

Bayou City Shoppes & The H-Town Champs



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Over on the southwest side of Houston, lifelong real estate investor Mr. Jim C. Rane owns an anchored shopping center that he built in 2012 and opened for business on January 1, 2013.

Located in a popular, up-and-coming, trend-setting neighborhood at 501 Crawford Street in Houston and situated on 9.5 acres, Bayou City Shoppes is a 100,640 SF, Class B shopping center anchored by popular local organic grocer Stro's Market, whose customer service, expansive selection of quality goods, and vibrant community outreach attract customers near and far. While the anchor occupies around 64% of the center, the remaining space is a single, long strip center currently occupied by 16 retail and retail service tenants. Given the popularity of both the location, as well as the anchor, the strip center will not likely experience vacancy anytime soon.

Mr. Rane developed and built the shopping center at a cost of \$11,800,000, most of which he financed. At the time, few could have predicted just how popular this location and Stro's Market would soon become. While Mr. Rane did construct a Class B quality retail property, it was admittedly a lower-end Class B. As the popularity of the location and Stro's Market exploded, Jim regretted not having constructed the property with a more attractive façade, higher-end appointments, and more lush landscaping.

As a retired Coast Guard veteran, Jim was ready to retire to his favorite spot in San Diego. For years, though, he deferred the retirement due to his own careful long-term financial planning, but by early 2017 his mind was made up. So, he actively pursued retirement plans.

Culminating as the last of his major real estate investments, Mr. Rane decided to sell Bayou City Shoppes and head to San Diego. Jim knew just the buyer, Ms. Daniella Carlos, and considered her an equally savvy local real estate investor. Originally, Daniella wanted to partner with Jim before construction began on the shopping center in early 2012. Initially, Daniella offered Jim a price that essentially reflected his 2012 costs, which Jim immediately dismissed with a toss of his hand. He was firm in his own price, which mirrored the value reflected in his own ARGUS® model. After some additional back and forth, Daniella ultimately agreed to Jim's price and, by September 1, she began a 60-day lookover of the property; together, they agreed she would put up earnest money by November 2, 2017. All intentions were to close by December 1.

Ms. Carlos would insure the property under her umbrella policy via Reddick Insurance; alas, against his better judgment, Mr. Rane quietly allowed his own policy – which was up for renewal in October – to lapse. Having somehow managed a decade now without a single insurance claim to his name, surely, he could manage one more month, he believed.

On the Wednesday evening of November 1, 2017, H-Town Wings & Sports Bar was electric as the popular sports bar was hosting Game 7 of the 2017 World Series® on their giant big screens and before a packed house. The series between the American League Houston Astros® and the National League Los Angeles Dodgers® was tied 3 games apiece, and the final deciding game would be played in Dodger Stadium. As Game 7 underdogs, the Houston Astros had never won a World Series title in the team's 56-season history. This year seemed different however, as the

Astros previously dispatched of both the Boston Red Sox® and New York Yankees® on their way to this final title match, and now this final game, against the Dodgers.

This World Series was a series defined by relief pitching and home runs. This is the first time in a World Series Game 7 that both starting pitchers did not pitch at least three innings. The Astros pounced early, scoring 5 runs in the first two innings and, while the Dodgers would eventually score a run, they'd ultimately strand 10 baserunners and go 1 for 13 with runners in scoring position.

Astros centerfielder George Springer was named the World Series MVP, with 5 home runs in the series, including 4 home runs in consecutive games, and including a home run in this Game 7. The Astros would defeat the Dodgers by a score of 5-1, and thus became World Series Champions. As the Astros retired the Dodgers, H-Town Wings & Sports erupted in celebration, as a 56-year dry spell came to an abrupt and celebratory end. As the jubilant patrons filed out of the establishment, ear-to-ear smiles and high-fives could be seen in every direction. No one could have foreseen the improbable disaster that was in the cards.

Sometime after the last of H-Town's employees locked up and exited for the evening, an on-site water main apparently ruptured, and water poured from under the parking lot surrounding the strip center portion of the shopping center. To make matters worse, an otherwise attractive concrete landscape planter that surrounds the strip retail building served to exacerbate the problem by containing much of the water in, around, and now inside of the building.

