S.E.C. Real Estate Observer
AN E-PUBLICATION OF THE SOCIETY OF EXCHANGE COUNSELORS
Service. Experience. Counsel.

"Multiplying Benefits When Cranking a Property for Cash"

Will Jones

*"<u>Case Study:</u> Cranking a Property for a Net Result of Cash,
a Business Purchase, a Note, and a Value-Improved Building."*

<u>Background Information:</u>

In April, 2004, a group of clients joined my partner and me in purchasing two properties in Phoenix for $7.9 Million. The seller carried back a note collateralizing both properties (umbrella note and one deed of trust) for $5,925,000 at 4% interest per annum, interest-only payments due monthly, and then Prime + 4% per annum thereafter with a loan maturity in the fifth year.

One property was general office, that we'll call ABC Office Park. It consisted of approximately 100,000 rental square feet (rsf) distributed among two four story-buildings totaling 86,818 rsf and one single-story building totaling just over 12,500 rsf. They were approximately 50% occupied at the time of purchase, and had tenant problems and were in need of several capital improvements. We improved, leased and sold off the small building and were fortunate enough to find a 43,002 rsf charter school user who filled the remaining square footage to 97% occupancy for both remaining four-story buildings. The certificate of occupancy for this new user is being issued in October, 2006 after a summer of construction.

The other property was a four-story medical building, that we'll call XYZ Professional Plaza. It consisted of 64,409 rsf. They were also approximately 50% occupied at the time of purchase, with tenant problems and a general condition that also required capital improvements.

In the process of turning both properties around, we began in mid-2004 by "cleaning up" the rent rolls. We removed a GE lien on some of XYZ's medical equipment by way of our leasing broker who found a more viable tenant, "fired" many tenant problem makers who were willing to leave, advertised, and reached out to the brokerage community. By mid-2005, we were in the early to mid thirty percent range of occupancy for both ABC Office Park and XYZ and we began the long journey of increasing the occupancy of both properties.

<u>Challenge:</u>

In late Fall, 2005, as the asset manager with my partner at that time, I saw that, although a difficult and complicated project, ABC Office Park would be filled sometime in third quarter

2006 due to the large charter school user. I also knew that in April, 2006, my seller financing payments would skyrocket and, in order to take that note out with a traditional bank-financed loan, I would need to also solve XYZ's vacancy issues or I would not have the income stream necessary to justify the debt necessary to finance the capital improvements, tenant improvements, leasing commissions and, of course, the seller financing note.

Opportunity:

At around the same time, Wayne Palmer, President of National Note of Utah, LLC (a private money lending company in Salt Lake City) called me and said that, through a developer contact of his, he had met with a couple of gentleman in Salt Lake City who desired to purchase a medical vocational school that was accredited in Utah for teaching dental technicians, x-ray technicians, etc. The owner of the school was well known nationally but she had suffered a stroke. The school had been struggling financially for over a year since this illness had debilitated its key person and her rainmaking abilities. The school's insolvent situation had reached a point where it was difficult for the school to make its payroll.

I flew to Salt Lake City in October, 2005 to meet with the two principals in Wayne's boardroom. Neither principal who desired to purchase the school had cash. However, the wife of one of the principals had a free and clear residential lot worth approximately $450,000 in a luxury area of Salt Lake City.

One of the prospective new principal owners of the school had been the head of IBM in France over twenty years ago and was the chief executive leading this project's business plan and projection. The other principal brought a good education designing mind as to the synergies that he could add to the school. He also had several educational contacts that were leaders in the industry. Lastly, in addition to adding operational efficiencies, that aren't necessary to expound upon here, they also had relationships with the top nursing authorities in the USA. They had the ability to add nursing to the school's current curriculum which had not previously available. A well led nursing program is in high demand throughout the country and enrollments are high, thereby assisting good school revenues.

Sales comparables for similar type schools could be up to three times gross revenues or more. However, for unprofitable schools, the ratio could be closer to one times gross revenue. There is still value for an unprofitable school due to the costly barriers of entry that exist to school start up, a staff, a brand name in the industry and the lengthy accreditation process for the first main branch location.

The idea that we discussed initially was that if we could create a structure for everyone that benefited everyone, and the two principals were able to receive the cash as a loan to buy the school, they, as future school chief executives, agreed that they would sign a 10 year NNN lease for 11,684 rsf in XYZ in Phoenix (they wanted to expand into Arizona and Nevada).

The Structure:

1. The Phoenix properties borrowed private financing from two individuals who provided $765,000 in cash. This was the net amount provided to the principals purchasing the school. In return, they wrote a note to the Phoenix property owners for $850,000 ($765,000 divided by .9 due to 10% origination fees), paying 18% (6% is accrued to the note's maturity and the monthly cash flow is 12% per annum or $8,500 per month).

