding period.

Overall

As you can see, I believe that the Chicago market can support a mix of product types in the South Bridge Redevelopment Project. Furthermore, I feel that the strength of the Chicago market will overcompensate for the drawbacks of the competition posed by nearby properties.

Financial Feasibility:

The following is a summary of the financial feasibility of this project. The assumptions that led to these numbers were taken directly from the case, with minor adjustments where noted.

	IRR (ROE)	Equity NPV*
Retail	12.96%	$8,834,485
Office	5.6%	-$14,317,773
Hotel	8.82%	-$11,775,266

* Discounted at desired equity yield, as specified in the case(I used the mid points on the Cushman Wakefield analysis). These yields were determined to be market averages by the Cushman & Wakefield study conducted in 1998. I believe these desired equity yields are rather conservative. Note: These NPV's would be lower if higher desired equity yields were used.

Retail Portion: These returns were calculated under the assumption that CF before Debt Service and Equity Residual (as calculated using all of the provided case assumptions) both increased by 5%. As you can see, this portion is the most successful if judged by IRR. (Note: All Cashflows discounted at the median rate project by Cushman & Wakefield in Exhibit 7).

	Initial Equity Investment	Cash Flow Before Debt Service	Debt Service	Cash Flow to Equity	Equity Residual	Net Cash Flow to Equity
Year 0	$ (62,382,469)					$ (62,382,469)
Year 1		$ 15,667,176	$ 12,345,377	$ 3,321,799		$ 3,321,799
Year 2		$ 15,668,445	$ 12,345,377	$ 3,323,068		$ 3,323,068
Year 3		$ 15,821,155	$ 12,345,377	$ 3,475,779		$ 3,475,779
Year 4		$ 15,832,551	$ 12,345,377	$ 3,487,174		$ 3,487,174
Year 5		$ 15,844,288	$ 12,345,377	$ 3,498,912		$ 3,498,912
Year 6		$ 17,353,573	$ 12,345,377	$ 5,008,196		$ 5,008,196
Year 7		$ 17,366,025	$ 12,345,377	$ 5,020,649		$ 5,020,649
Year 8		$ 17,378,851	$ 12,345,377	$ 5,033,475		$ 5,033,475
Year 9		$ 17,392,062	$ 12,345,377	$ 5,046,685		$ 5,046,685
Year 10		$ 17,405,669	$ 12,345,377	$ 5,060,292	$ 137,851,174	$ 142,911,466
Equity IRR						12.96%
Equity NPV						$8,834,485

Office Portion: These returns were calculated under the assumption that revenues will grow at an ambitious rate. Even with this assumption, the Equity IRR is below the desired Equity Yield, thus giving a negative NPV.

rowth e	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Year 8	Year 9	Year 10	Year 11
tions	0%	6%	5%	4%	3.5%	3.5%	3%	3%	3%	3%	3%

	Initial Equity Investment	Cash Flow Before Debt Service	Debt Service	Cash Flow to Equity	Equity Residual	Net Cash Flow to Equity
Year 0	-$36,268,125					-$36,268,125
Year 1		$7,771,089	$8,815,859	-$1,044,771		-$1,044,771
Year 2		$8,245,061	$8,815,859	-$570,798		-$570,798
Year 3		$8,662,607	$8,815,859	-$153,253		-$153,253
Year 4		$9,011,837	$8,815,859	$195,977		$195,977
Year 5		$9,328,654	$8,815,859	$512,795		$512,795
Year 6		$9,656,603	$8,815,859	$840,744		$840,744
Year 7		$9,946,301	$8,815,859	$1,130,442		$1,130,442
Year 8		$10,244,690	$8,815,859	$1,428,831		$1,428,831
Year 9		$10,552,031	$8,815,859	$1,736,172		$1,736,172
Year 10		$10,868,592	$8,815,859	$2,052,733	$56,839,123	$58,891,855
Equity IRR						5.6%
Equity NPV						($14,317,773)

Hotel Portion: Similar to the retail portion, these returns were calculated under the assumption that CF before Debt Service and Equity Residual (as calculated using all of the provided case assumptions) both increased by 5%. As you can see, this portion is unsuccessful if judged by IRR and NPV.

	Initial Equity Investment	Cash Flow Before Debt Service	Debt Service	Cash Flow to Equity	Equity Residual	Net Cash Flow to Equity
Year 0	$ (35,017,500)					$ (35,017,500)
Year 1		7021900.166	$ 8,228,236	$ (1,206,336)		$ (1,206,336)
Year 2		8509625.073	$ 8,228,236	$ 281,389		$ 281,389
Year 3		10128758.6	$ 8,228,236	$ 1,900,522		$ 1,900,522
Year 4		10432621.35	$ 8,228,236	$ 2,204,385		$ 2,204,385
Year 5		10745599.99	$ 8,228,236	$ 2,517,364		$ 2,517,364
Year 6		11067967.99	$ 8,228,236	$ 2,839,732		$ 2,839,732
Year 7		11400007.03	$ 8,228,236	$ 3,171,771		$ 3,171,771
Year 8		11742007.24	$ 8,228,236	$ 3,513,771		$ 3,513,771
Year 9		12094267.46	$ 8,228,236	$ 3,866,031		$ 3,866,031
Year 10		12457095.49	$ 8,228,236	$ 4,228,859	51935184.02	$ 56,164,043
Year 11						
Equity IRR						8.82%
Equity NPV						($11,775,266.71)

Final Recommendation:

These results prove that gut instinct alone does not justify going forward with a project such as the South Bridge Redevelopment Project. A quick glance at the market gave me confidence that Chicago could support a project with a diverse product mix. Further inspection indicates that the financial feasibility of such a project is not good.

I recommend that this project incorporate only retail uses. If the assumptions given in the case are accurate, then hotel and office uses will not meet your desired equity yields, even under more ambitious projections. The low vacancy rates and high attainable rental rates in Chicago's retail real estate market give additional support to this decision. The South Bridge Redevelopment Project should therefore *not* be a mixed-use project, but rather it should be a retail only project.