

Real Estate Underwriting and Asset Valuations: The Good, the Bad and the Ugly

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Sponsor-Level Due Diligence

An appropriate sponsor review will identify issues relating to the sponsor that may warrant disclosure in offering documents, and will provide the investment firm with information to consider in determining whether it wants to participate in the sponsor's offerings.

The following are some of the items that a prudent person would investigate in connection with a sponsor review:

- Organizational structure and control;
- Litigation;
- On-site management interviews;
- Background investigations;
- Reference checks;
- Management and staff capability analysis;
- Review of policies and procedures;
- Financial statement review;
- Prior performance review;
- Prior performance disclosure;
- Overall performance; and
- Analysis of internal controls and procedures.

Entity/Individual and Litigation Search

As part of a reasonable basis due diligence inquiry, each due diligence review must contain a review of background information on the entity, officers, directors, shareholders owning more than 5% of the equity of the offering, as well as any affiliates of the above.

Databases Used During the Course of Our Searches

- Westlaw (People Search, Business Search, Adverse Filings, Tax Liens, Bankruptcies)
- Public Access to Court Electronic Records (“PACER”)
- Financial Industry Regulatory Authority’s BrokerCheck Report (“FINRA”)
- Securities and Exchange Commission (“SEC”)
- National Futures Association (“NFA”)
- U.S. Commodity Futures Trading Commission (“CFTC”)
- Federal Bureau of Investigation (“FBI”)
- Internal Revenue Service (“IRS”)
- International Criminal Police Organization (“INTERPOL”)
- Google
- Criminalsearches.com
- Ripoff Report
- Better Business Bureau
- LinkedIn
- Zoominfo
- www.investorfraudpro.com
- Standard & Poor’s
- National News and Magazine Articles State, District and County Court National Search
- EDGAR Database of Online Corporation Financial Information

Product-Specific Due Diligence

Checklists are only the beginning

Regulators state that blind reliance is insufficient

Roadmap to determine where the road takes you

Additional follow-up and documentation required

Checklists As a Starting Point

Real Estate Due Diligence Review Checklist

- Phase I Environmental Assessment
- ALTA/ACSM Survey
- Title Commitment
- Purchase Agreement
- Loan Terms or Commitment (w/supporting documents)
- Appraisal
- Inspection/Engineering Report (Property Condition Assessment)
- Rent Roll and Abstracts of $\geq 15\%$ Space Leases
- Executive Summary of the Offering/Property
- Two years historical operating financials

Real Estate Due Diligence Review Checklist Cont.

- Private Placement Memorandum
- Master Lease (if applicable)
- Development Agreements and CCRs
- Entity Documents (Articles of Incorporation/Organization, Bylaws/Operating Agreement)
- Call Agreement
- Power of Attorney
- Escrow Agreement
- Legal and Tax Opinions
- Form D
- Broker-Dealer Selling Agreement

Real Estate Due Diligence Review Checklist Cont.

- Insurance Certificate/Declarations Page
- Aerials/Photos
- Major tenant leases (15% or greater rentable space)
- Property Management Agreement
- Pro Forma Financials/Projections/Assumptions
- Argus (in native application) or Excel spreadsheet of underwriting
- Major tenant financials (15% or greater rentable space)
- Zoning letter or report
- ADA compliance report

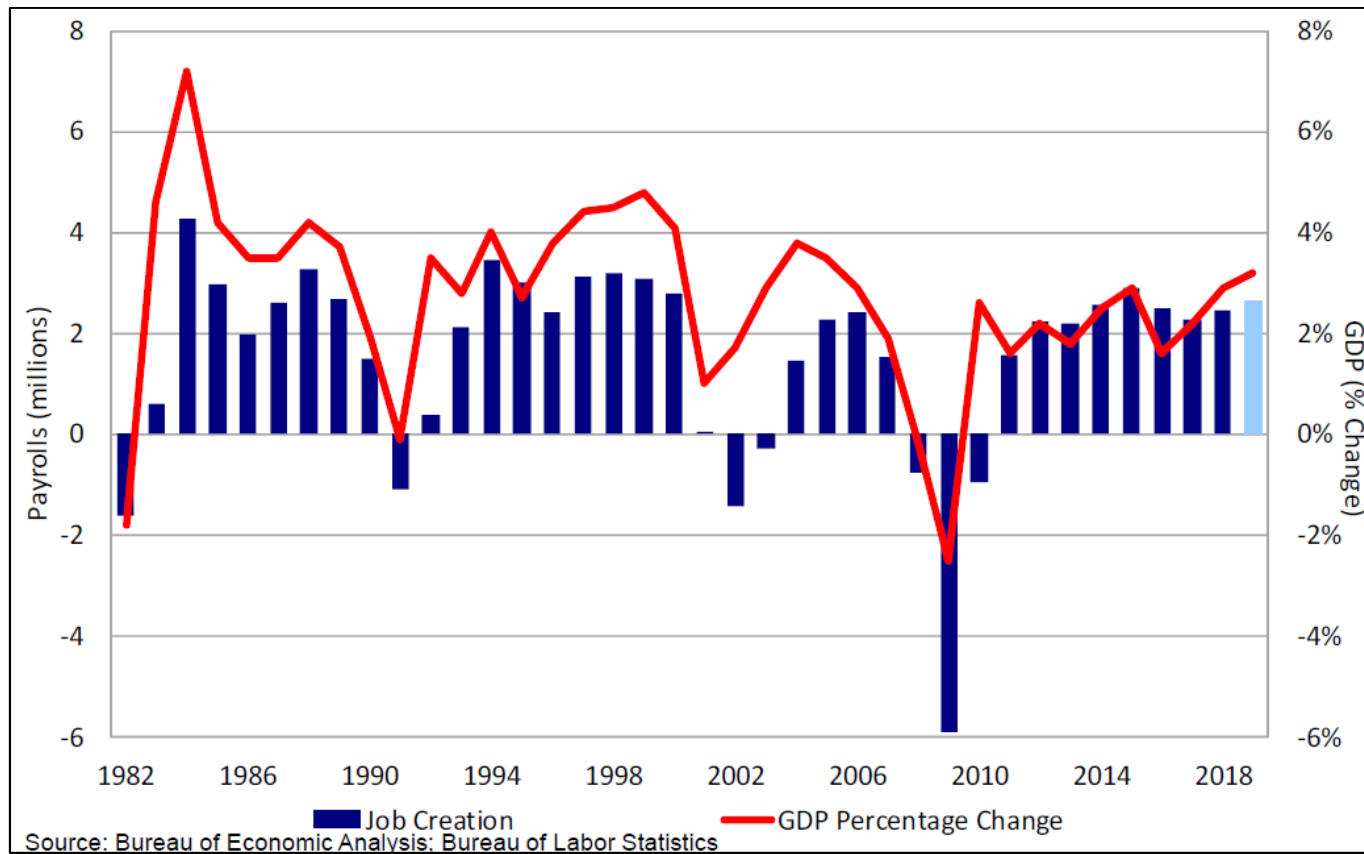
Real Estate Anyone?