When the strip center's first employee arrived to open in the morning, he was met with a soggy mess. Around a foot of water had inundated the strip center, and even the anchor experienced some isolated damage as well. A day passed before a clean-up crew was secured to begin working to dry flooded areas of the center. Several more days passed thereafter before repair contractors were secured to fully assess the damages and estimate repairs. Now unable to conduct their businesses, furious tenants demanded answers.

As is typical, all the leases within Bayou City Shoppes were contracted so that the landlord was responsible for structural repairs only, including in the event of a disaster. Contractually, the tenants were responsible for any interior suite repairs. Given that the landlord's insurance policy was allowed to lapse, the landlord would now have to pay out of pocket for any and all required structural repairs. Also, as per the norm, and despite the disaster, all the leasing contracts required tenants to pay their rents in a continual manner, as contracted.

Meanwhile, the pending sale to Ms. Carlos was now tenuous, or delayed at best. In private, Mr. Rane admitted his property insurance dilemma to Ms. Carlos. To his surprise, Ms. Carlos insisted she was willing to buy the property "as is," if he adjusted the original purchase price to reflect the eventual repair cost estimates, once they were known. Both consulted their own contractors and agreed that landlord repair costs would total around \$450,000, which included a profit on repair costs to Ms. Carlos and, although not contracted, some minor tenant concessions and temporary forgiveness of late fees, should any occur. Ms. Carlos still wanted to buy the property; this much was known.

Alternatively, Mr. Rane had another idea lurking. His own contractor offered to give him a good deal to instead, notably upgrade the property, during the repairs otherwise. This upgrade would emphasize the property façade, landscaping, and would also include basic interior repairs to the tenant suites. Clearly, repairs within the tenant suites were not required per the lease contracts, but Mr. Rane saw this as an opportunity to reaffirm his good tenant relations, immediately help them get repaired and their businesses resumed in the shortest time possible. The only catch to this alternative plan is that suite rents would need to rise, as existing in-line leases expired. Given the otherwise dynamic position of Bayou City Shoppes in the local market, and assuming the upgrades, Mr. Rane was certain that he could achieve Market Rents for Class A retail space; and do so without much – if any – tenant pushback. Mr. Rane’s contractor provided a firm cost estimate of \$1,000,000 (Estimate A), and the contractor insisted that the repairs/upgrades could begin immediately and would be complete before the end of the year.

Before Mr. Rane could officially offer his suggestion to his in-line retail tenants, a representative of anchor Stro’s Market caught wind of the idea and suggested that upon several conditions being met the anchor would be willing to increase, beginning on January 1, 2018, their base rent to market for the area’s Class A anchor space, with no other contract changes, and commit to these terms through 2032 (eliminate the option). The anchor’s conditions included Mr. Rane completing the anchor’s minor interior repairs, as well as some additional building, façade, and interior upgrades that the anchor management had been internally contemplating for 2018. For this scenario, Mr. Rane’s contractor provided a firm cost estimate of \$1,150,000 (Estimate B), and the contractor remained confident that the repairs/upgrades would be complete before the end of the year. Additionally, these anchor repairs/upgrades could be completed without disrupting Stro’s Market business.

While Mr. Rane is confident in his own ARGUS models, he’s admittedly nervous at the scale of these decisions, and he’s now consulting you to aid in his decision-making process. Be it Ms. Carlos, or several other investors that he knows well, he is certain that he can sell, upon completion of whatever repairs/upgrades he pursues (should he pursue either scenario), by January 1. Mr. Rane will choose whichever option leaves him with the most cash in his pocket at closing.

You have reviewed Mr. Rane’s original ARGUS model (for the original scheduled sale), and you concur with his assumptions and value conclusions therein. Yet, you will need to create alternative versions of this model to reflect the various scenarios that he is considering.

Should Mr. Jim C. Rane:

- **Scenario A:** Sell the property “as is” to Ms. Daniella Carlos, with a December 1, 2017 closing date,
- **Scenario B:** Borrow and spend \$1,000,000 to repair and upgrade Bayou City Shoppes per Mr. Rane’s contractor’s Estimate A (assume a January 1, 2018 closing), or

- **Scenario C:** Borrow and spend \$1,150,000 to repair and upgrade Bayou City Shoppes, to include additional notable renovations to the anchor space, per Mr. Rane's contractor's Estimate B (assume a January 1, 2018 closing)?
- Finally, rounded to the nearest \$10,000, what do you suppose was the original, pre-flood price that was agreed to between Mr. Rane and Ms. Carlos?

