Team #8 – Developers' Den III
Schulich School of Business

Current Real Estate Landscape

Current Real Estate Environment

- Compressing cap rates induced by historically low interest rates
- Purchase activity dominated by REIT and private investors using leverage

Office Space Market

- Comparably low vacancy (7.2%) when compared to the suburban market (10.4%)
- New supply with lower rents and better parking ratios

A&I Core Strategic Values

- Maintain all equity investor profile for A&I
- Increase real estate asset allocation from 9% to 12%
- Seeking to outperform benchmarks through active asset management and selected value add / development activities
- Positioned as a high quality office product in a suburban market

Decision Criteria

Financial Considerations

- BIGPF Target rate of return of 7%
- Build vs. Buy analysis
- Current market considerations (interest rates and cap rates)

Alignment with strategic direction

- 100% equity investment
- Increase real estate portfolio to 12% of overall holding
- Retention of existing value
- Lack of purchase opportunities to expand real estate investment allocation

What to do with DELTA land?

A Develop DELTA III

- Build 344,000 sq ft of Class A office space
- Alignment with corporate objective to engage in selective value add projects
- Improves portfolio mix and reduces exposure to large tenants

Findings

- Demand for high end Class A office is not sufficient
- 5.5% return on development cost

B Optimize current assets

- Actively manage existing leases to maximize NOI and reduce risk associated with lease expiry profile and large lease renewals
- Alignment corporate strategy but does not improve net asset allocation in real estate

Findings

- Risk of increase vacancy
- Lowering NOI
- Large tenant Prophet renewal risk

Preferred Option

C Sell DELTA I & II

- Sell existing DELTA office towers and adjacent land
- No alignment with strategic values

Findings

- Limited buying opportunities for unlevered investments
- Sale price potentially depressed due to perceived Prophet renewal risk

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Develop DELTA III - Analysis

- Synergies of building Delta III
  - Connect Delta III to the existing atrium
  - Improve our ability to service our clients
  - Spread the cost of maintenance and upcoming cap ex over more tenants
  - Increase rents /collections from existing retail tenants due to increase foot traffic
  - Ability to serve a wider range of tenants – high end and ultra-high end with the new building – this could attract previously downtown tenants who are looking to move uptown but want to maintain quality and service
  - Better able to accommodate current tenant expansions
- However, marginal benefit of the new building is reduced due to opportunity cost of giving up existing surface parking.

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Develop DELTA III - Analysis

Development Pro Forma		
SALES REVENUE	**Note**	**Total**
Office	*292,400 sf $18.5 psf/6.1% Cap (1)*	$88,678,689
Parking	*(600 x $115 + 80 x $90)/6.1% Cap*	$14,990,164
TOTAL SALES REVENUE		$103,668,852
DEVELOPMENT COSTS		
Office	*344,000 sf x $270psf*	($92,880,000)
Parking	*600 spaces x $45,000*	($27,000,000)
TOTAL DEVELOPMENT COSTS		($119,880,000)
LAND VALUE	*Given*	($5,000,000)
TOTAL DEVELOPMENT COSTS (INCLUDING LAND VALUE)		($124,880,000)
Project Profit		**($21,211,148)**
Profit Margin on Development Cost (Unlevered)		**(17.0%)**

1) Assuming 85% efficiency of 344,000 sf

Implications

Development pro forma based on an assumption to sell at market cap rate (see “Comparable Transactions” next slide), Delta III could not be sold for a profit.

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Develop DELTA III – Analysis (Con't)

Implications

- Insufficient returns to justify development
  - 5.06% Cap Rate is below cap rates of analogous buildings
  - Development cost psf greatly exceeds the price PSF of comparable buy options
  - 5.06% Cap Rate vs potential 7% target return of BIGPF

Going-In Cap Rate		
	Notes	**NOI**
Office	*292,400 sq ft * $18.5 psf*	$5,409,400
Parking	*(600 Spaces x $115 + 80 Spaces x $90)*	$914,400
Total		$6,323,800
Development Cost		$124,880,000
Going In Cap Rate		**5.06%**