2. My partner and I received 20% equity in the new school vesting entity. National Note of Utah, LLC also received 20% equity in the new school. Both National Note and we also have the right to broker all future school expansions and have a first right of refusal to buy the building that the school wishes to occupy in any future expansions.

3. The current ownership group assigned the note to my partner and me for our work as asset manager during the last two and a half years. A legal document was created executing this assignment.

4. XYZ Professional Plaza received a new 10 year lease for $16 psf annually NNN for 11,684. There were no leasing commissions, and only $5 psf in tenant improvements (which is minor compared to the other costly medical tenant improvements that had been done in the building to date). As well, annual base rent escalations were the greater of CPI or 3%. The school in Arizona could not operate yet since they needed to wait for their Arizona accreditations. However, their lease payments would begin within one month after receiving its funding for the school purchase. This lease brought XYZ to 82% occupancy. Along with ABC Office Park at 97% occupancy, the project could now be underwritten by a traditional bank underwriter. This allowed us to better fund the charter school at ABC Office Park which we had already committed to. It also allowed the project to have separate deeds of trust collateralizing separate portions of the new note. This allowed greater flexibility for the future sale or refinance of the project, or a portion thereof, when the ownership shall carry out their exit strategy. If not for this medical school lease at XYZ, there would have probably remained one umbrella note and deed of trust which could have forced a total project refinance or sale if a portion of the project was sold or refinanced.

5. The school sellers received a note for 12% per annum paid monthly for approximately $635,000. They were happy to have equity and cash flow since their alternative had nearly been a bankrupt school and no retirement equity that had nearly all been lost. They had been within a few weeks of losing everything after all that they had built and funded into the school for years of work. To assist in the accreditation of the new principal officers, which would take several months, and to assist in the transition of the operation's executive, the sellers remained working at their post as they always had.

6. This payment to the sellers was made by National Note of Utah, LLC. National Note designed both notes and there was no maturity date on them. Wayne's company took on the obligation to the school sellers and added $130,000 in cash. National Note had minimal cash down payment relative to the Phoenix property owners and yet also received an $850,000 note at the same terms as the Phoenix owners. In addition, since XYZ was receiving the benefit of the lease improvement and its compounded value created by cap rate, National Note also received the collateral of the free and clear lot and the sole rights to joint venture the improvement of that land with the principal who put it up as collateral.

7. Due to the Phoenix properties' disproportionate down payment of capital ($765,000 compared with National Note's $130,000), if the school defaulted, National Note, LLC promised to carry a note to my partner and me for the greater loss difference that we were exposed to, especially since we were not collateralized by the land either. If this occurred, maturity of that note would be in two years.

The Risk:

The greatest risk lies in the viability of the much greater leveraged business entity that is now the new school's operator. They not only purchased the school with very expensive money but needed to pay Phoenix rent on non-operational space while they wait for their Arizona accreditation approvals for a non-main campus approved by the state regulatory body (an unknown time event that is out of our control) that has that authority. In addition, they also needed to implement their business changes for the school which also spent their capital.

The note is not secured by real property and the business risk is the note's risk. If not for our assessment of the management team and our belief in them to meet their projections of their business plan, neither we, nor National Note, would have exposed ourselves to this risk.

If the school becomes insolvent, they may borrow again, and the risk is that they could choke on debt and fail. If that should happen, XYZ will be empty and $765,000 out of pocket (and more since it borrowed from private investors whom they need to pay back at a greater rate). National Note and I (and my partner) would need to measure the fallout of what equity would be left and whose distribution was out of balance. Calculations would need to be made balancing the land lot and a new National Note promissory note with the cash amounts put out by each underwriting partner.

In Summary:

The school is three times ahead of enrollment projections and has recently executed a forward lease doubling their space in XYZ. They shall begin paying rent on that excess square footage in XYZ two months after they get their Arizona accreditation approvals (rent commencement contingent on their obtaining the same). Therefore, the final leasing result for the Phoenix branch of their Utah school will be a total use of approximately 23,000 square feet in XYZ by late 2007, and they shall increase their rent to $20 psf NNN for all of their space at the time of the expansion's rent commencement. Accreditation approvals of the school's new principal owners are almost complete which will allow them to execute the purchase and allow the school's sellers to retire. The nursing approval by the school's main Utah campus has been achieved. They are currently looking into expanding into Nevada and feel that they will have the cash position to pay off the $1.73 Million in total loans to National Note and us.