TRINITY | Private Equity Group

CASE STUDY: REAL ESTATE DEVELOPMENT

Isle at Watercrest – Mansfield, Texas

INITIAL **PROJECT PLAN**

In November of 2009, TPEG partnered with experienced senior living developers South Bay Partners and Integrated Real Estate Group (the "Sponsors"), to build a 93-unit, 123-bed assisted living and Alzheimer's residence in Mansfield, Texas, a suburb of Dallas and Fort Worth. The $17.8m project employed $4.6m of preferred equity and accrued a 12% preferred return throughout the life of the investment. Equity investors would also earn 60% of the project's profits, after their capital was returned and their preferred return was paid. The Sponsors and TPEG shared the other 40% of the profits.

The investment lifecycle consisted of three parts:

- A **Construction Phase** of between 12 and 14 months and review period of three months ending with the issuance of a certificate of occupancy and all operating licenses. Operating licenses issued by the Texas Department of Aging and Disability Services are required to provide services at this type of facility.

- A **Lease-Up Phase** of up to 28 months, commencing upon issuance of the operating licenses and ending when the project reaches 90% occupancy.

- **Stabilized Operations** including a refinancing and, ultimately, a sale.

TPEG and the Sponsors were initially attracted to this project because the demand for senior care facilities was clearly increasing on a national level. Further diligence was required to conclude that there was sufficient local demand, and that there was insufficient local supply. Once satisfied that local supply and demand for assisted living in Mansfield created an opportunity for investment, TPEG began vetting the project.

TPEG conducted exhaustive due diligence on the Sponsors, the assisted living industry, the local market, and the submarket. TPEG worked with the Sponsors to create a detailed financial model that allowed TPEG to perform a series of scenario analyses. TPEG and its legal counsel vetted all bank documents, the land purchase contract, the construction contract, the operating agreement for the project special purpose entity, the management agreement for the assisted living facility, and other contracts and agreements, including documents related to development, entitlements, and titling.

TPEG, with the Sponsors and with TPEG legal counsel, structured the transaction in such a way as to align the interests of all stakeholders. TPEG created a special purpose entity for investors, and TPEG principals and the Sponsors made equity contributions under the same terms as TPEG investors. As with most TPEG real estate transactions, TPEG and the Sponsors would receive equity profit distributions only after TPEG investors had received a full return of the capital they invested along with an annual preferred return of 12%.

TPEG then prepared a full private placement memorandum for its investors, detailing all material issues and factors related to the project and to the investment. TPEG hosted a webinar for potential investors to hear from, and ask questions of, TPEG and the Sponsors. The webinar was followed by multiple site visits that allowed potential investors further opportunity to familiarize themselves with the Sponsors, the local market, and the project. TPEG principals and employees were available to answer questions throughout the process.

THE **PROJECT**

Construction went according to plan and in June of 2011, after a three month review, Watercrest received its operating licenses. Lease-up commenced immediately. The project was completed on time and on budget, with no major cost overruns and no significant delays. The project's performance during the early months of lease-up was strong, as average revenues per bed were significantly higher than initial projections, and the assisted living (AL) and Alzheimer's (ALZ) components of the facility began filling up rapidly. However, expenses per bed were also higher than projected, and as a result the project's interim cash flows were slightly below those projected.

During 2012, the Sponsors were focused on leasing the property up to stabilization (90%+) and operating it efficiently. While there were certain challenges related to achieving stabilization, the project benefited from its proximity to an adjacent independent living (IL) facility, also operated by Integrated Real Estate Group, that served as a natural source of potential residents. This model, placing an AL/ALZ facility adjacent to an IL facility, is a common strategy, as it allows older IL patients to relocate to an AL/ALZ facility without totally leaving behind their familiar environment and social circle. By the end of 2013, the property was generating over $300,000 of net operating income (NOI) per quarter, and was trending upward. Given 2012's occupancy and rent trends, the Sponsors believed that NOI of between $140,000 and $150,000 per month was achievable during 2013 and 2014.

During mid-2013, the partnership received a favorable offer to buy the property, as part of a portfolio of assets, to CNL, which is a non-traded real estate investment trust (REIT) that focuses on senior-living and healthcare properties. The purchase contract specified a price of $25,000,000 ($2,000,000 higher than TPEG's initial projections), but also allowed for an increase in the sale price in response to improvements in the property's NOI (an "earn out"). The Sponsors were able to materially increase the NOI during the prescribed timeframe, and ultimately earned a final sales price of approximately $31,300,000.

THE **RESULTS**

The property was sold in May of 2014, 55 months after the initial investment. **TPEG investors realized a pre-tax IRR of approximately 27% and a cash-on-cash return of approximately 295% after all distributions were made.** The following table shows annual cash flows to TPEG investors. TPEG does not charge asset management fees to investors, so the cash flows represented in this table are net pre-tax cash flows.

TPEG INVESTOR RETURNS
Isle at Watercrest

		YEAR 1	YEAR 2	YEAR 3	YEAR 4	YEAR 5
CASH FLOW TO EQUITY INVESTORS						
TPEG Investor Contribution	($4,627,557)					
Current Yield						$2,545,156
Return of Equity Capital						$4,627,557
Split of Remaining Cash - 50%						$6,482,745
Total	**($4,627,557)**	-	-	-	-	**$13,655,458**
CASH FLOW PER $100,000	**($100,000)**	-	-	-	-	**$295,090**
Annual Cash Yield		*0.00%*	*0.00%*	*0.00%*	*0.00%*	*295.09%*
ACTUAL IRR	**26.90%**					
ACTUAL CASH-ON-CASH	**295.09%**					

Each TPEG investment has unique characteristics, but it's not uncommon for our development projects to delay return of capital, payment of preferred return, and distribution of additional profit share until a refinancing or sale. Because development projects typically do not generate consistent cash inflows until the lease-up period is well underway, delaying distributions to equity allows more financial flexibility and enhances capital efficiency.

Development projects also tend to involve higher overall risk than value-add/repositioning projects. To be successful, a real estate development project should:

- Make sense macroeconomically, with favorable trends in the local economy
- Address a significant demand in the relevant submarket
- Be thoroughly vetted legally
- Be thoroughly modeled financially, including stress testing in scenario analysis
- Be structured properly, aligning the incentives of all stakeholders
- Be conducted by the right people (our operating partners/sponsors)
- Include outside oversight (TPEG)

TPEG considers each of these factors a requirement and will not invest in a project that falls short in any of these areas. The Isle at Watercrest Mansfield project was TPEG's first real estate investment. It was successful, and it provided a roadmap that we've used and improved over the past six years.