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Bonnie Road

Victor Alexander was intrigued by the packet of papers that lay in front of him. The papers were part of a brochure that GardenState Bank had put together in an effort to sell the Bonnie Road Distribution Center in Somerset, New Jersey. Bonnie Road was a 19-year-old, 160,000-square-foot warehouse facility located in Somerset County. GardenState was asking $9.7 million for the property. GardenState wanted a quick "as is, where is" sale in 45 days.

It was April 2020 and the New Jersey real estate market was sputtering. Uncertainty and risk stemming from the slower than desired pace of the U.S. economic recovery and continued economic shock waves emanating from Covid-19 made this a challenging time. Lenders were nervous, and debt for speculative new construction had all but disappeared. Alexander had recently raised $2.2 million to invest in troubled properties, and he wondered whether Bonnie Road would make a good investment.

Victor Alexander

Born in Argentina, Alexander had moved to Los Angeles when he was eight. He was a gifted soccer player and received a scholarship to a prestigious private high school. After being recruited by several universities, Alexander chose Yale University and graduated in 1997. He moved to New York City to work at Goldman Sachs and then attended Harvard Business School (HBS), graduating in 2004. After graduation, Alexander worked as a research associate at HBS and then took a position with AT Realty focusing on acquisitions.

After fifteen years, Alexander considered himself reasonably experienced in identifying real estate investment opportunities. He now wanted to build his own equity.

Toward this goal, Alexander convinced 10 friends to put up $200,000 each in addition to his own $200,000 to acquire one or two troubled properties. Alexander decided to focus on warehouse properties due to their relatively small size, strong historical performance, and his relevant experience. During discussions with his friends, Alexander explained that his goal was to acquire properties that would generate a reasonable current return and substantial appreciation. Even though these were his friends, he wondered whether he should also take a "promote" in the form of a larger share of the upside for his efforts.

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Bonnie Road

Built in 2000, Bonnie Road was a 160,000-square-foot, class A, multi-tenant industrial building with divisible and functional warehouse-distribution space. Set on 10.55 acres, Bonnie Road offered 24′ clear height, 40′x40′ column spacing, and 24 loading doors (21 dock height and 3 drive-in). Inside the building, an area of 23,995 square feet, or about 15%, was built out as air-conditioned office space. The property had 220 parking spaces. Alexander liked the property's stone, glass, and aluminum façade, which created a high level of curb appeal and attracted a mix of sale and front-office tenants, as well as more traditional warehouse users. Further, the building had been designed to include many energy-conserving features such as skylights to reduce the need for electric lighting, motion detectors and photo sensors to automatically shut off unused lights, and water-saving plumbing fixtures. Not only did these features reduce operating costs, but Alexander believed they would also increase the marketability of the building (**Exhibit 1** shows the site plan and photos).

Situated between the New York City and Philadelphia metropolitan regions and halfway along the Boston-to-Washington, D.C., corridor, Somerset County enjoyed easy access to one of the most densely populated regions in the United States (see **Exhibit 2** for a map). The Somerset and Middlesex Upper 287 Corridor Industrial Submarket consisted of Piscataway, Middlesex, South Plainfield, and Dunellen in Middlesex County and Franklin Township in Somerset County. Demand for the market's industrial space was due not only to the large, affluent population but to proximity to one of the nation's largest ports. Bonnie Road was within a 30-mile radius of millions of consumers, employees, households, and suppliers. Within a 20-mile radius, there were approximately 100,000 businesses employing nearly 1 million people.

Situated at 65 Bonnie Road in Somerset, the property's location offered easy access to all major thoroughfares, including I-95, I-287, and I-78. Alexander also liked that fact that Bonnie Road was located in the middle of the Princeton and Rutgers Research Corridor where many research and development facilities were located.

In the fourth quarter of 2019, the entire Central New Jersey industrial market totaled approximately 398 million square feet, with a current vacancy rate of 10.8% and a positive net absorption of 3.1 million square feet. The Somerset submarket consisted of approximately 40.2 million square feet, with vacancy rate of 7.8%. There was also positive net absorption of 361,577 square feet[a] (**Table A** shows average rents for different types of industrial space according to a national real estate service company).