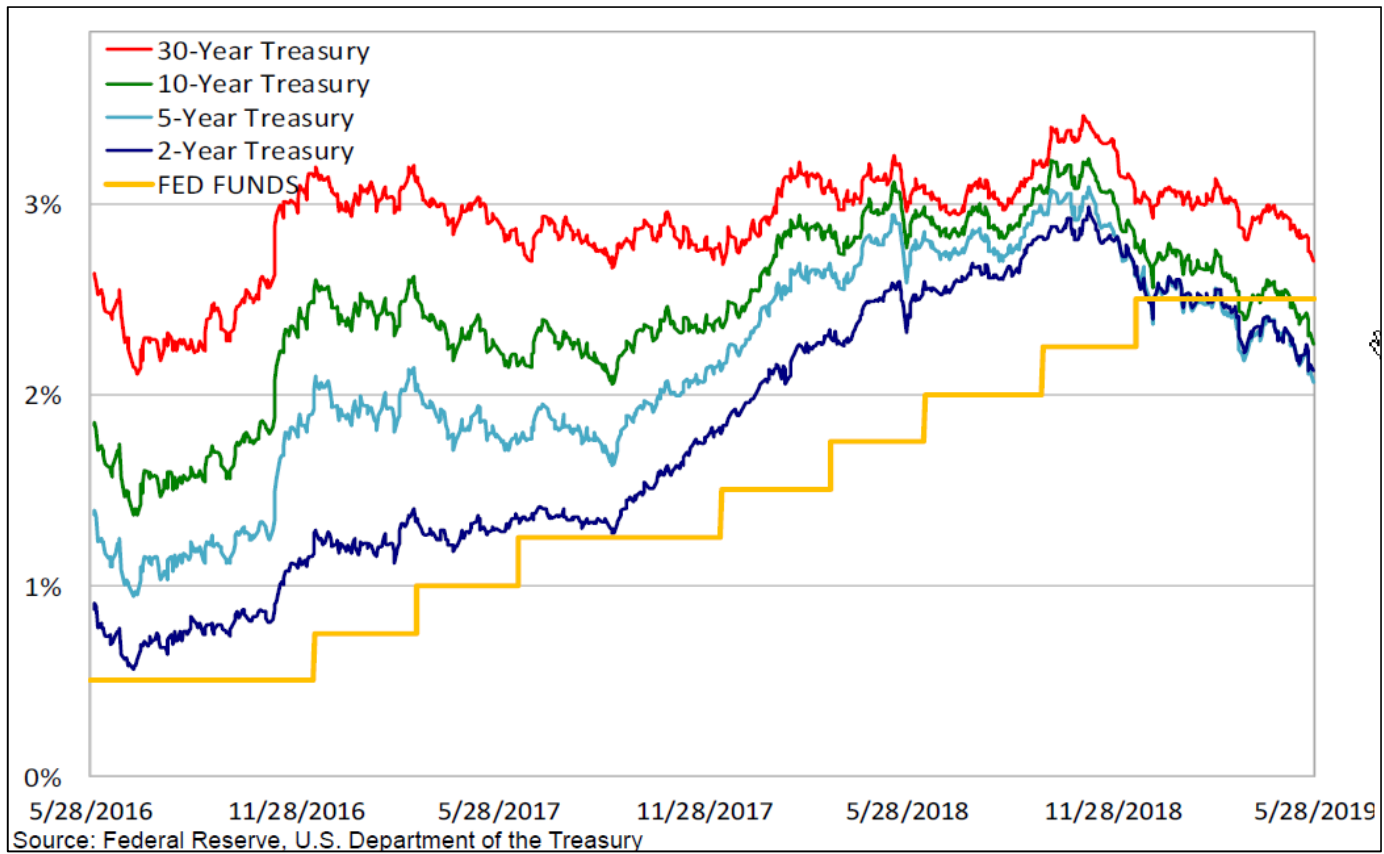
Macro Outlook

- The US economy remains relatively stable
 - May's jobs report indicated just 75,000 new jobs, well below 2018 average of 223,000.
- First quarter 2019 GDP growth was 3.8% (annualized)
- Unemployment lowest level since 1969 – 3.6%
- 10-year economic expansion – equal to the '91-'01 expansion
- Federal Reserve “patient” with future increases
 - Nine 25 bps increase since 2015
 - Fed indicates a pause at 2.5%
- Inversion of 3 month and 10 year treasury maturities
- Cap rates remain low
- Overall real estate fundamentals are strong

