

ANATOMY OF AN APARTMENT DEVELOPMENT

As many real estate players know, the apartment market has been on fire for the last few years and especially in supply constrained markets like Manhattan, San Francisco, Seattle and Silicon Valley. Nationally, apartment rents in 2012 increased an average of about 5% depending on the specific market and there are more than 240,000 units slated to be built this year.

With so many new units being built, we thought it would be instructive to look at the metrics of a hypothetical new apartment development deal. This development is located in the Midwest and contains 250 units. The project has 175,000 rentable sq. ft. and is being built on 12.5 acres. The average unit size is 700 sq. ft. and the density is 20 units per acre. The average rent is projected to be \$850 per unit and \$1.21 per sq. ft. The developer has built more than 5,000 units during the last 15 years and has a solid reputation. The project will be financed with a construction/permanent loan at 65% of cost and an equity investment of 35% from an institutional investor. The developer will not invest any equity in the project. The development budget is as follows:

	<u>Per Sq. Ft.</u>	<u>Per Unit</u>	<u>Total</u>
Land	\$20	\$14,000	\$3,500,000
Hard Costs	85	59,500	14,875,000
Soft Costs	12	8,400	2,100,000
Reserves & Contingency	<u>10</u>	<u>7,000</u>	<u>1,750,000</u>
Total	\$127	\$88,900	\$22,225,000

The capitalization of the project is as follows:

	<u>Amount</u>	<u>Percentage</u>	<u>Rate</u>	<u>Split</u>
Construction/Perm Loan	\$14,500,000	65%	5%	NA
Equity Investment (from institutional investor)	<u>7,725,000</u>	35%	8%	8% Preferred Return and 75% of Deal
Total	\$22,225,000			

Stabilized operating data are as follows:

	<u>Per Unit</u>	<u>Amount</u>
Gross Income	\$10,200	\$2,550,000
Vacancy-5%	(510)	(127,500)
Other Income-3%	<u>306</u>	<u>76,500</u>
Effective Gross Income	\$9,996	\$2,499,000
Operating Expenses	<u>3,500</u>	<u>875,000</u>
Net Operating Income	\$6,496	\$1,624,000
Stabilized Cap Rate and Return on Cost		7.3%

A summary of the investor financial return over a five year hold is shown below:

	<u>Amount</u>
Investor Equity Investment	\$7,725,000
Preferred Return	8%
Terminal Cap Rate	7%
Inflation Rate	3.5%
IRR to Investor	14.5%

As shown above, the economics and financial return of apartment development are very attractive at this point in the CRE cycle. The equity investor can earn an IRR of 14.5% with manageable risks over a five year investment horizon. Although development projects add risk to an equity investor, these risks can be minimized by partnering up with a financially solid apartment development company that has a good development and management track record.

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