South Bridge Student Case Response

By Frank Su - 1st year Program in Real Estate Student

To: Jean DuSable – Chairman Jean DuSable Company
From: Frank Su – Associate

Regarding: South Bridge Project

The South Bridge Project is a mixed-use concept located in the North Michigan Avenue portion of Chicago's business district and is to contain retail on the first few floors, class A office, and a 300 room hotel. The existing area of South Bridge is a redevelopment zone, which currently consists of retail/entertainment, office, parking, and luxury hotels. Currently, the proposed project emulates the existing product mix in the South Bridge Area and our task is to analyze the market and propose a product mix. That is financially viable and that highest and best use of the site.

Before analyzing each separate product type, the proposed product mix was analyzed to determine project cash flows and a project IRR. Figure 1 is a ten-year cash flow with NOI's from Retail, Hotel, and office and incorporating given loan terms. A reversion value was computed with given cap rates from the project year 11 NOI, which is increased via the inflation rate from the base NOI. The pre-tax IRR for the proposed project is 19.34% and the pre tax NPV, after financing, at 15% is $31,766,422.

Figure 1 shows that the proposed project is indeed quantitatively viable based on the assumptions of a mixed-use building with retail, office, and a 268-room hotel. Next, we will look at each product type and see what the impacts are for only a hotel, retail, or office. If the project is just a retail building, the project would cost $303 million, rent at $30 a square foot, and have a $31 million dollar base NOI. This retail only project yields a 26.19% IRR over a ten year hold period. If the project is just a hotel it would cost $270 million, have 700 rooms, and a base NOI of $23.7 million. This hotel would yield an IRR of 11.57% over a ten year hold period. If the project is an office building it would cost $303 million, rent at $20 a square foot, and have a base NOI of $21.2 million. This office building would yield an IRR of 12.08% over a ten year hold.

The analysis above shows that the retail portion yields the highest IRR, with the office next, and the hotel at the lowest IRR. The retail portion demands the highest rents and is comparable in costs to an office or a hotel. But realistically the entire building cannot be only retail for 15 floors and a mix between the hotel and office needs to be achieved. The original proposed project has an almost equal allocation between the Hotel and Office. The main question becomes what is the best mix between office and

Figure 1

Proposed Mix

	0	1	2	3	4	5	6	7	8	9	10	
	($121,483,125)											
Retail NOI		$14,921,120	$15,368,754	$15,829,816	$16,304,711	$16,793,852	$17,297,668	$17,816,598	$18,351,096	$18,901,628	$19,468,677	$20,052,7
Hotel NOI		$9,092,692	$9,365,473	$9,646,437	$9,935,830	$10,233,905	$10,540,922	$10,857,150	$11,182,864	$11,518,350	$11,863,900	$12,219,8
Office NOI		$8,125,232	$8,368,989	$8,620,058	$8,878,660	$9,145,020	$9,419,370	$9,701,952	$9,993,010	$10,292,800	$10,601,584	$10,919,6
Total NOI		$32,139,043	$33,103,215	$34,096,311	$35,119,201	$36,172,777	$37,257,960	$38,375,699	$39,526,970	$40,712,779	$41,934,162	
Total Debt		($19,102,488)	($19,102,488)	($19,102,488)	($19,102,488)	($19,102,488)	($19,102,488)	($19,102,488)	($19,102,488)	($19,102,488)	($19,102,488)	
BTCF		$13,036,556	$14,000,727	$14,993,824	$16,016,713	$17,070,289	$18,155,472	$19,273,211	$20,424,482	$21,610,291	$22,831,674	
Retail Reversion											$250,659,220	
Hotel Reversion											$106,259,282	
Office Reversion											$126,972,464	
Less: Selling Exp											($9,677,819)	
Less: RMB											-$170,672,869	
Total BTCF	($121,483,125)	$13,036,556	$14,000,727	$14,993,824	$16,016,713	$17,070,289	$18,155,472	$19,273,211	$20,424,482	$21,610,291	$326,371,952	

hotel, assuming retail on the first few floors, based on the market analysis and the competing projects in the area?

In the South Bridge area, there is an agglomeration of retail services and hotels. A large mass of retail is positive because shoppers come to an area not for only one store but to take advantage of a "shopping district" in order to visit a mass amount of stores in a small radius. Therefore the amount of retail currently proposed maximizes the first four floors of the building with the department store and some specialty retail. In the South Bridge area there is also a large concentration of 2,300 hotel rooms with a projected 2,027 luxury hotel rooms projected in the Chicago area. There are major flag hotels in the area including Marriott and Hilton. The proposed project would not only add 268 new rooms in the market, but would need to obtain a firm management company, with a flag, to compete directly with the hotels in the area. With the large amount of supply, we proposed to not develop a hotel but only retail and office. The Hotel market is a riskier product type with short term leases where as office can offer long term leases and less risk. The South Bridge area currently has 1.2 million square feet of office and the addition of 750,000 square feet to the market will add a significant portion of office space. Downtown Chicago is definitely a desirable location for office and the retail in the area provides desirable services for the office tenants. Though there is a large base of office in the area, we believe that office is definitely less risky and a good supply of quality office space can better compete against some of the older stock.

Figure 2 shows a 10 year cash flow with the proposed original amount of retail and the expanded office. The office portion now includes the original hotel square footage. The total cost for the project is $332 million, stabilized BTCF of $11 million, a total project IRR of 19.24%, and a NPV of $30 million at 15%. We can see that this product mix yields a similar IRR but avoids the risk of adding more hotel rooms to a potentially saturated hotel market.

Conclusion

Our recommendation for the property is to provide the maximum amount of retail on the first four floors, with the department store anchor, and provide office space from floors four to fifteen, which will reduce the risk of a volatile and over supplied Hotel market. Instead of adding the complexity of constructing a hotel, the project should take a simpler approach and build retail only, to take advantage of the retail area, and office, to reduce risk with long term leases.

Figure 2

Office & Retail		loan	debt	RMB
Office Hard Costs	$110,250,000	$113,937,500	($9,340,765)	$87,828,120
Office Soft Costs	$41,666,667			
Retail Hard	$129,018,750	$102,073,125	($8,758,948)	$79,775,742
Retail Soft	$16,800,000			
Land	$35,000,000			
Total Costs	$332,735,417			
Loan	$216,010,625			
Equity	($116,724,792)			

	0	1	2	3	4	5	6	7	8	9	
Reatil NOI ($30/sf)		$14,921,120	$15,368,754	$15,829,816	$16,304,711	$16,793,852	$17,297,668	$17,816,598	$18,351,096	$18,901,628	$19,46
Office NOI($20/sf)		$15,000,000	$15,450,000	$15,913,500	$16,390,905	$16,882,632	$17,389,111	$17,910,784	$18,448,108	$19,001,551	$19,57
Less: DS		($18,099,713)	($18,099,713)	($18,099,713)	($18,099,713)	($18,099,713)	($18,099,713)	($18,099,713)	($18,099,713)	($18,099,713)	($18,09
BTCF		$11,821,407	$12,719,041	$13,643,604	$14,595,903	$15,576,772	$16,587,066	$17,627,669	$18,699,491	$19,803,467	$20,94
Retail Rev											$250,65
Office Rev											$234,40
Less: Selling											($9,70
Less: RMB											($167,60
Total BTCF	($116,724,792)	$11,821,407	$12,719,041	$13,643,604	$14,595,903	$15,576,772	$16,587,066	$17,627,669	$18,699,491	$19,803,467	$328,69

Total project IRR	19.24%
Total NPV @ 15%	$30,454,063