Employment and GDP

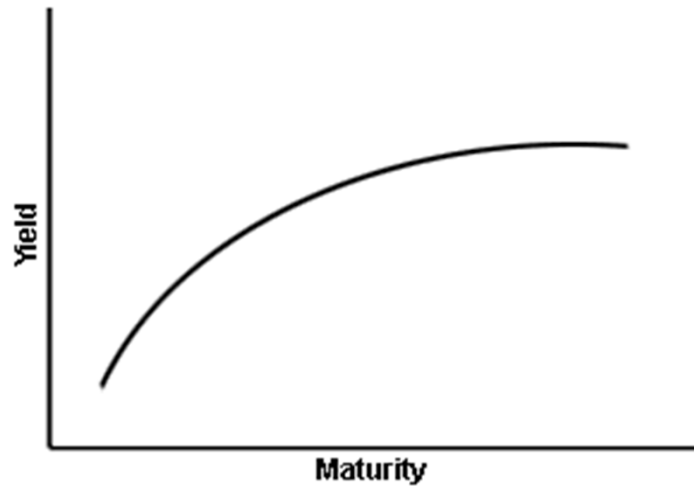


Flattening Yield Curve

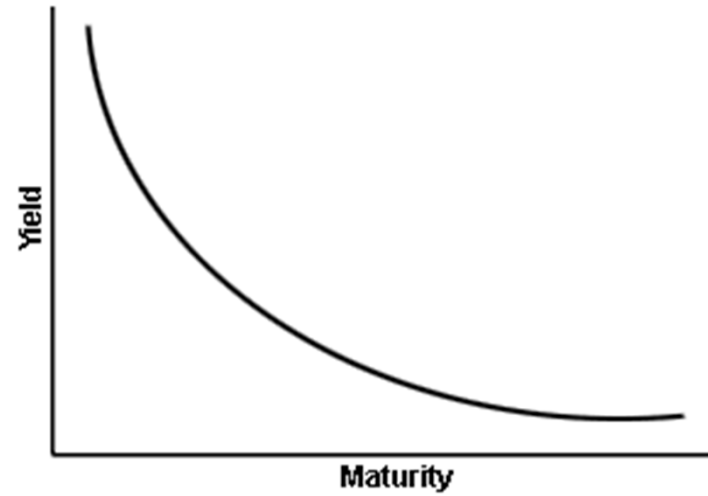


Normal Yield Curve vs Inverted Yield Curve

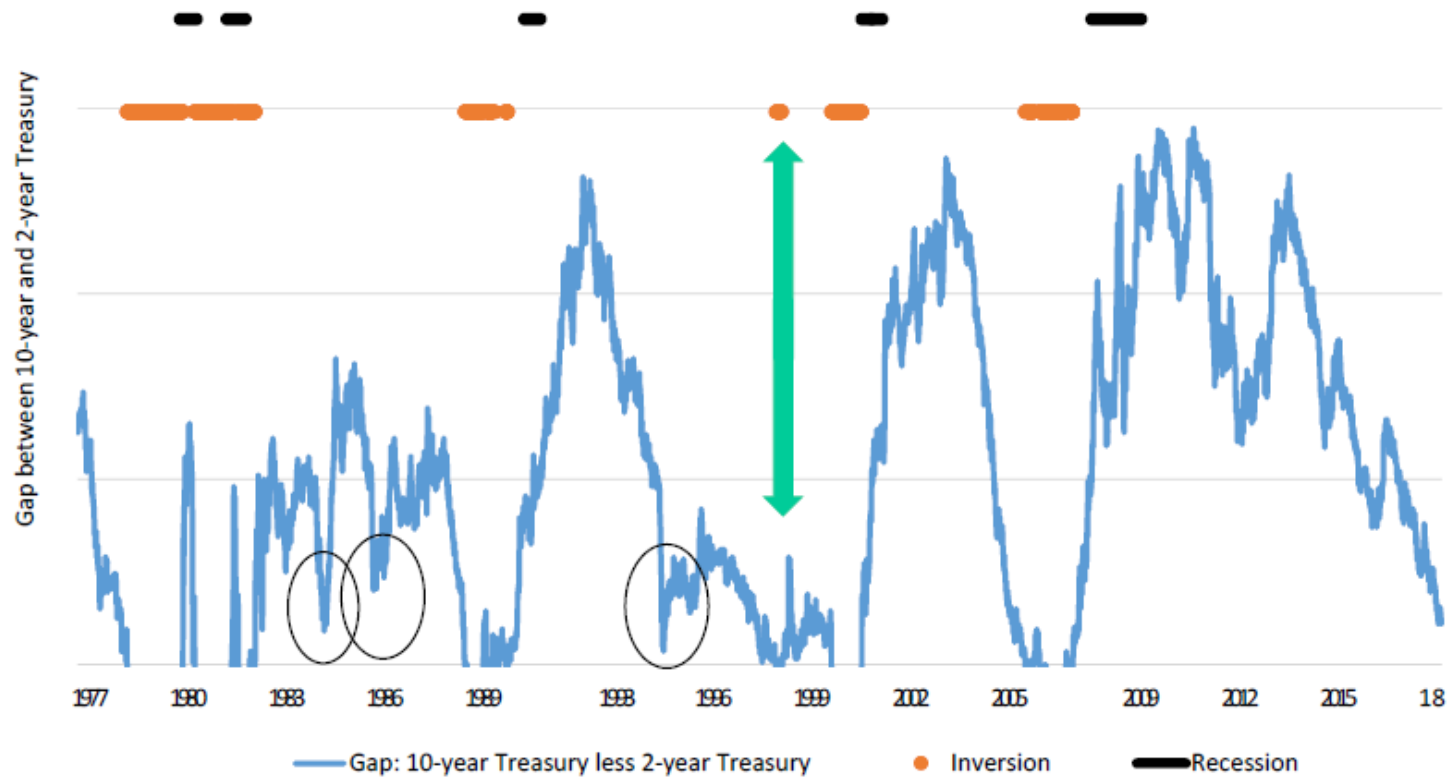
Normal Yield Curve



Inverted Yield Curve



Flattening Yield Curve & Recessions



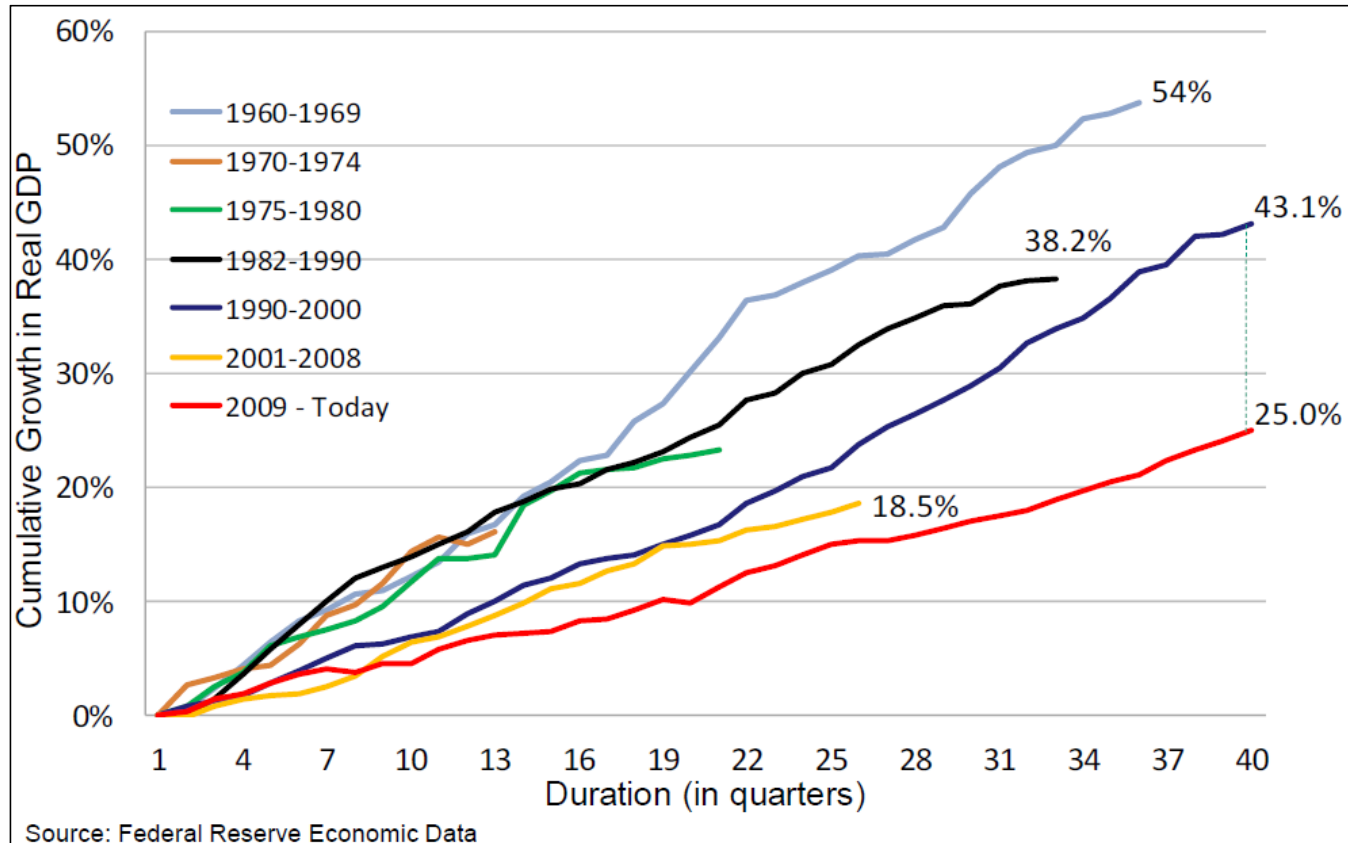
Source: Federal Reserve Economic Data

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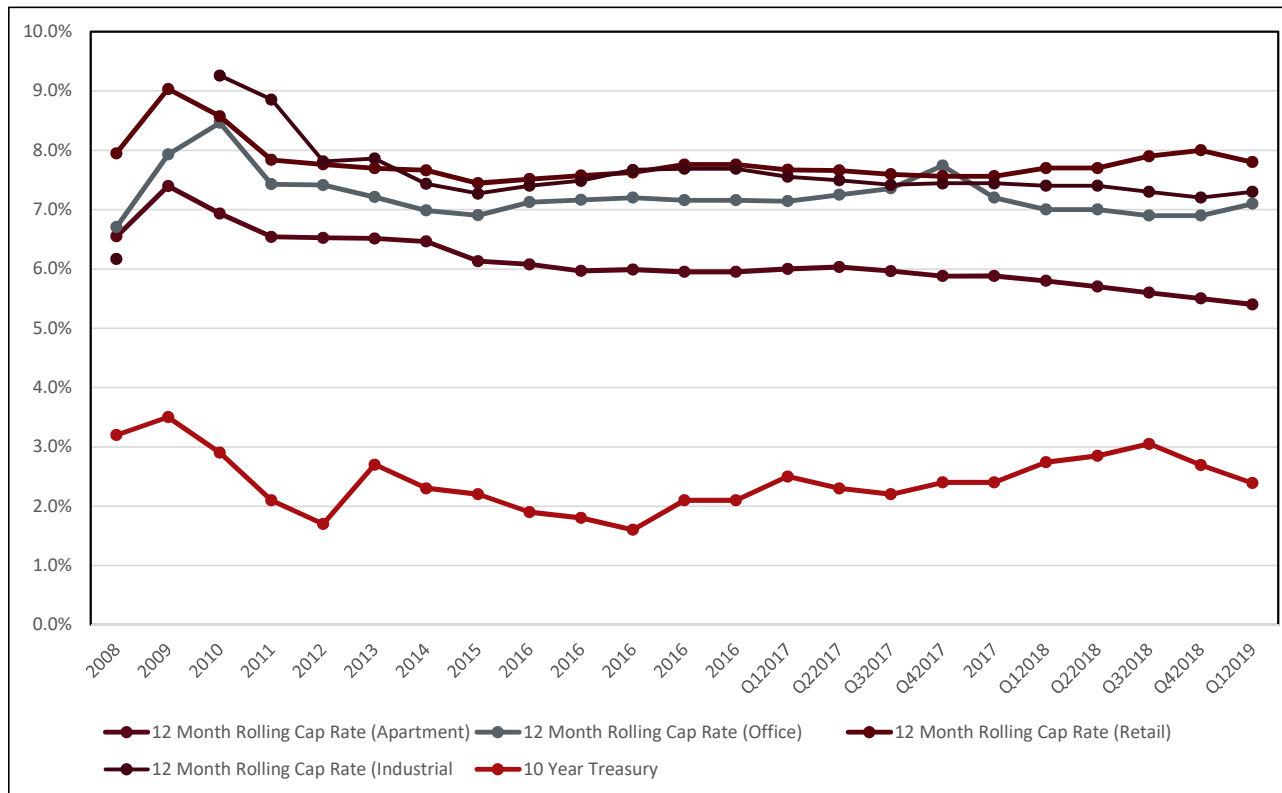
Current Expansion