Table A Average Rents for Industrial Space in Somerset and Middlesex Counties

Type of Industrial Space	Average Triple Net Asking Rents (per square foot)
Warehouse/ Distribution Space	$4.78
Research and Development and Flex Space	$10.97
Manufacturing Space	$5.16

Source: Casewriter.

While some real estate professionals worried that changes in technology and consumer shopping patterns would decrease the need for warehouse space, industrial markets in New Jersey continued to flourish. For his investment model, Alexander assumed that rental rates would continue to increase at

[a] Company documents. Net absorption is calculated by subtracting the amount of occupied space at the beginning of the year (or quarter) from the amount of occupied space at the end of the year.

3% per year. Alexander believed that in a built-up area like Somerset, increasing land prices would decrease competition and that his 3% number might be very conservative.

One thing that Alexander liked about investing in industrial real estate was that the supply of space tended to be self-regulating, compared with office or hotel markets. Industrial developers could wait until they had secured a tenant before starting construction because industrial buildings took only about six months to build, were relatively simple to construct, and required considerably less capital. On the other hand, with warehouses, there was always the danger of functional obsolescence. For example, many tenants would not even consider renting space in older warehouses that were only 18 feet high. Even newer warehouses might not be competitive if they did not have enough truck doors and trailer storage to accommodate the faster turnover of inventory that had become a trend in the industry.

As part of the sales brochure, GardenState provided a summary of Bonnie Road's projected operating results for 2020. Bonnie Road would have total gross revenues of $1,115,000 and Cash Flow from Operations (CFO) or Net Operating Income (NOI) of $824,000.

The building was 100% leased to three credit tenants. All three leases were up for renewal at the end of 2020 (see **Exhibit 3** for a summary of lease terms). Thaler, the smallest tenant, indicated it was willing to sign a new lease for 5 years; Hopkinson Logistics, for 7 years; and Malcom, Graham & Rue Industries, for 10 years. All three tenants indicated, however, that they would only sign a new lease at the current fair-market rent. They all insisted that the base rent remain flat for the first five years. At the end of five years, the tenants expected a bump in the base rent in line with the cost of living. Because the leases were triple net,[b] the tenants would be responsible for any increases in operating expenses like real estate taxes and insurance.

Back in 2015, as an incentive to sign their leases, the developer had agreed to finance the tenants' improvements to the space, the cost of which was amortized over five years as part of their rental payments. The costs associated with these improvements had now been repaid, and the new rents would be exercised at current fair market value. The tenant improvements included some special secure-storage rooms and racking systems. A restoration provision in the lease agreement provided that the landlord had the right to make the tenant restore the building to its original condition at the tenant's cost. However, the landlord might not exercise this provision since other tenants could probably use the racking systems and storage rooms.

Alexander reasoned that if he acquired the property and extended the leases, he would not incur additional costs such as leasing commissions and tenant improvements. If he brought in new tenants, he would expect to incur a tenant improvement expense of $2.80 per square foot. The owner would also be required to pay a leasing commission on a typical five-year lease of 7% of the first year's rent, net of all expenses. This would be payable up front to the leasing broker, usually at lease signing or upon occupancy. Alexander might lease the space himself, but even in that case, he would probably have to share the brokerage commission with another leasing agent.

[b] "Triple net" means that the tenant is responsible for all the operating expenses such as repairs and maintenance, insurance, property management, and for real estate taxes. GardenState paid these expenses and then was reimbursed by each tenant on a pro rata square-foot basis. These payments were shown on the income statement as expense reimbursements. Tenants paid their utility bills directly except for things like exterior lighting and water and sewer, which were paid by the landlord and then reimbursed. The landlord is typically responsible for any structural reserves. In some markets, leases are "absolute" triple net and include all capital expenses.

Based on a recent appraisal, the 10.55-acre site was valued at $3 million. The appraiser used a standard combination of income approach, comparable sales, and replacement value to arrive at a $10.5 million valuation for both the land and the building. On the issue of replacement cost, the appraiser confirmed Alexander's estimate that to purchase land and construct a new warehouse in this location would cost about $75 per square foot.

A structural engineering report indicated that the roof was relatively new and in good condition, with a 15-year remaining life. The heating, cooling, and ventilation systems (HVAC) were adequate, and the parking lots had recently been resurfaced.

