Real Estate Investment: A Strategic Approach
Fourth Edition, 2023

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Chapter Seven
Asset Management

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The WeWork case: brief intro

- Sunset City, Brooklyn is a 20-acre, 5 million square foot mixed-use facility situated on the waterfront catering to Brooklyn's growing 'maker' community, traditional office tenants, retailers, light manufacturers, and other creative businesses
- Jamestown was contemplating the optimal mix of uses for Sunset City and had been intrigued by WeWork and the growing trend in shared office space
- WeWork had recently been valued at a staggering $10B in June 2015, up from $5B just six months prior. As a service company that doesn't even own the underlying assets were they worth such a valuation?

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The WeWork case: brief intro

- Jamestown thought WeWork could be an ideal tenant to anchor the new development, but wondered what would happen to WeWork and their ability to pay rent if the shared office trend reversed?
- Did it make more sense for Jamestown to lease their space to a traditional tenant?
- Given the enormous valuation, should Jamestown cut out the middle-man, develop their own shared office brand, and capture the value created by renting to smaller tenants at higher prices?

The WeWork case

- What should Jamestown do? Should they:
  - lease to a traditional tenant?
  - lease to a 3rd party co-working management company like WeWork?
  - operate their own co-working space?

The real estate lease

- A lease is a binding contract between landlord and tenant
- It will include references to:
  - Term
  - Repairs, insurance, management
  - Rent and reviews/revisions
  - Renewals, extensions, dilapidations
  - Assignment and sub-letting

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The real estate lease: term

- Short leases: 3-5 years
- Long leases: 10-25 years
- Ground leases: 99 years-999 years

- Co-working and flex space: one month plus licences, not a lease

- Break clauses and penalties

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The real estate lease: repairs etc

- Single tenant? FRI, triple net
- Multi-tenant? Internal repairing only
- Common parts: service charges

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The real estate lease: rent and reviews

- Fixed, indexed, stepped, or variable
- Variable
  - Reviews to market
  - Sometimes upward only – call options

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The real estate lease: renewals

- Sometimes as of right (national or state legislation)
- Usually by negotiation – 're-gearing'

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Cash flow inputs

Property purchase price
+ acquisition fees
= gross outlay

Net operating income
+ expected resale price
- sale fees
= net cash flow

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Net operating income

Gross rental revenue
+ Other income
= Gross potential income
- Vacancy
= Gross effective income
- Operating expenses
= Net operating income

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Calculating effective rents

- Face rent (p.a.): £20 psf*
- Lease term: 5 years
- Rent free: 12 months
- Above-standard fit-out:£10 psf
- Moving allowance: £25,000
- Discount rate: 8%
- Effective rent psf?

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Calculating effective rents

- PV of contracted rent £838,080
- (quarterly in advance at 8% annual effective)
- Less: PV of rent frees / rental discounts £194,350
- = PV of rent payable by lessee £643,730
- Less: moving and fit-out allowances £125,000
- = PV of effective rent £518,730
- PV of effective rent/PV£1 p.a. 5 years @8% = £129,919

- **Effective rent psf £13.00**

Estimating GRR: use comparable evidence

- As a result of depreciation, rental values follow a function which is a combined result of market rental growth and depreciation, at the following rate: *(1+g)/(1+d)*

Projecting GRR: example

- Current ERV of the subject 10-year old building is £25 per square foot
- A rental growth estimate of 6% per annum over the 10 year holding period is projected for the location
- 15 year old similar buildings currently let at £22 per square foot; 20 year old buildings currently let at £18 per square foot
- The projected rental values are as follows:
- Year 1-5: = £25.00
- 6-10: $£22 \times (1.06)^5$ = £29.44
- 10 (resale): $£18 \times (1.06)^{10}$ = £32.24

- The depreciation rate is given by *(1+ location growth)/(1+ property growth) – 1 = (1.06)^10/(1.0257)^10 = 3.34% p.a*.