- The current expansion is growing slower than past expansions

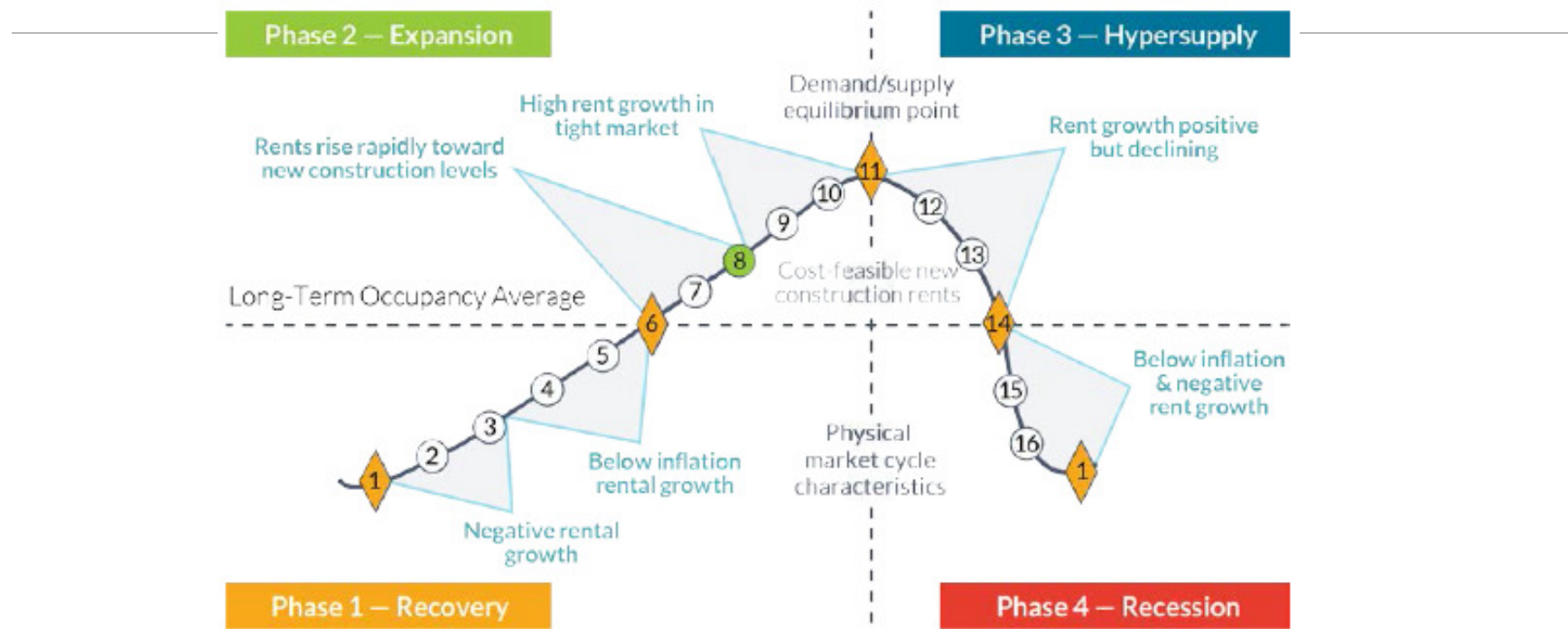


Relationship of Interest & Cap Rates

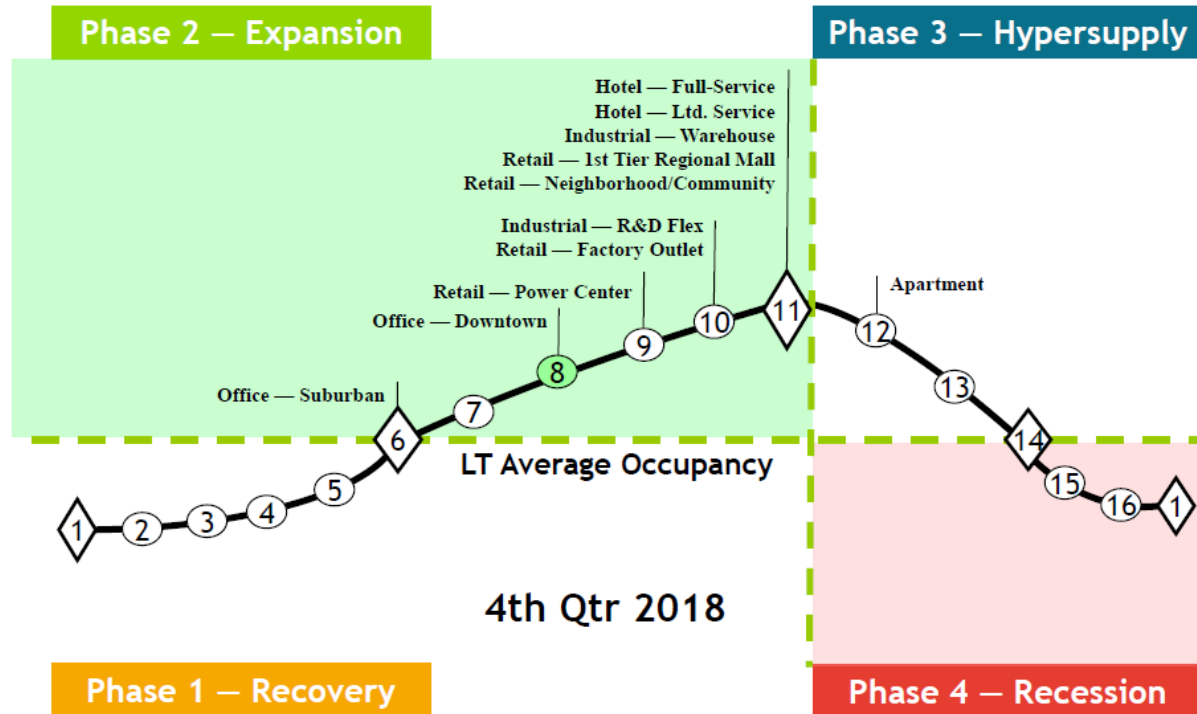
- Cap rate spread over 10-year treasury dating back to 2001
- Spreads have widened over the past 6 months