GardenState decided to sell the property on short notice to raise capital and to reduce its real estate exposure. It was also concerned that the New Jersey industrial rents had plateaued and might fall.

Financing

Because of the small size of the property, most institutional investors would not be interested in this investment. GardenState believed that the eventual purchaser would probably be an individual or group of individuals. To sweeten the deal, GardenState indicated that it was willing to provide a $7.76 million loan secured by a purchase-money first mortgage with a 7-year term, 30-year amortization schedule and a 4% interest rate (see **Exhibit 4** for the interest and principal payments associated with this loan). The mortgage had an exculpatory clause, which meant that the bank had no recourse to the personal assets of the borrower. The property being pledged was the sole security for repayment.

A purchase-money mortgage was a mortgage from the seller to the buyer. In this case, the mortgage was at market rates and terms, but the seller's offer to provide the mortgage simplified the transaction for Alexander and reduced his need for additional time to obtain outside financing. In recent months, financing had become more difficult and cumbersome to obtain.

Analysis

Alexander had reviewed several investment opportunities over the past six months. Before he spent money on lawyers and engineers, Alexander wanted to do a quick analysis to see if the investment made sense. As a starting point, Alexander created a "setup" for the project using the financial information that GardenState had provided. A setup was a simplified cash flow statement. From GardenState's numbers, Alexander decided to deduct a 5% vacancy allowance and a structural reserve allowance of $32,000 based on $0.20 per square foot per year. Even for a relatively new building, it was a good idea to be disciplined and set aside a reserve for any capital expenditures that might be incurred in the future, such as a new roof or repaving of the parking lots. These reserve expenses could not be passed on to the tenants. Alexander also wanted the setup to reflect a $34,000 property management fee (typically based on 3% to 4% of collected rents). The property management fee could be passed on to the tenants in accordance with market norms in New Jersey. The asset management fee could not be passed on to the tenants (**Table B** shows the setup with the original GardenState assumptions and also Alexander's revisions).

Table B Bonnie Road Setup ($000s)

	Original	Revised
Base Rent (160,000 sf)	$ 824	$ 824
+ Expense Reimbursement	291	325
Gross Revenue	$ 1,115	$ 1,149
– Vacancy	-	57
Effective Gross Income	$ 1,115	$ 1,092
– General Operating Expense (repairs, water and sewer, common area utilities, etc.)	75	75
– Real Estate Taxes	203	203
– Insurance	13	13
– Property Management Fee		34
– Structural Reserve ($0.20 psf)		32
Total Expenses	291	357
Cash Flow From Operations or NOI	$ 824	$ 735
– Tenant Improvements	-	-
– Lease Commissions	-	-
Cash Flow Before Financing	$ 824	$ 735

Source: Casewriter.

The $9.7 million asking price reflected a capitalization rate of 8.5% on the original projection of $824,000 in cash flow from operations, but only 7.6% on the revised cash flow from operations of $735,000. The capitalization rate was also known as an unlevered first-year's return on assets (ROA). While the term "cap rate" was widely understood in the real estate industry, the definition might vary depending on what was included or excluded (i.e., as in this example, vacancy and structural reserve allowances were included). Major capital items such as roof repairs, tenant improvements, and/or leasing commissions were never included because they were "below" the cash flow from operations (CFO) or net operating income (NOI) line and not deducted to determine value using cap rate methodology.

As a tax-paying private investor, Alexander was more interested in the Cash Flow After Financing (CFAF) and the Cash Flow After Taxes (CFAT). Some investors referred to this as the "cash in fist" or CIF that an investor got to keep. To determine these two numbers, Alexander began by calculating the monthly payment on the loan and then separating out the portion of that payment that was principal and the part that was interest.

Using the mortgage calculator at www.mortgagecalculator.org, Alexander determined that the monthly payment on a $7.76 million loan with a 4% interest rate and a 30-year amortization schedule was $37,047. Each month, the outstanding mortgage balance was reduced by the principal part of the payment, but the full payment amount of $37,047 remained the same. This type of mortgage is called a "constant payment" mortgage. Although it was easy to calculate the annual payment by multiplying the monthly payment by 12, the mortgage calculator did the complex math in determining the portion of the annual payment that was repayment of principal and payment of interest each year (see **Exhibit 4**).

