REAL ESTATE DECISION MAKING – MULTI-FAMILY DEVELOPMENT

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We got interested in student housing. This example is the first student housing deal 908 Development Group did. Like I said, this one was closed in August, 2013. It just finished up construction this August, and opened up for students.

And if you can see, highlighted in orange is the University of Tennessee. Our property, U. Walk Knoxville, if you can see up there, highlighted in green and outlined in green, that's our property. We're about a little less than half a mile from campus. At the time, we were the closest one being built to campus, closest new product.

That Evolve is one that's opening this year, as well. But that one's more of a mid-rise deal with parking garage underneath and units stacked on top of it, which is a much higher construction cost than our project, which was four-story buildings with surface parking. So we're diversified from those guys who are closer, because they're charging, I think, $799 for a bedroom for the four-bedroom units. And we're charging $550 a bedroom for the four-bedroom.

So some of the specifics of student housing, and what the investors want for student housing, these days are pedestrian to campus locations. You want to be able to walk to campus. Off-campus housing need-- so we want to find, what are the other nearby student housing projects occupied at? Do they have 15% vacancy? No way we're going to do a deal on that market.

Or are they all 1% or 2% vacancy? Are they highly occupied? Do they really need student housing? Then we're like, OK, check mark one. We like that market.

University enrollment is a big thing the investors and we look at. First of all, is it 20,000 plus enrollment? High barriers to entry is another one that we look for. So we don't want a university that has a ton of vacant land around it.

So say we build this year. We open up, we did great. But next year, there's a ton more land. We did great. Three other developers come along. And they want the site next to us, and the site two blocks from us. And all of a sudden we have a ton of competition.

But Knoxville was pretty similar. And I think I had the map up there that I can go back to. I guess you can't see here. But basically, can you see my mouse pointer?

This is the main strip of restaurants and bars. All of this area is built out with current apartments, restaurants, offices. There's almost no vacant land there unless you go across the river to where these guys are. And that's too far. Kids don't want to live there.

You go over here, there's really not much vacant land. So we like those deals where-- it makes it tough for us at the same time. Finding this site was not easy.

But we're out there connecting ourselves in these university markets, telling the brokers, hey guys, we want student housing close to the university, as close as you can get. We don't care if it's an existing building. We can tear it down if it's a dilapidated old building. But we need at least one and a half acres of land up to three or four acres-- which we're probably not going to get three or four acres. But we might get one and a half, two acres.

Some other things we look at on the student housing side, like I said, is enrollment. A big thing we look at is percentage of full-time enrollment. So is this university a commuter school, or is it pedestrian friendly, everybody lives and goes to that school?

Knoxville, with 93%, is pedestrian-friendly school. That's one of the higher ratios we see there. USF, I haven't checked. I would consider it to be lower.

But I think USF is more in the transition, well into the transition from a commuter school to a pedestrian-friendly, full-time environment. So a lot of investors are catching on to USF, actually. So that's something we look at.

So we look at net full-time undergraduate students, 19,000. See how many on-campus bedrooms there are, 7,000. So that leaves 12,000 renters for us. We have 508 beds, so we only have to get 4% of the renters out there that need housing, and we're OK.

Occupancy in the market, if you see here, is at 92%, which is pretty good. And then one of the most important parts on if your project is going to do well is, what are you setting your rents at? Are you saying your project's so nice that you can get a 20% rent premium that everybody else is offering in the market? That's kind of risky.

We try to either offer our projects with rents that have already been established in the market, that people are already getting. Or if we have an excellent location, we're going to be brand new, there's not much new stuff, maybe we'll go up to a 10% rent premium if it's truly a superior location.

But that's where a lot of developers get themselves in trouble. They think their project's going to be the best project, which it probably is. They have the best location. But the rents that they're projecting to make their deal work are too high. And that's a situation.

And we have to constantly be reevaluating ourselves, because we get caught up in the same thing. We're like, oh, man, our property really is better. We probably can get rents higher than we're projecting.

But the way we look at is, let's draw a line in the sand. Maybe it will get rents higher than we projected and need them to. But if it does, great. The deal works out better than we wanted it to.