Market Cycles



National Property Type Cycle Locations

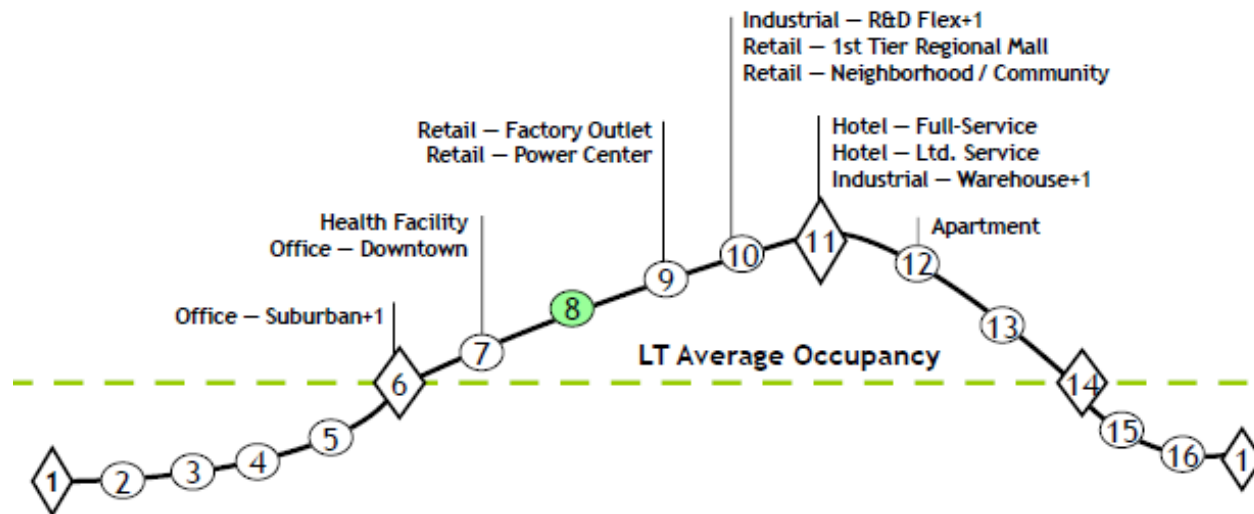


Source: Mueller, 2019

National Property Type Cycle Locations

Phase 2 — Expansion

Phase 3 — Hypersupply



2Q 2017

Source: Mueller, 2017

Phase 1 — Recovery

Phase 4 — Recession

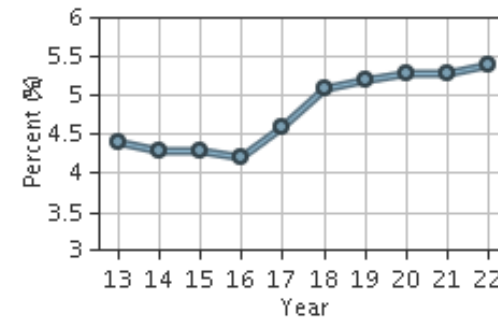
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Multifamily

- Fundamentals

- 1Q19 US Vacancy rate 4.8%
- 1Q18 US Vacancy rate 4.7%
 - Below 5.0% since 1Q12
 - Rising since 3Q16 – Cycle low of 4.1%
- Forecast at 5.1% by year end and trending up
 - 5.4% by 2023
- Rental Rates up 5.1% during 2018
 - Average rental rate now \$1,443/month (driven by Class A adds)
- Average cap rate 4.9%



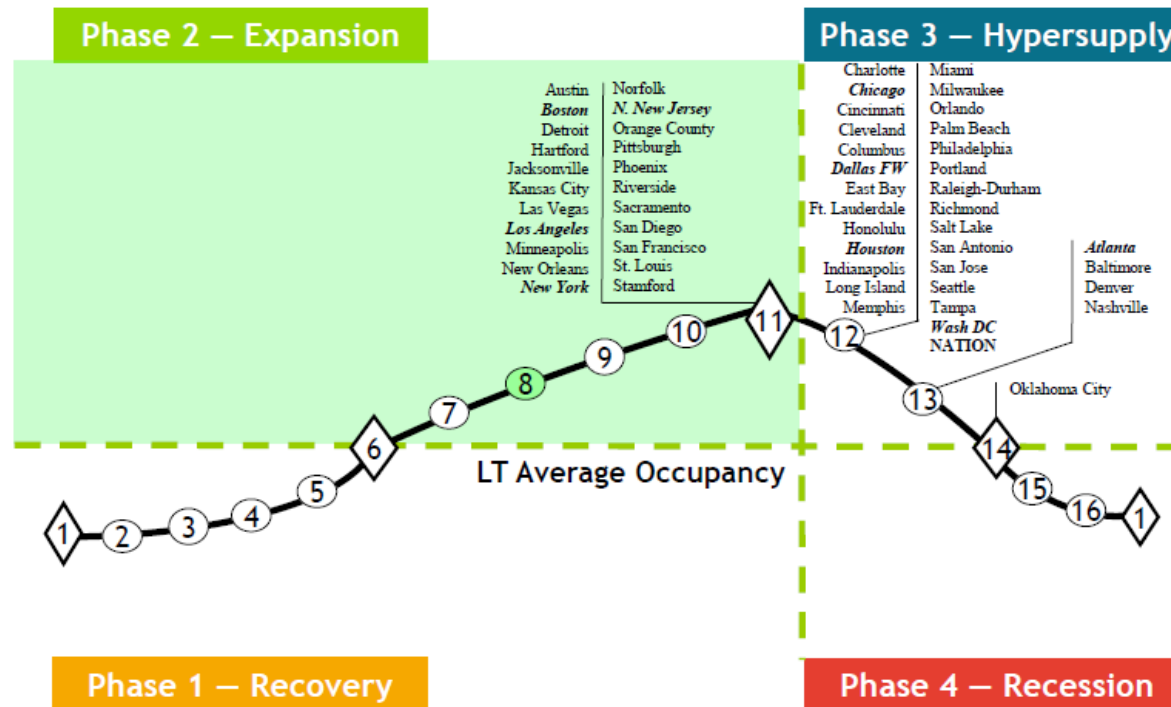
Multifamily

- Current Cycle is Decision Driven
- Challenges in the Sector
 - Overbuilding has already occurred in some metros. Additional markets expected to experience overbuilding in 2018 and beyond.
 - New construction is preliminarily Class A, so gauging true year-over-year rental rate growth is difficult.
 - Construction cost increases

Multifamily

Apartment Market Cycle Analysis

4th Quarter, 2018



Source: Mueller, 2019

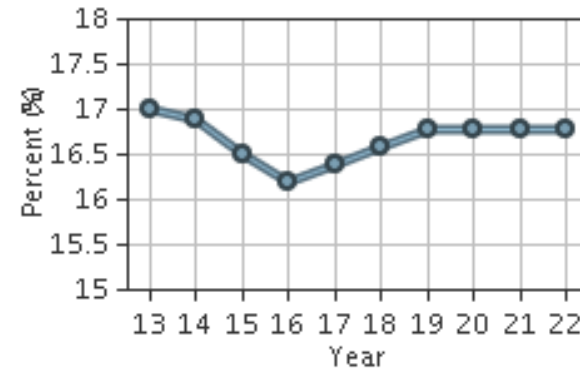
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Office

- Fundamentals

- 1Q19 US Vacancy rate 16.6%
- 1Q18 US Vacancy rate 16.5%
 - Cycle high of 17.6% in 2010



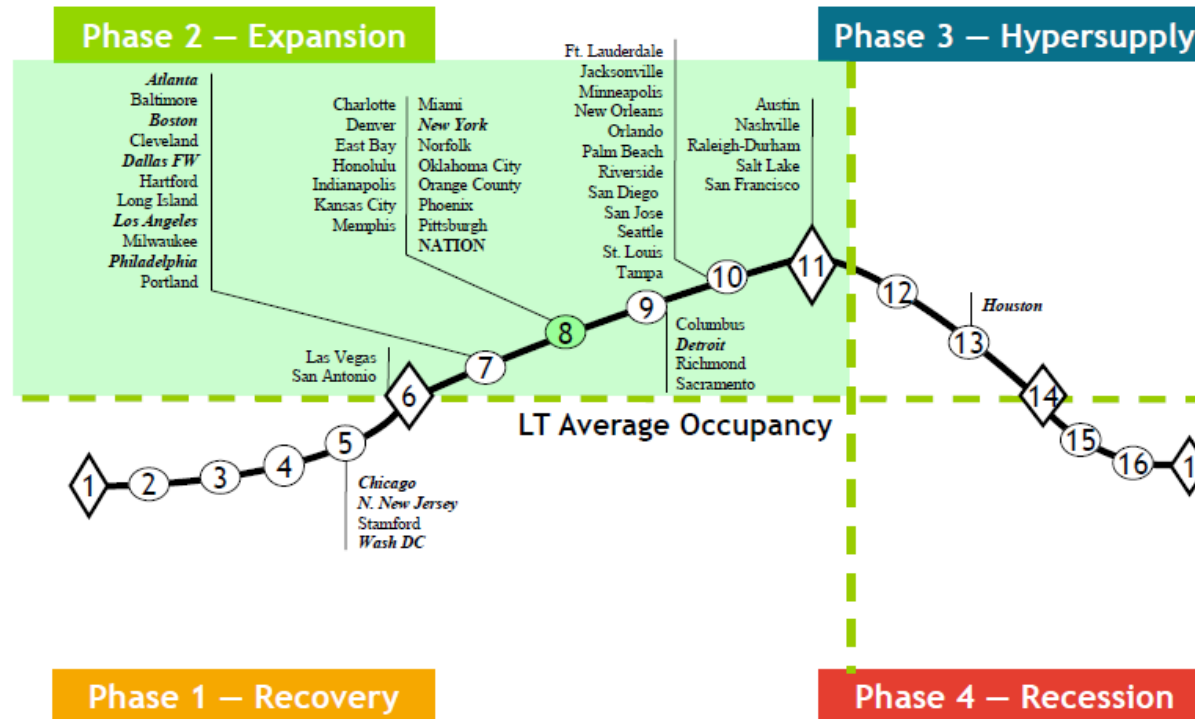
- Forecast is nearly flat – 17.1% by 2022
- Rental Rates up 2.5% over trailing 12 months
 - Average rental rate now \$33.58/SF