The term of the loan was seven years, meaning the outstanding mortgage balance would have a lump-sum payment due at the end of the seventh year. Originally, GardenState proposed a five-year term, but Alexander insisted that it be at least seven years. This lump-sum payment might be paid off by selling or refinancing the property. GardenState's terms were somewhat less onerous in that they said that the loan could be paid off at any time without a prepayment penalty. The financial leverage from an 80% loan at a 4% interest rate was positive, but leverage also carried considerable risk with it, especially if one of the tenants defaulted on its lease payments.

To calculate taxable income, Alexander began with the Cash Flow from Operations (or Net Operating Income) and subtracted the interest part of the mortgage payment, which was deductible. Next he calculated the annual depreciation. To calculate the depreciation, he started with the purchase price of $9.7 million and subtracted the $3 million value of the land. Land was not depreciable. By subtracting the land from the overall price, he arrived at $6.7 million as the value of the building. He then divided the value of the building by the depreciable life or cost recovery period of 39 years.[c] To complete the calculation of taxable income, Alexander then added back the structural reserve, which was not deductible for tax purposes (**Table C** shows the calculation of cash flow after taxes).

After arriving at the taxable income under the current rules, Alexander then multiplied the taxable income by the maximum federal income tax rate of 37%[d] to arrive at the income tax for year one. In this analysis, Alexander chose to ignore any state and local taxes.

Table C Bonnie Road Setup, Annual Cash Flow after Financing and Taxes ($000s)

Cash Flow from Operations or NOI	$	735
– Debt Service ($7.76 million loan at 4%, 30 years)		445
Cash Flow after Financing	$	290
Cash Flow from Operations or NOI	$	735
– Interest		308
+ Structural Reserve		32
– Depreciation		172
Taxable Income	$	287
Income Tax (37%)		106
Cash Flow after Financing	$	290
– Income Tax (37%)		106
Cash Flow after Taxes	**$**	**184**

Source: Casewriter.

[c] Over the years, the U.S. government changed the depreciable lives of buildings depending on policies to either encourage or discourage real estate capital investment. At one point in the early 1980s, for example, commercial properties were depreciated over 15 years, making it considerably more desirable to invest in real estate for its tax advantages.

[d] For calculation purposes, please use 2020 tax law creating a new top marginal tax of 37% according to The Tax Cuts and Jobs Act that went into effect on January 1, 2018.

The $184,000 cash flow after taxes on $1.94 million of equity represented a 9.5% cash-on-cash return before transaction costs such as legal fees. The 9.5% return was slightly above the 7.6% return on assets calculated earlier. The increase was a result of positive financial leverage.

If the partnership invested in Bonnie Road, Alexander assumed that it would hold the property for five years. He also believed he would be able to sell the property in 2025 at a 7% cap rate. The cap rate would be applied to the projected 2026 cash flow from operations, which he assumed to be the existing 2021 rental rate of $824,000, increasing at 3% per year for five years to $955,242. He also assumed that most expenses like real estate taxes, insurance, and property management would increase at the same 3% rate, but kept the structural reserve at $32,000.

To estimate the sales price at the end of 2025, he created a new setup with the $955,242 base rent. This new setup showed that the cash flow from operations was $856,642. A 7% capitalization rate resulted in a sales price of $12.238 million. Then, to arrive at a net sales price, he deducted 5% from the gross sales price for the costs of selling the project, including broker fees as well as other transaction costs, such as transfer taxes and lawyer fees.

To complete his analysis, Alexander needed to calculate the after-tax sales proceeds from the sale of the property at the end of year five. Tax-paying owners of real estate maintained three sets of books: one to understand their cash position, a second to understand their tax position, and a third for accounting purposes. The three were quite different, and the individual owner needed to understand each and their interrelationships. To arrive at the taxes due on sale, Alexander did a number of computations.

First, he always started on the tax side. To calculate the taxable gain on sale, Alexander began with the purchase price, subtracted the depreciation and added undepreciated capital expenditures over the holding period.[e] This calculation provided the book value of the property. The book value, along with all closing costs, was then deducted from the sales price. The difference was the gain on sale.