Other income

- Car parking spaces
- Telephone aerial and mast rental
- Advertising
- Insurance premiums
- Service charge profits

Vacancy

- Delay in letting – single lets or multi-lets
- Frictional vacancy - the vacancy unrelated to disequilibrium in supply and demand, but due to tenant relocations as leases roll over and expire – common for multi-lets and shorter leases
- Frictional vacancy is the normal vacancy rate in any given market, expressed as a percentage of gross potential income

Operating expenses

- Gross or net lease? FRI (UK), gross (US)
- Repairs: structural, external, internal
- Decoration
- Insurance
- Management

Resale price

$$MV_t = NOI_{t+1} / cr_t$$

- This requires the projection of:
  - *Estimated rental value at resale - NOI_{t+1}*
  - *Going-out capitalization rate – cr_t*
- Remember: NOI_1 is a combined result of market rental growth and depreciation, *(1+g)/(1+d)*
- The capitalization rate for a 10 year old building is currently estimated at 7% (comparable evidence) and the projected resale capitalization rate is 8% in 10 years' time, when building will be 20 years old

Deriving resale price

- The growth rate for the property is from £25 to £32.24 over 10 years, which represents a rate of 2.57% pa
- The current valuation is given by: *£25/0.07 = £357.14 per square foot*
- As the resale capitalization rate is predicted as 8%, the resale price is:
- *Rent/cap rate = £32.24/0.08 per square foot = £402.94 per square foot*

Deriving net operating income

Years	Outlay	Income	Realisation
0	-£357.14		
1-5		£25.00	
6-10		£29.44	
10			£402.94

The internal rate of return of this investment - gross of all costs - is 8.37%

Co-working and traditional lease economics

	Co-working	Traditional lease
Total sq ft	70,632	70,632
Gross revenue per sq ft	£92	£31
Indexation	2% per annum	2% per annum
Average lease term	6 months	5 years
Service charge	£10 per sq ft pa	£10 per sq ft pa
Fit-out cost	£140 per sq ft	£10 per sq ft capex
Additional capex*	£5 per sq ft pa	£0
Location operating expenses	£20 per sq ft pa	£0
Marketing costs**	£4 per sq ft pa	10% rent
Tenant's moving expenses	£0	£25,000
Business operating costs	£5 per sq ft pa	£0
Rent free period	£0	12 months
IRR	17%	5%

** In years 5, 10 and 15*
*** Incl. digital marketing and broker fees)*
Source: Lisa Cations, 2022

Revenue share model

Revenue Share	Landlord	Operator
Tier 1	0%	20%
Tier 2	75%	25%
Tier 3	50%	50%

- Income upside 40% for the investor vs traditional lease
- Flex income 2.5/3x vs traditional rent
- Downside risk protection for the operator

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Property management models

Operational leverage is increasing

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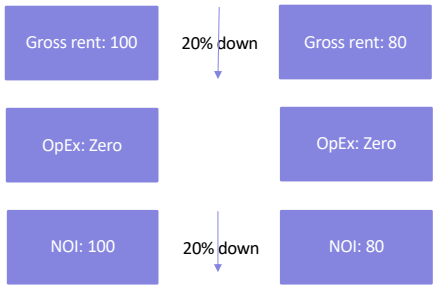
No operational leverage



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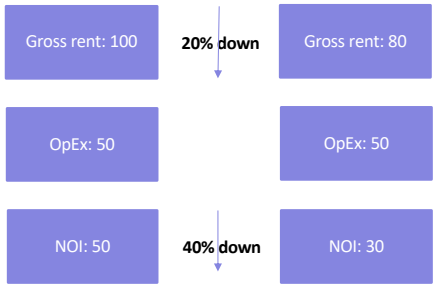
50% operational leverage



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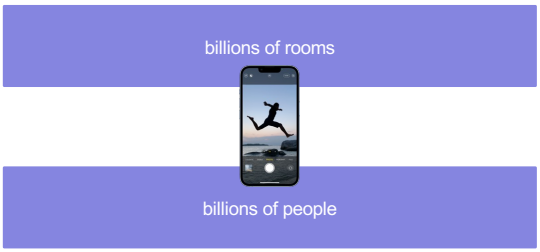
2008: the app



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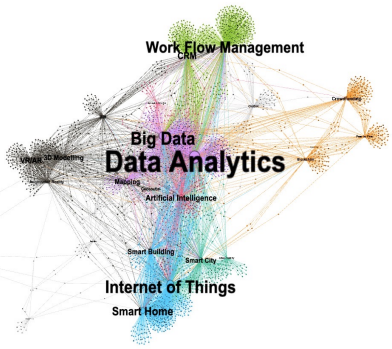
It's all about digitalisation…

- Data – 'the new oil, the new oxygen'
  - IPSX, Brickvest
  - IoT, intelligent buildings
  - Location data: Gyana, Datscha
  - Lease information extraction: Proda, Leverton
- Complexity
  - Shorter leases, more data (rollover rates etc)
  - Tokenisation, fractionalisation, blockchain
- Social property media
  - Property passports



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