Real Estate Development 101 - Pro Forma Analysis

From the Community's Perspective

DOWNTOWN REVITALIZATION AND ECONOMIC ASSISTANCE FOR MISSOURI

D·R·E·A·M INITIATIVE

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INTRODUCTION

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DREAM

Downtown Revitalization & Economic Assistance for Missouri

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Real Estate Development

- Real Estate Finance
- The Role of Incentives
- Glossary of Terms
- Pro Forma Analysis

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Real Estate Finance Sources

- Equity
  - Developer's own money or capital contributions from investor partners.
- Debt
  - Mortgage(s)
- Public Assistance
  - Tax abatement, TIF, or other special taxing district assistance.

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Current Debt Characteristics

- Interest rates are currently very low for residential mortgages
  - Average is around 4% right now.
- Rates for construction are a bit higher
  - 5% to 7%.
- Money is cheap, but is hard to get.
  - Lenders requiring equity of 20% or more in each deal.
  - The upside of this is that, when projects happen, they typically won't be over-leveraged.
  - The downside is, projects on the edge are harder to get done…
    - And so developers may ask for public assistance more often.

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The Role of Incentives

- Incentives (or "public assistance") help fill a gap in a project's financing.
- Goals:
  - Help a project overcome certain development obstacles.
  - Level the playing field between an urban project or a greenfield project.
  - Fulfill a "public purpose" such as:
    - Economic Development
    - Elimination of "Blight"
    - Job Creation

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Glossary of Terms

Net Operating Income ("NOI")

- Income a project generates after all revenues are collected and all costs accounted for.

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Internal Rate of Return ("IRR") or Rate of Return ("ROR")

- The Rate of Return provides an indication of the quality of an investment.
- It represents the Developer's expected return on investment.

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What are Acceptable Rates of Return?

- Typically, a Developer will not do a project for a Return of 5% or less.
  - They'd be better off putting their money in a Money Market Account or a Mutual Fund or something.
- Returns of 5% and up are acceptable.
- To receive assistance, the Developer must demonstrate that his or her return without assistance is not acceptable, or sustainable.
- The Community involved must analyze the Developer's Rate of Return and make a determination whether it:
  - A: Believes the Developer's representation.
  - B: Believes the return is acceptable.

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Debt Service Coverage Ratio

- The ratio of NOI to Debt Service

$$DSC = \frac{NOI}{Debt\ Service}$$

- Tells us whether a project generates enough revenue to cover its debt.

Developer's Fee

- What the Developer pays him or herself (or earns) at closing in the sale of a property.

The Clawback

- In any public assistance scenario, the agreement related to the incentive should have a "clawback" provision.
- This provision should stipulate a "ceiling" for the Developer's proceeds from the Project.
- If the Developer's proceeds exceed the ceiling, then the level of assistance is reduced or "clawed back" by the City.

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Let's look at a
couple of examples.

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Thank you

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