This is just the site plan so you have an idea. It's like I said, surface park, three buildings, four stories. Mostly four-bedrooms, heavily weighted in the four-bedrooms, a good amount of three-bedrooms, smaller amount of twos, hardly any one-bedrooms just because students, a lot of times, don't want to pay that rent for a one-bedroom.

Students are, OK-- you guys, I'm sure, are OK-- have roommates, live with other people. So you would rather pay the lower rent and live with someone, live with other people, we found, than pay higher rent and live in a one-bedroom apartment-- especially freshmen and sophomores. So we definitely pack them in there.

But at the same time, we give big rooms, and every bedroom has their own bathroom. People don't like to share bathrooms. I'm sure you guys don't like to share your bathroom. So we give everybody their own bathroom.

One thing I was talking about, the unit and community features that we do. So we offer nine-foot ceilings. You have a washer/dryer in your unit. Television, internet, all that stuff included, granite countertops.

High-speed internet's a huge one. We pay a lot of extra money on each deal we do to work with the cable and internet providers. And we even have a consultant that we pay just to help us deal with the cable and internet providers to make sure that our internet speed is the fastest in the market.

I'm sure you guys get really frustrated if you're in a place where your internet's too slow, especially with the amount of interaction in class, and just Netflix or whatever. People want really fast internet and are willing to pay for it, we've found. So we pay extra to give the students that. Like I said, the resort-style pool, security-controlled building with the fobs and so forth, tanning beds, high-quality fitness center, one-stop shop kind of stuff.

And how these deals work when we're looking at them, because we look at so many different sites a year at all these different universities. So we need to be able to-- somebody sends me a site today. I need to, in an hour, two hours, be able to look at this site and determine, OK, generally, do I think this would be a good deal?

So we have some things we abide by. Land cost, we do it by the bedroom. So we don't like to pay more than $5,000 to $8,000 per bedroom, depending on the location.

How we do that is, say I have a one and a half acre site. I know with that site, my construction type is going to be a mid-rise building, which is going to have two-story parking garage with five stories of wood construction on top of that parking garage, just because that's as high as you're allowed to build a wood construction. And wood is cheaper than concrete.

And so that maximizes-- in that type of building, on that site, I can fit the most people. So I know that product, I'm getting probably 120 bedrooms per acre. So an acre and a half, what is that? 180

bedrooms on that site. So you just take your land price divided by that 180 bedrooms that I'm generally calculating in, see if you're in the ballpark.

Construction costs are another thing we need to know. Because if we have that one and a half acre site on that construction type I just talked about, the mid-rise with a two-story parking garage, I know I'm looking at $150 to $160 per square foot in construction costs. Whereas, if I was looking at this Knoxville one-- which is a five-acre site, surface parking, four stories-- that one's going to be more like $100 per square foot.

So we need to know the different types of construction we can do on different sized sites, the costs associated with each of those to plug into our financial model and give us a quick idea of whether we can do the deal or not.

Another thing we know, financing and general development costs typically on the deals we see are 25% to 35% of construction costs. But with past experience, you can really get detailed.

You pay the architect this money before you know how much you're going to pay him for the next one. Same with engineering consultants, environmental stuff, developer fees. All of these pretty much based on past deals that we've done. We know how much that's going to cost and plug into our pro forma to see if the deal's going to work for us.

And the financing versus, is a lot different than low-income housing tax credit stuff. And how 908 Development Group got into student housing and financed the first project, where these are a little bit tougher to do unless you have money, because you have to invest money on your end. Probably the lowest amount you're going to invest as a developer, and get a deal on it, will be 5% of total development costs. And that's what we invested in on our first deal, 5%.

And we know the people we're building this for, to sell to eventually, are-- the biggest buyers are big real estate investment trusts. I mentioned one earlier, American Campus Communities. Another one is EdR, Education Realty Trust. And they're big real estate investment trusts, big companies that all they invest in is student housing.

They try and buy student housing for cheap, operate it better. And that's where their growth comes. Buy really good student housing assets, that's how they make their money.

So with this deal, we didn't want to put a whole lot of money into it. We knew we probably couldn't put 10 to 20% into it. So we approached a big real estate investment trust who was able to-- one financing product they offered us was a pre-purchase agreement.