Office

- Investment Market
 - Average cap rate now 6.71%
 - Up 8 basis points over 2Q2018
 - Average cap rates of 7.91% for suburban properties
 - Stable over 2Q2018
- Industry Challenges
 - Efficient office use (250 SF per person is now 200 SF)
 - Older, functionally obsolescent product may never be used again
 - “Modern office” offers space worth paying for
 - High ceilings, good access to natural light, strong amenities
 - Office as a recruiting tool

Office

Office Market Cycle Analysis
4th Quarter, 2018

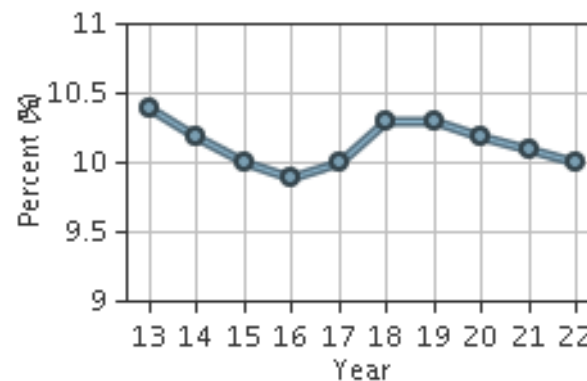


Source: Mueller, 2019

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Retail



- Fundamentals

- Q119 US Vacancy rate 10.2%
- Q118 US Vacancy rate 10.0%
- Q216 rate of 9.8% was lowest since 2011

- Forecast to remain stable; 10.1% by 2023

- Rental Rates \$21.30/SF; up 1.6% over the trailing 12 months

Retail

- Investment Market
 - Single Tenant NNN leased retail - cap rates at 6.27% (historic low occurred 3Q 2016, 6.10%)
 - Average cap rate for all retail property asset classes was 7.50% as of 2Q 2018, increase of 9 bps over 2Q2017
- Industry Challenges
 - Cap rate expansion with low/no rent growth (NNN)
 - Online shopping is re-defining the face of modern retail
Best Buy, Sports Authority, KMart/Sears

Retail

The Shift in Retail Spending



TRADITIONAL RETAIL
2006: 76.3%
2016: 61.2%

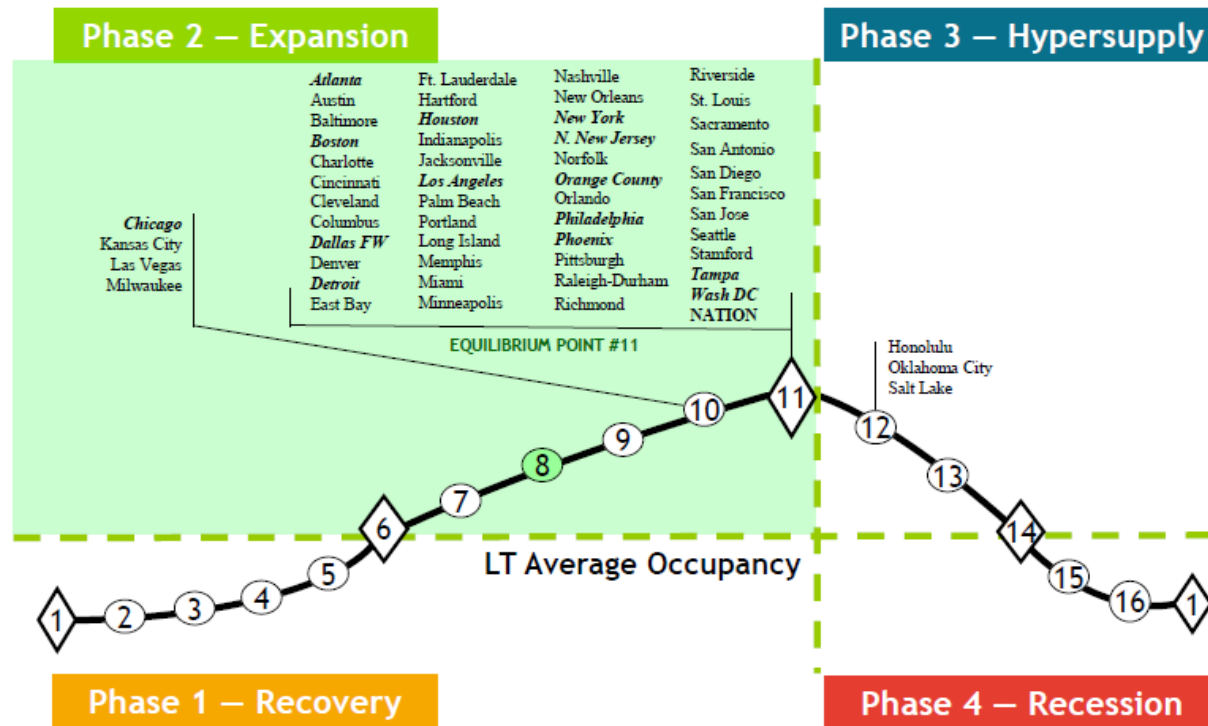


NON-TRADITIONAL RETAIL
2006: 23.7%
2016: 38.8%

Source: GlobalData's consumer spending model and consumer panel data

Retail

Retail Market Cycle Analysis 4th Quarter, 2018



Source: Mueller, 2019

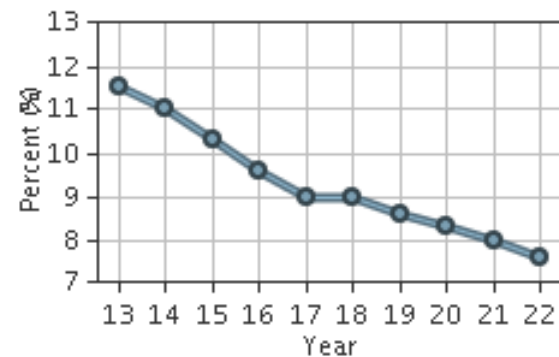
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Industrial

- Fundamentals

- 1Q19 Vacancy rate 9.4%
- 1Q18 Vacancy rate 9.2%
- Only sector of the big 4 that
Is forecast to fall – 7.9% by 2023