From the gain on sale, Alexander then computed the part of the gain on sale due to depreciation and the part due to appreciation. The part due to depreciation (which in this situation was simply the $172,000 annual depreciation multiplied by five years) was taxed at a 25% rate. The gain due to appreciation, which was the difference between the gain on sale and the gain from depreciation, was taxed at a 20% rate.

Moving from the tax side to the cash side, Alexander started with the projected sales price of $12.238 million and subtracted the closing costs, the balance remaining on the mortgage, and the total taxes due (all of these calculations are shown in **Table D**).

[e] For this exercise, we assume that the reserves are not spent through the fifth year and no depreciation was taken against these capital expenditures.

Table D Calculation of Tax on Sale at the End of 2025 and Net Cash from Sale ($000s)

Tax			Cash		
Purchase Price	$	9,700	Sales Price – 7% Cap Rate	$	12,238
Less: Depreciation Taken (5 yrs.)		859	Less: 5% Closing Costs		612
Plus: Cap Ex (5 yrs. struct. res.)		160	**Net Sale Price**	**$**	**11,626**
Book value	**$**	**9,001**			
Net Sale Price (less 5% fee)	$	11,625	Less: Mortgage Balance		7,019
Less: Book Value		9,001	Before Tax Residual	$	4,607
Taxable Gain on Sale	**$**	**2,625**	Less: Tax Due		568
			Net Cash from Sale	**$**	**4,039**
Gain Due to Depreciation	$	859			
Tax on Depreciation (25%)		215			
Gain Due to Appreciation	$	1,766			
Tax on Appreciation (20%)		353			
Total Tax Due	**$**	**568**			

Source: Casewriter.

The deal did not look bad. Alexander would make approximately $184,000 annually in after-tax cash flow on his $1.94 million initial investment. At the end of year five, the partnership would receive $4,039,000 after taxes. Alexander saw no need to push the numbers further. His biggest concern was verifying key assumptions, such as the $5.15-per-square-foot annual rental level in the existing leases. What was the current market rent? He checked with local brokers who prepared an analysis for him (**Table E** summarizes a list of competitive properties, their occupancies, and rents). Alexander also compiled a list of comparable leases in the market (see **Exhibit 5**).

Table E Total Square Footage, Occupancy, and Rent Rates for Competitive Properties, March 2020

Building	Total	% Occupied	Average Base Rent ($/PSF)
1	8,000	100%	$5.77
2	240,000	90	4.25
3	120,000	97	4.67
4	60,000	100	5.39
5	180,000	92	4.68
6	100,000	96	4.97

Source: Casewriter.