Good Luck!

Bayou City Shoppes – Rent Roll as of November 1, 2017

BAYOU CITY SHOPPES CURRENT RENT ROLL												
Tenant	Suite	SF	Start Date & Term	Rent PSF / Yr	Fixed Steps/Yr	% Rent		Net Expenses			Market	
						%	Sales/SF	Recover	Exclude	% Recov	Leasing	Other
Stro's Market	100	64,700	1/1/2013 10 years w/ 10-yr option	\$5.50, \$6.70 (option)	1.90%	None	N/App	w/ 5% cap	Janitor, Pking Lot, Prof Fees	75% Mgmt	Anchor	Market
Mack's XM Discount Furniture	107	5,600	2/15/2013 10 years w/ 10-yr option	\$11.00, \$13.25 (option)	\$0.23/SF	None	N/App	+0.5% Admin	Prof Fees	100%	XL In-Line	Market
H-Town Wings & Sports Bar	101	3,200	2/15/2013 5 years	\$13.25	\$0.28/SF	3.0%	\$220.00	+0.5% Admin	Prof Fees	100%	L In-Line	Market
P. It-Ching Clinic	116	3,200	1/1/2013 10 years w/ 5-yr option	\$13.00, \$14.25 (option)	1.90%	None	N/App	+0.5% Admin	Prof Fees	100%	L In-Line	Market
Orbit Sushi	104	2,200	1/1/2013 5 years	\$15.00	\$0.30/SF	3.0%	\$280.00	+1.0% Admin	None	100%	M In-Line	Market
Miss Texas Apparel	111	2,200	7/1/2013 5 years	\$15.00	2.00%	3.0%	\$170.00	+1.0% Admin	None	100%	M In-Line	Market
Crawford Street Health Spa	115	2,100	2/1/2013 5 years	\$15.25	\$0.32/SF	3.0%	\$200.00	+1.0% Admin	None	100%	M In-Line	Market
Underdog Deli	103	2,000	3/1/2013 5 years	\$15.25	2.00%	3.0%	\$240.00	+1.0% Admin	None	100%	M In-Line	Market
LoPay Rolls & Bakery	105	2,000	3/15/2013 5 years	\$15.15	\$0.33/SF	3.0%	\$160.00	+1.0% Admin	None	100%	M In-Line	Market
Made In A Minute Coffee	106	2,000	1/1/2013 5 years	\$15.10	2.00%	3.0%	\$370.00	+1.0% Admin	None	100%	M In-Line	Market
3D Champ Nails	109	2,000	3/1/2013 5 years	\$15.25	2.00%	3.0%	\$100.00	+1.0% Admin	None	100%	M In-Line	Market
Playoff Cleaners	112	2,000	4/15/2013 5 years	\$15.25	\$0.30/SF	3.0%	\$170.00	+1.0% Admin	None	100%	M In-Line	Market
SI Cover Printing & Ship	102	1,500	1/1/2013 5 years	\$16.15	2.00%	3.0%	\$190.00	+1.0% Admin	None	100%	S In-Line	Market
Season 56 Gold Exchange	108	1,500	1/1/2013 5 years	\$16.50	2.00%	3.0%	\$200.00	+1.0% Admin	None	100%	S In-Line	Market
Verlander's 4- Seam Tailor	110	1,500	1/1/2013 5 years	\$16.50	2.00%	3.0%	\$150.00	+1.0% Admin	None	100%	S In-Line	Market
Correa's Jewelry	113	1,500	3/1/2013 5 years	\$16.25	\$0.35/SF	3.0%	\$225.00	+1.0% Admin	None	100%	S In-Line	Market
Springer's MVP Trophies	114	1,440	1/1/2013 5 years	\$16.50	\$0.33/SF	3.0%	\$175.00	+1.0% Admin	None	100%	S In-Line	Market
Total: 100,640												
*An on-site Cell Tower behind Stro's Market began on January 1, 2013 at \$24,000/Yr, and which increases annually at CPI.												
**All % rents use general inflation with natural breakpoints.												