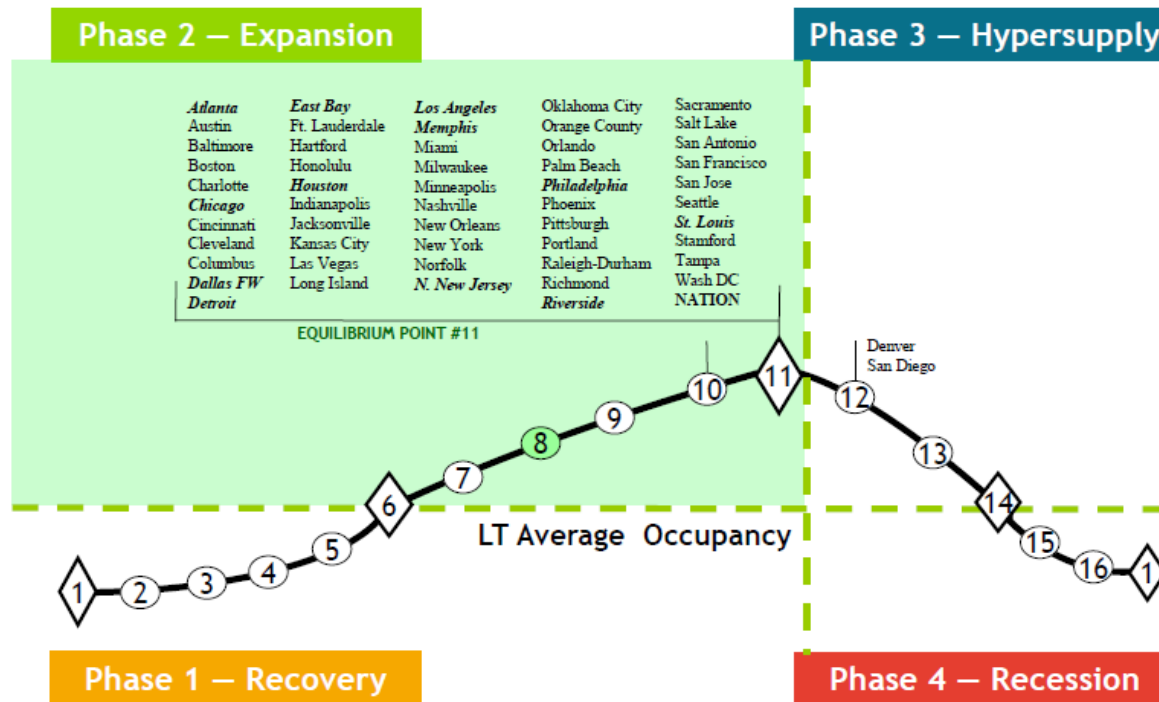
- CBRE & JLL report cap rates are at a 20 year low
- Market is highly fragmented
 - Newer generation product is sub 5% in many markets
- Rental Rates up 2.7% over trailing 12 months
 - Average rental rate now \$5.19/SF

Industrial

- Investment Market
 - Class A cap rates 5.07%
 - Cap rate for all classes reported at 6.34%
 - Strong market velocity
- Industry Challenges
 - Functionally obsolete product

Industrial

Industrial Market Cycle Analysis
4th Quarter, 2018



Source: Mueller, 2019

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Underwriting Process

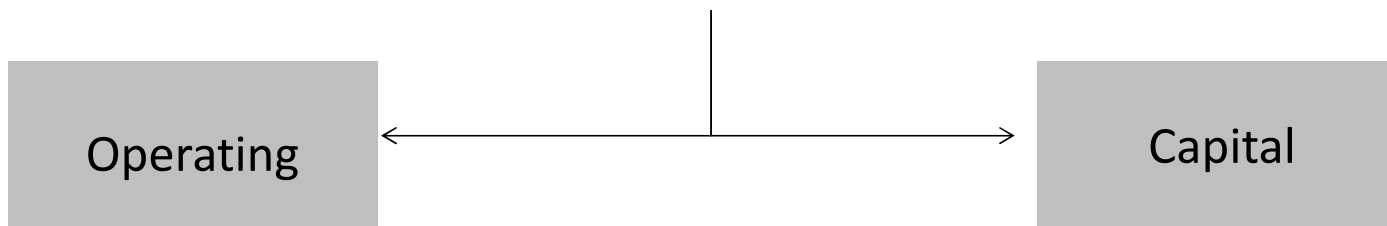
Discussion of individual real estate asset underwriting

DST / TIC

REIT's / Funds

Why assumptions matter

Underwriting Process



- What are the Income sources and amount?

- What does the operating expense (current and future) picture look like?

- What is the appropriate rate of growth / changes in assumptions over time?

- What return can be earned?

- Are investors getting a good value?

- Is there financing proposed & does it add value?

- What are the future capital needs of the property and how will they be funded?

- What is the exit strategy?

A Look at the Asset Performance Underwriting

- Primary Sources of Information
 - Rent Roll / Tenant Roster / Tenant Leases
 - Historical Operating Expenses
 - Market Reports / Market Information (leasing)
 - Capital Markets Report
 - Market Operating Expense Information
 - Sales Comps / Lease Comps/Broker interviews
 - Loan Docs / Loan Summary
- 

A Look at the Asset (continued)

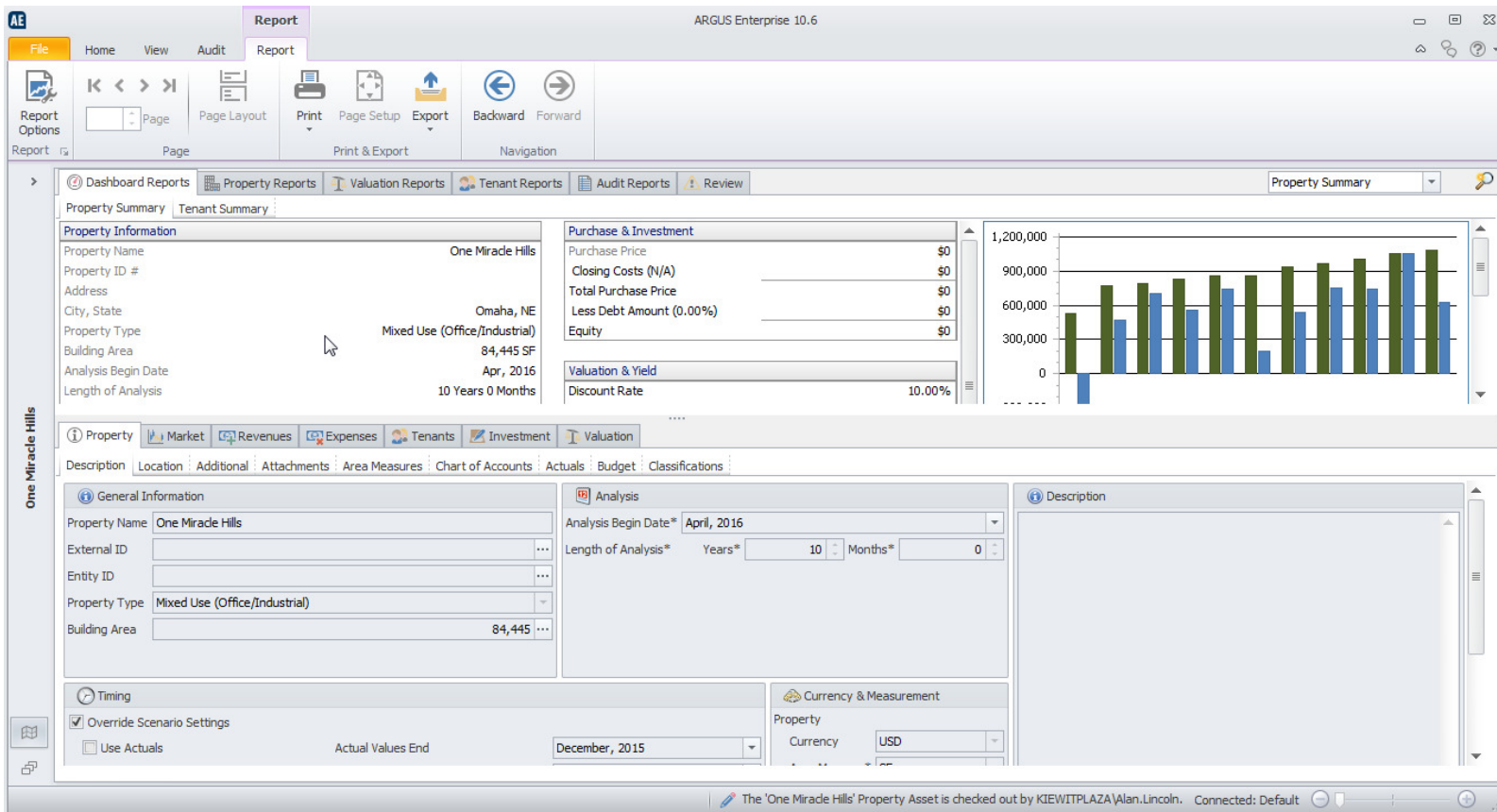
- Secondary Sources
 - Appraisal
 - Property Condition Report
 - Demographic Information
 - Economy Information
 - Tenant Interviews / Estoppel Certificates

The Age of Information

Third Party Information Providers

- REIS
 - Market & submarket specific fundamentals
 - Forecasts
- The Boulder Group
 - Net leased information
- CBRE
 - Market reports
 - Capital markets information
- Smith Travel Research (STR)
 - Hospitality market information
- National Investment Center for Seniors Housing (NIC)
 - Seniors housing market information
- JLL
- Colliers
- Integra Realty Resources (IRR)
- Real Capital Analytics
- Moody's Economy.com

Build a Model



Understanding the Cash Flow

- Compare to Pro-Forma Projections
 - Assumptions utilized
 - Cash-on-cash return
 - Waterfall / split payout considerations
 - Refinancing scenarios
 - Disposition projections
 - Range of residual capitalization rates
 - Determine break-even

What Do We Find?