Comparable Transactions					
#	**Price**	**Net Rentable SF**	**NOI**	**Cap Rates**	**Value PSF**
1	$218,000,000	651,542	$12,000,000	5.50%	$335
2	$161,000,000	549,000	$9,841,000	6.11%	$293
3	$107,775,000	311,787	$7,182,790	6.66%	$346
4	$76,500,000	269,081	$4,689,450	6.13%	$284
			Average	6.10%	$314

Delta III Buy vs. Build Analysis	
Total Development Cost	$124,880,000
Total Rentable SF (85% Efficiency	292,400
Development Cost PSF	$427

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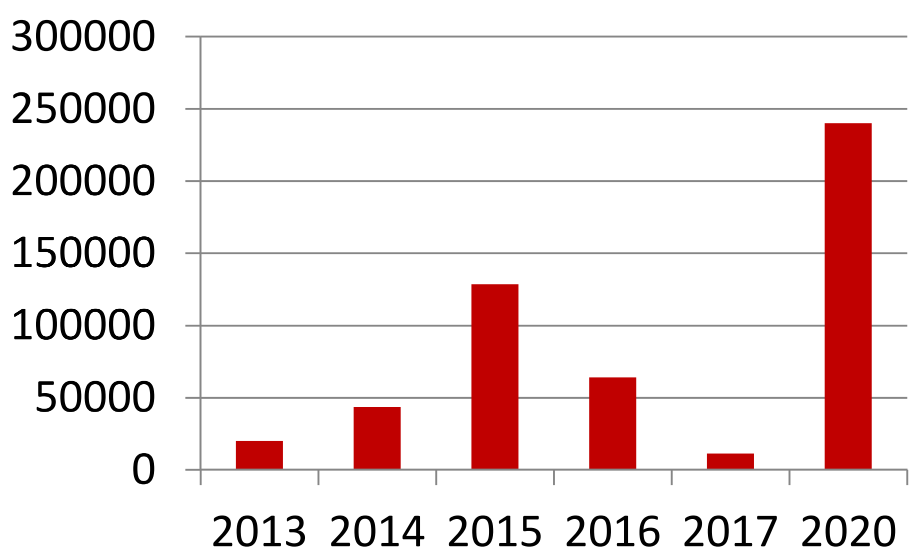
Hold and Optimize DELTA I & II

Current Lease Expiry Profile



Risk Mitigation Strategy

2013 - Lease existing vacancies to Prophet Inc.
2014 – To reduce single tenant exposure, Lease 8th floor of DELTA II to St. Joe's Cement.
2015 – Forecast 70% renewal of existing tenants and remaining space to be absorbed by external demand and internal tenant growth.
2016 - Forecast 70% renewal of existing tenants and remaining space to be absorbed by external demand and internal tenant growth.

B

Hold and Optimize DELTA I & II

Prophet Inc. Lease Renewal Analysis – Lease Termination Scenario

- 12 months notice + $2 MM termination fee (~6 months rent) + 12 months of operating expenses = at least 18 months lead time to release space before any financial losses
- Many other tenants have expressed a need to expand upon renewal
- Quality of the asset (location, amenities and public transit access) makes Delta competitive in the office leasing market
  - Not withstanding more supply coming on the market, Delta will be able to capture a significant portion of the office space absorption

Financial risks are substantially mitigated

C

Sell Delta I & II

- Potential sale price range of $152 MM to $172MM based on our comparable transactions analysis below

Delta I & II Valuation			
	Delta I & II	**Avg Comparable Sales Metric**	**Valuation**
Rentable SF	550,000 sf	$314 PSF	$172,700,000
NOI	$9,315,000	6.1% Cap Rate	$152,704,918

- However, given the significant perceived leasing risk and the appraised value of $149 MM, the actual sale price would be on the lower end of the range
- Delta I & II are strategic assets core to A&I's and BIGPF's real estate investment strategy
- Larger potential upside as development opportunity may become viable in the future

Recommendation

- Recommend A&I to hold existing DELTA I and II office towers
  - Do not pursue development option at the current time as the financial costs outweigh the strategic benefits
  - Reassess development options periodically as market conditions change over time
  - Lease 8th floor to St. Joes Cement
  - Mitigate lease renewal risk and large tenant exposure by renegotiating lease terms