And basically what that is-- so we knew generally what we were going to do. We had our site plan on the deal. We had our rents. We knew our product type. We approached them with our product type.

And we were like, hey guys, we want to do a pre-purchase agreement with you. So what happens there is before the deal even starts construction and closes, you pre-negotiate what your rents are going to be. You pre-negotiate and project what your expenses are going to be on the deal. And you both have to come to an agreement on those rents and expenses to come to a net operating income number.

And once you have that net operating income number which you both have agreed to-- and you fight back and forth a little bit. They're saying the expenses are going to be higher, because they want to buy it for less. We're saying the expenses are going to be lower, because we want to sell it for more. So we come to that NOI number. And that's how-- I'm sure you guys know-- it's how real estate is valued, based off NOI divided by a cap rate.

Say if we had financed this deal ourselves, owned it for two or three years, sold it as an operating apartment complex, we could probably get a cap rate maybe 6% at a good university-- so that NOI divided by 6%. But with a pre-purchase agreement, we're not taking the lease-up risk. As soon as that property gets done with construction, then ACC is forced to buy it from us at our pre-negotiated sales price. And at pre-negotiated sales prices, you'll be giving them a higher cap rate, because you're not taking the lease-up risk.

So I don't remember what we did on this one. While we could've probably sold it at 6% cap rate, I think we pre-negotiated the sales price at a 6.75% cap rate. So you're leaving some potential money on the table.

But at the same time, you're in and out of the deal quicker. And you don't have to take the risk of OK, are we going to get the rents were projecting? Are we going to get all the students we want to make this property successful? So that's some of the quirks of the pre-purchase agreement.

Another one is, what these rates offer is a mezzanine debt. Because traditionally, you'd have to-- so say the bank's going to give us a 65% construction loan. So you have another 35% of equity money that you need to get this deal done.

Normally, you would fund it yourselves if you have enough money, or joint venture and partner with another investor to get it done. But what these rates offer is mezzanine debt, which is basically a hybrid of debt and equity. So basically, they offer us 30% of the development costs in mezzanine debt, which is charging us a really high interest rate. I think we were at 15 to 18%.

But it's basically only during construction, is when we're paying interest. So it's not a long period of time. And that debt can quickly be converted to equity in the company for them, say if we can't perform. If we don't get this deal built in time, or if we run out of money building the deal and they're stuck with a deal that's halfway under construction and they need to finish it up, and they don't want to lose their money-- that mezzanine debt product allows them to quickly take control of that 30% of debt they put on the property.

So there's some pros and cons to that pre-purchase agreement. Like I said, pros-- no lease-up risk, lower developer capital investment and quickly churn capitals. You're in and out of these deals quicker. I only have to wait till construction completion to sell my property. Whereas, typically, like I said, you complete it. You lease it up, hold it for one to five years, and then sell it, a lot longer time frame.

Cons of that higher cap rate you're going to have to take on the sale-- and if the property outperforms your projections, say we projected $550 a bedroom in rent. It really got $625 a bedroom in rent. That property's making a lot more than we thought on our financial analysis. But all of that benefit goes to ACC, because we agreed to sell it at this amount based on this rents, not the actual rents when we open up the property.

So that's how we got started. I mean, that's the transition period. The future of 908 Development is to develop not just student housing, not just LIHTC, but also market rate stuff, and to own these properties, not do the pre-purchase agreements.

Maybe we'll do one a year if we're doing three deals a year, or something like that. But now we want to take more of the lease-up risk. And we want to hit our projections, manage these properties, and sell them for more once we make a successful property.

Like I said, the student housing and-- that Knoxville deal I showed you, I think it was around five acres. I can't remember, three to five acres. And that one was half a mile from campus, surface parking, four stories.

What we've really finding our niche to be is more like the one and a half acre sites I was talking about. A lot easier to find one and a half acres of land than three or four acres. So we can get those right across the street from campus, right next to the college bars and college restaurants, where students really want to live.

And we'll just build the parking garage with the units on top-- a more high-density, more expensive product. But we think students are willing to pay more rents for it because they're closer to campus and so forth. So that's what we're getting into doing more of.