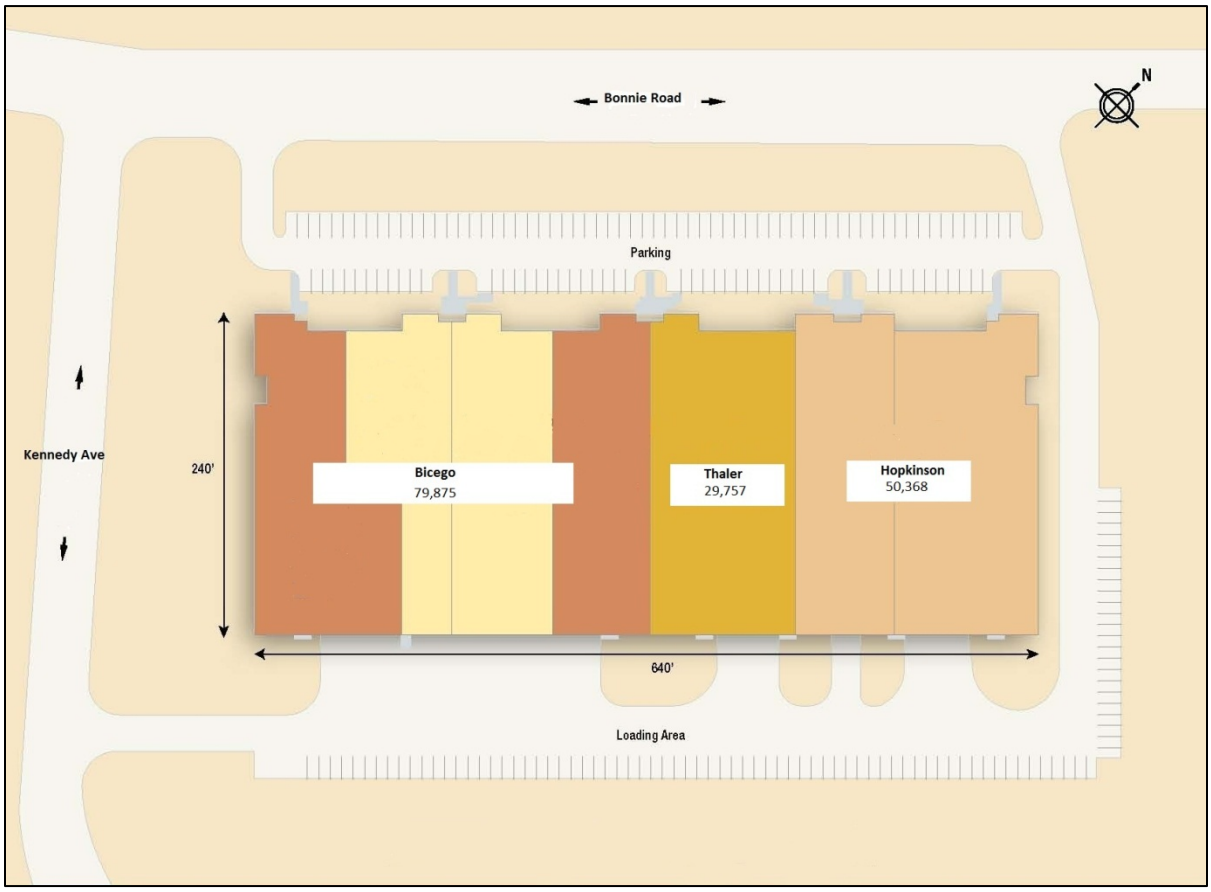
Based on that information and making adjustments for the location and quality of the buildings, Alexander decided that the fair market rental rate for Bonnie Road was about $4.65 per square foot. He further assumed the leases would be flat for five years with no annual "bumps," based on his discussions with the tenants and norms in the local industrial market. Although the base rent would remain flat for five years, the previous assumptions regarding 3% annual growth in operating expenses, real estate taxes, insurance, and property management were still valid, though these increases would be passed through and paid by the tenants as reimbursable expenses. Similarly, for

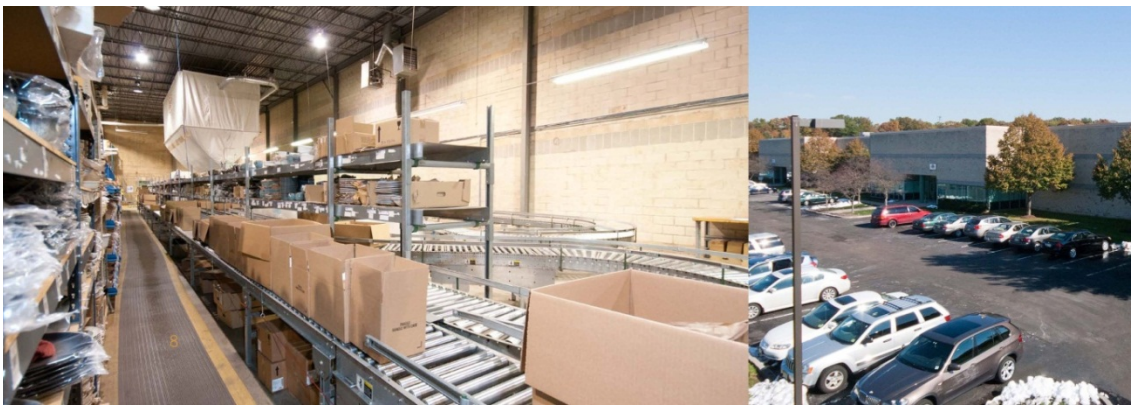
simplicity, the calculation of the structural reserve would remain fixed. Additionally, the base rent in year six of $5.39 reflected a 3% annual growth in market rents during the holding period.