Bayou City Shoppes – Operating & Capital Expenses

OPERATING & CAPITAL EXPENSES			
	Expense	%	
Operating Expenses	Per Year	Fixed	Expense Timing Comments
Property Taxes	\$175,750	100%	Paid in June each year, and increases at expense inflation rate.
Lanscaping Contract	\$32,500	100%	Paid in January each year, and increases at expense inflation rate.
Property Insurance	\$25,000	100%	Paid in September each year, and increases at expense inflation rate.
Pest Control Contract	\$16,000	100%	Paid monthly, increases at expense inflation rate.
Janitorial Contract	\$25,000	100%	Paid in January each year, and increases at CPI.
Maintenance Contract	\$54,000	100%	Paid in April each year, and increases at CPI.
Electric, Water, Sewer	\$0.65/SF	100%	
Management	3% EGI	100%	
Parking Lot Contract	\$12,500	100%	Paid monthly, increases at CPI.
Professional Fees	\$0.10/SF	100%	
Sprinkler Systems	\$18,500	100%	Paid monthly, increases at CPI.
Security Contract	\$28,000	100%	Paid in January each year, and increases at expense inflation rate.
Capital Expense	Expense	%	
	Per Year	Fixed	Expense Timing Comments
Capital Reserves	\$0.10/SF	100%	Paid monthly, increases at expense inflation rate. Not reimbursed.

Inflation

All available market resources indicate that General Inflation & Expense Inflation ought to be around 3.0% during the projection period. While Market Inflation & CPI Inflation are projected to be 3.5% during the projection period, Market Inflation for the first two years is expected to be closer to 4.0%.

Vacancy & Collection Loss

Although the subject location and profile is very strong, even Mr. Rane models a 5% General Vacancy applied to Total Rental Revenue; grossed up for Absorption & Turnover, and he reduces General Vacancy by Absorption & Turnover. Further, his model includes a 1% Credit Loss applied to Total Rental Revenue. Finally, the anchor space includes a Vacancy & Collection Loss override of 0%.

Market Rents – Retail Space

You surveyed the local retail market, combed through numerous in-house ARGUS retail models, and spoke with several local retail brokers and investors. Following are the result of your analyses for the area's Market Rents:

Space Type	Year	Class A		Class B		Class C	
		Rent/SF	% Chg	Rent/SF	% Chg	Rent/SF	% Chg
Grocery Anchors	2013	\$6.67	3.6%	\$5.20	3.5%	\$4.20	3.6%
	2014	\$6.91	3.6%	\$5.39	3.5%	\$4.35	3.6%
	2015	\$7.17	3.7%	\$5.58	3.5%	\$4.52	3.9%
	2016	\$7.45	3.9%	\$5.78	3.6%	\$4.70	4.1%
	2017	\$7.75	3.9%	\$6.00	4.0%	\$4.90	4.0%
5,000 - 6,000 SF Shopping Center In-Line Suites	2013	\$12.34	3.6%	\$10.40	3.5%	\$9.21	3.6%
	2014	\$12.80	3.6%	\$10.77	3.5%	\$9.55	3.6%
	2015	\$13.28	3.7%	\$11.16	3.5%	\$9.91	3.9%
	2016	\$13.79	3.9%	\$11.57	3.6%	\$10.31	4.1%
	2017	\$14.35	3.9%	\$12.00	4.0%	\$10.75	4.0%
3,000 - 3,500 SF Shopping Center In-Line Suites	2013	\$13.76	3.6%	\$12.78	3.5%	\$11.05	3.6%
	2014	\$14.27	3.6%	\$13.24	3.5%	\$11.46	3.6%
	2015	\$14.81	3.7%	\$13.72	3.5%	\$11.89	3.9%
	2016	\$15.38	3.9%	\$14.22	3.6%	\$12.37	4.1%
	2017	\$16.00	3.9%	\$14.75	4.0%	\$12.90	4.0%
2,000 - 2,400 SF Shopping Center In-Line Suites	2013	\$15.70	3.6%	\$14.51	3.5%	\$12.42	3.6%
	2014	\$16.28	3.6%	\$15.04	3.5%	\$12.88	3.6%
	2015	\$16.89	3.7%	\$15.58	3.5%	\$13.36	3.9%
	2016	\$17.54	3.9%	\$16.15	3.6%	\$13.91	4.1%
	2017	\$18.25	3.9%	\$16.75	4.0%	\$14.50	4.0%
1,250 - 1,750 SF Shopping Center In-Line Suites	2013	\$17.63	3.6%	\$15.81	3.5%	\$13.79	3.6%
	2014	\$18.29	3.6%	\$16.38	3.5%	\$14.30	3.6%
	2015	\$18.97	3.7%	\$16.98	3.5%	\$14.84	3.9%
	2016	\$19.70	3.9%	\$17.59	3.6%	\$15.44	4.1%
	2017	\$20.50	3.9%	\$18.25	4.0%	\$16.10	4.0%

Market inflation is projected to remain at 4.0%/yr through 2020, and then return to 3.5%.