Market rate is another kind of development we're trying to get into, primary and secondary markets. But we're looking more at secondary markets than primaries. So it's hard to do a deal in Miami, or Boston, or Manhattan, especially for a development company the size of us.

Right now, we're doing one deal a year. Maybe we'll start to getting to doing two or three deals a year. But up there, if you don't know somebody who owns the land, or know somebody who knows somebody who owns the land, then it's a lot tougher to find the good land in those cities.

And so we're focusing more secondary markets, like the Charlotte, North Carolina or the Columbia, South Carolina, or markets like that, that have up and coming downtown areas, but haven't been

tapped into quite as much as a lot of the core cities. And we want to take our student amenities to market rate and design for the millennial, Generation Y.

So Generation Y and the millennials who, a lot of them are getting through college, and have graduated college recently, and are liking these urban infill products, and living and walking close to where they work, and where they play, where they go to restaurants and bars. They're OK with the smaller apartment if it's close to what they want to do after work. So that's what we're looking at doing.

And here's a little thing for the build to own versus a pre-purchase sale, which we're getting into. So like I said, it's a longer investment horizon. You sell it one to five years after completion.

We have to put in more developer money on our end. We have to build relationships and partnerships with people who want to joint venture with us on these deals, and trust us to invest their money for them and with them. So that's what we're looking at doing down the road.

A graphic I put here is the longer investment horizon. So how we look at these deals on the metric is called yield on cost. And yield on cost is NOI, net operating income, divided by your total development costs. And what we like to do is we want an NOI of 7 and 1/2% or higher, and then in an area that we plan on selling the property at a 6 to 6 and 1/2% cap rate.

So basically what we're making on the sale is the difference between the NOI divided by 6% cap rate is x amount of money. Our cost is NOI divided by that 7 and 1/2% yield on costs. So it costs us this much to build it, 7 and 1/2% yield on costs. Say we're selling it at 6 and 1/2%, or we sell it at 6%. That chunk is what we're looking at.

And our development costs stay the same. But our yield on costs only increases as we go because we're raising rents 3% a year. So say we build the project in year one, our NOI over total development costs is 7 and 1/2%.

We raise our rents year two at 7.7%. Year three, it's 8%. And year four, it's maybe 8 and 1/2%. So at that point, the spread you're making on that deal is pretty big, if you're selling it at a 6% cap rate. So that's why the longer investment horizon works better for us.

And like I said, the yield on costs, I said 7 and 1/2%. On really good deals, we'll get down to 7.25%. Another thing that our investors, our joint venture partners, are looking at in us is hey man, I'll give you money. I'll invest with you. You develop this deal for us, but I'm going to give you a large portion of the money.

But I want you to make me an equity multiple of 2x. And I want an IRR of at least 25%. And that equity multiple is basically they put in $1 million. They want $2 million back. They want double their money back.

And you guys know what IRR is. So they want at least a 25% IRR, which is pretty high. But these development deals, a lot of times they get much higher than that. I think on our Louisville project we're forecasting 50% IRR and a 3x. So that one's looking pretty good if we can hit our projections, if we can hit the rents we want.

But that yield on cost is really what everybody in this industry looks at. And that's the metric we base ourselves on. And that can change very quickly.

For example, our Knoxville deal at $550 a bedroom on the four-bedroom units, that's a 7 and 1/2% yield on costs that we're getting. But say we're only getting $500 a bedroom-- only a $50 difference in rent per bedroom-- our yield on costs is all the way down to 7% now. And that spread from 6% to 7 and 1/2%, that's not much. So if you're not hitting the rents that you're projecting, your yield on costs isn't going to be where it's going to be. If you're not forecasting operating expenses the right way, then it's not going to be where it's going to be.

So really the best thing that we've found is to conservatively underwrite these deals. Don't get yourself into thinking you'll get too much of a rent premium. We, if we're equidistant to where everybody else is on campus, we want to be at market rates. If we have the best location to campus, maybe we'll give ourselves a 10% rent premium.

Expenses, if we think we're going to be at 35% operating expense ratio, we're actually going to do more like 45%. So if we do better than our projections, great. But if not, we know we're not getting ourselves in trouble and being too risky.