Having run a first set of numbers, Alexander had a good template for calculating the annual cash flows and the ultimate sale price, using this lower base rent. Once he got the results from these revised calculations, he could do an internal rate of return and a net present value of the five years of after-tax cash flow plus the after-tax sales proceeds. Alexander thought his investors would want an after-tax internal rate of return of at least 10%, including an annual after-tax current cash flow in excess of 5%. Clearly, there were a lot more numbers to run.

As Alexander headed out for the weekend, he wondered about the qualitative side of this investment. The property was well located and had some other advantages. What were the greatest risks? Should this investment be characterized as low risk or high risk? It was one thing to make acquisitions for large, diversified institutional investors. It was quite another to put his and his friends' scarce equity at risk.

Exhibit 1 Site Plan and Photos of 65 Bonnie Road





Source: Casewriter.

Exhibit 2 Map of the Region

Source: Casewriter.

Exhibit 3 Rent Roll—April 2020

Tenant	Sq. Ft. Occupied	Rate per Sq. Ft. (triple net)	Annual Triple Net Rent	Expiration
Malcom, Graham & Rue Industries	79,875	4.80	$ 383,400	December 31, 2020
Thaler Industries	29,757	5.36	$ 159,498	December 31, 2020
Hopkinson Logistics	50,368	5.58	$ 281,053	December 31, 2020
Totals	160,000	5.15 *weighted average*	$ 823,951	

Source: Casewriter.

Exhibit 4 Annual Mortgage Payments Payable Monthly for 7-Year Term on $7.76 Million Loan at 4% Interest Rate Using 30-Year Amortization Schedule

	2021	2022	2023	2024	2025	2026	2027
Interest	307,913	302,345	296,551	290,520	284,244	277,712	270,914
Principal	136,656	142,224	148,018	154,049	160,325	166,857	173,655
Mortgage Balance	7,623,344	7,481,120	7,333,101	7,179,052	7,018,727	6,851,870	6,678,215

Source: Casewriter.

Exhibit 5 Comparable Leases Chart

Date	Tenant	Address	Leased Area (SF)	Term (Yrs)	Rate (PSF, NNN)	Comments
3/1/19	Denby USA	65 Clyde Road Somerset, NJ	24,779	2	Year 1: $5.90 Year 2: $6.01	Renewal
11/1/18	Seine Tech	65 Clyde Road Somerset, NJ	19,886	4	Year 1: $4.50 Year 2: $4.57 Year 3: $4.64 Year 4: $4.71	3 months free rent
10/1/18	Promotion in Motion	1600 Cottontail Lane Franklin Township, NJ	90,000	7	Year 1: $7.83 Year 2: $7.99 Years 4-5: $8.49 Years 6-7: $9.49	7 months free rent
9/1/18	Bunge Amorphic Solutions	65 Clyde Road Somerset, NJ	19,900	3	Year 1: $4.55 Year 2: $4.65 Year 3: $4.75	2 months free rent
6/1/18	Hydratight Operations	12 Worlds Fair Drive Somerset, NJ	15,000	6	$10.33	4 months free rent; 18' clear height
5/1/18	Pinestar Technology	400 Apgar Drive Somerset, NJ	7,300	5	$9.46	Renewal; 6 months free rent
3/1/18	Prolong Pharmaceuticals	300 Corporate Court South Plainfield, NJ	24,000	4	$11.00	Flex building; 18' clear height
9/1/17	Libotani	625 Pierce Street Somerset, NJ	21,839	5	$4.40	13% office build-out; 26' clear height
8/1/17	Access Bio	65 Clyde Road Somerset, NJ	49,668	10	Year 1: $5.25 Year 4: $5.50 Year 7-10: +CPI	4 months free rent
7/1/17	Akorn	72 Veronica Avenue Franklin Township, NJ	50,000	6	$9.30	Renewal; 22' clear height
6/1/17	A Teameffort Design	65 Clyde Road Somerset, NJ	15,040	5	Year 1: $4.50 Year 2: $4.75 Year 3: $5.00 Year 4: $5.25 Year 5: $5.50	2 months free rent
3/1/17	Specified Technologies	210 Evans Way Branchburg, NJ	28,727	2	$9.00	22' clear height

Source: Casewriter.