Market Leasing Assumptions

Your diligent and in-depth analyses of the local retail market revealed the following as most-likely Market Leasing Assumptions for the pre- and post-flood subject shopping center:

MARKET LEASING ASSUMPTIONS (Scenario A - Pre-Harvey)																	
Tenant Type	Term Years	Renew %	Months Vacant	Base Rent PSF		Rent Increases	Free Rent Mos		Net Exp Recoveries	TI \$'s			Leasing Commissions				
				New	Renew		New	Renew		New	Renew	Timing	New	Renew	Timing	% Rent	
Anchor	10	80.0%	5.0	?	Same	2%/Yr	3	0	w/ 5% cap	5	3	100%	5.0%	2.0%	100%	Continue	Prior
XL In-Line	10	75.0%	3.0	?	Same	2%/Yr	3	0	+0.5% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior
L In-Line	5	75.0%	3.0	?	Same	2%/Yr	3	0	+1.0% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior
M In-Line	5	75.0%	3.0	?	Same	2%/Yr	3	0	+1.0% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior
S In-Line	5	70.0%	3.0	?	Same	2%/Yr	3	0	+1.0% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior

MARKET LEASING ASSUMPTIONS (Post-Harvey Scenarios)																	
Tenant Type	Term Years	Renew %	Months Vacant	Base Rent PSF		Rent Increases	Free Rent Mos		Net Exp Recoveries	TI \$'s			Leasing Commissions				
				New	Renew		New	Renew		New	Renew	Timing	New	Renew	Timing	% Rent	
Anchor	10	80.0%	5.0	?	Same	2%/Yr	3	0	w/ 5% cap	5	3	100%	5.0%	2.0%	100%	Continue	Prior
XL In-Line	10	80.0%	2.0	?	Same	2%/Yr	1	0	+1.0% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior
L In-Line	5	80.0%	2.0	?	Same	2%/Yr	1	0	+1.0% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior
M In-Line	5	80.0%	2.0	?	Same	2%/Yr	1	0	+1.0% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior
S In-Line	5	80.0%	2.0	?	Same	2%/Yr	1	0	+1.0% Admin	10	5	100%	6.0%	3.0%	100%	Continue	Prior

Capital Market Assumptions

You reviewed all relevant capital market publications and statistics for the different classes of space in the Houston Retail Market, and following are the results of that research:

CAPITAL MARKET STATISTICS			
Retail Class	Going-In Cap Rate	Going-Out Cap Rate	Discount Rate
Class A	5.93%	6.45%	6.92%
Class B	6.47%	7.01%	7.23%
Class C	7.27%	7.81%	8.10%

As always, you'll round your own rate conclusions to the nearest 0.25% point. After careful consultation with numerous retail brokers and investors, you conclude that the broader market will assign Class A rates to the assumed fully-upgraded (Scenario C) Bayou City Shoppes. Finally, you conclude it most prudent to assume the Class B rates for Scenario B.

Debt Financing

Mr. Rane provided you with the details of his original debt financing, along with the terms that he's confident he can secure, given his strong equity position in Bayou City Shoppes, and assuming the various scenarios under consideration.

DEBT FINANCING							
Scenario	Loan	Loan Amount	Origination	Term (Yrs)	Interest	Amort (Yrs)	Other
Scenario A	1st	\$8,850,000	January 1, 2013	20	4.5%	30	1 point
Scenario Financing Options*:							
Scenario B	2nd	\$1,000,000	November 1, 2017	10	5.5%	20	None
or...	or...						
Scenario C	2nd	\$1,150,000	November 1, 2017	10	5.5%	20	None

*Assume that each loan begins on November 1, and that the funds are spent 50/50 (Nov/Dec).