- Errors of fact
- Errors of omission
- Errors of misunderstanding
- Aggressive underwriting

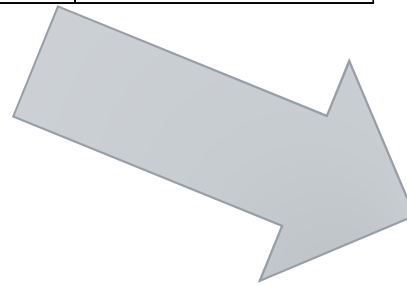
Why Does This Matter?

- Quick Example

| Reserve at Tradewinds | | | |
|------------------------------|---------------|--------------------------|---------------|
| | Project | Underwriting Assumptions | Market |
| Occupancy | 93% | 95% | 90% |
| Rent Growth | 4.20% | 3.50% | 2.70% |
| Rents / Door | \$985 | \$1,020 | \$955 |
| Operating Expenses / Door | \$5,213 | \$4,723 | \$5,100 |
| | | | |
| Purchase Price | \$ 28,000,000 | \$ 28,000,000 | \$ 28,000,000 |
| Equity | \$ 10,200,000 | \$ 10,200,000 | \$ 10,200,000 |
| Debt | \$ 20,000,000 | \$ 20,000,000 | \$ 20,000,000 |

Why Does This Matter?

| Reserve at Tradewinds - Sponsor Underwriting | |
|--|--------------|
| | Project |
| Gross Income | \$ 3,054,050 |
| Expenses | \$ 1,184,662 |
| NOI | \$ 1,869,388 |
| | |
| Cash-on-Cash | 6.89% |
| Average 10 Year C-O-C | 9.98% |
| Equity Gain | \$ 5,515,000 |



| Reserve at Tradewinds - Mick Underwriting | |
|---|----------------|
| | Project |
| Gross Income | \$ 2,703,825 |
| Expenses | \$ 1,273,153 |
| NOI | \$ 1,430,672 |
| | |
| Cash-on-Cash | 3.56% |
| Average 10 Year C-O-C | 6.78% |
| Equity Gain | \$ (3,854,522) |

Interest Rate Sensitivity

| | |
|-----------------------|-------------------|
| Cap Rate | 6.00% |
| Purchase Price | \$5,000,000 |
| Debt | \$3,250,000 |
| Load | 12.00% |
| Equity | \$1,988,636 |
| 10 Year Treasury | 1.37% |
| Spread (Basis Points) | 250 |
| Interest Rate | 3.87% |
| Net Operating Income | \$300,000 |
| Debt Service | \$184,993 |
| Cash Flow | \$115,007 |
| Cash-On-Cash Return | <hr/> 5.78% <hr/> |

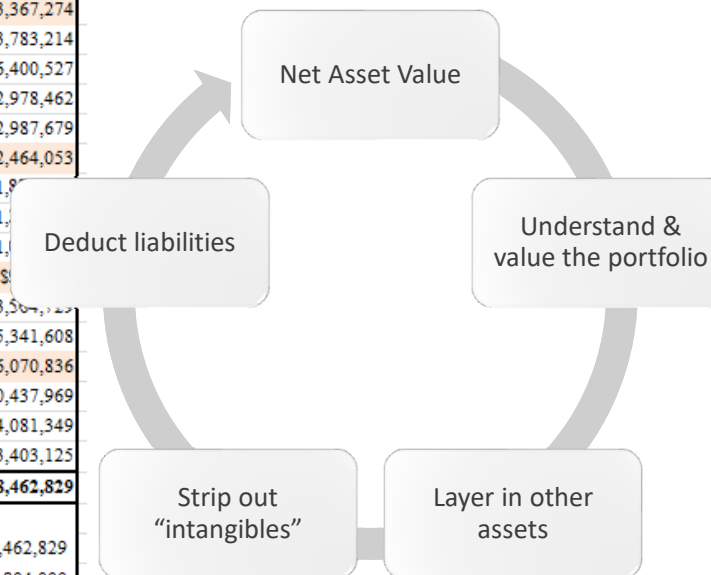
Interest Rate Sensitivity

| | |
|-----------------------|-------------|
| Cap Rate | 6.00% |
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| Debt | \$3,250,000 |
| Load | 12.00% |
| Equity | \$1,988,636 |
| 10 Year Treasury | 3.20% |
| Spread (Basis Points) | 250 |
| Interest Rate | 5.70% |
| Net Operating Income | \$300,000 |
| Debt Service | \$228,580 |
| Cash Flow | \$71,420 |
| Cash-On-Cash Return | 3.59% |

A Word About REIT's?

- Net asset value starts with underlying asset value

| Asset Name | Acquisition Date | Year One Rental Income | Estimated NOI ¹ | Estimated Cap Rate | Estimated Market Value |
|-------------------------------------|------------------|------------------------|----------------------------|--------------------|------------------------|
| Walgreens | 12/7/2011 | \$195,574 | \$193,618 | 5.75% | \$3,367,274 |
| CVS | 12/8/2011 | \$214,000 | \$211,860 | 5.60% | \$3,783,214 |
| Walgreens | 12/8/2011 | \$362,050 | \$358,430 | 5.60% | \$6,400,527 |
| CVS | 12/9/2011 | \$176,000 | \$174,240 | 5.85% | \$2,978,462 |
| CVS | 12/9/2011 | \$169,000 | \$167,310 | 5.60% | \$2,987,679 |
| Advance Auto | 12/20/2011 | \$174,226 | \$172,484 | 7.00% | \$2,464,053 |
| Dollar General | 11/30/2012 | \$129,996 | \$128,696 | 6.85% | \$1,878,125 |
| Dollar General | 10/22/2014 | \$85,760 | \$84,902 | 6.75% | \$1,258,125 |
| Dollar General | 11/6/2014 | \$71,250 | \$70,538 | 6.75% | \$1,038,125 |
| Advance Auto | 6/17/2015 | \$66,500 | \$65,835 | 6.75% | \$978,125 |
| FleetPride | 10/22/2015 | \$273,656 | \$270,919 | 7.60% | \$3,564,125 |
| Title Resource Group | 11/24/2015 | \$1,053,767 | \$1,043,229 | 6.80% | \$15,341,608 |
| Chili's & PetSmart Center | 12/10/2015 | \$466,044 | \$461,384 | 7.60% | \$6,070,836 |
| Home Depot Center | 12/31/2015 | \$1,548,331 | \$1,532,848 | 7.50% | \$20,437,969 |
| Walgreens Distribution Facility | 2/29/2016 | \$960,092 | \$950,491 | 6.75% | \$14,081,349 |
| Shopko Hometown | 3/4/2016 | \$275,000 | \$272,250 | 8.00% | \$3,403,125 |
| TOTAL | | \$20,759,348 | \$20,551,755 | | \$298,462,829 |
| | | | | | |
| Market Value of Real Estate | | | | | \$298,462,829 |
| Less Secured Loans | | | | | \$107,804,000 |
| Net Value of Real Estate | | | | | \$190,658,829 |
| | | | | | |
| Plus Other Assets ² | | | | | \$22,574,000 |
| Less Other Liabilities ³ | | | | | \$7,184,000 |
| Total NAV | | | | | \$206,048,829 |



Summary

Questions??

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