Altus Group

2025

ARGUS University Challenge

Healthy returns: a medical complex study

PARKER MEDICAL OFFICE COMPLEX
1100 NW 119TH TERRACE, ALACHUA, FL 32615

CASE INTRODUCTION

It's a pivotal moment—graduation day at ARGUS University. The sun is shining as you cross the stage, diploma in hand, ready to embark on your new career. As you step down, a seasoned real estate investor approaches with an enticing offer. *"I've been following your progress,"* she says, handing you her business card. *"You've learned from the best here at ARGUS University, and I need someone sharp for financial analysis work. I'm offering an annual salary of $75K with full medical benefits, a 401(k) matching plan, and three weeks of paid vacation. How does that sound? See you at my office, 8 AM sharp on Monday."*

She pauses, then adds, *"I've received an offering memorandum for a medical office building that I need entered into ARGUS Enterprise software—a trusted tool in the real estate world—by 9:30 AM. But I'm not just looking for data entry. I need you to handle complex tenant reimbursements, using multiple methods, some straightforward, others more intricate. You'll also need to analyze how tenant rollover might affect our ability to meet annual debt service. And, I need a comprehensive assessment of the tenants' creditworthiness, especially in terms of rollover risk."*

This case study will test your ability to apply the knowledge you've gained at ARGUS University in a real-world scenario. You'll need to demonstrate your expertise in handling tenant reimbursements with varying complexities, analyzing tenant rollover risks, and assessing the tenants' financial stability from a credit perspective. Your results will be compared with the investor's own Excel-based cash flow projections, so the stakes are high. Success in this project could set the tone for your future in the highly competitive world of real estate finance.

This challenge requires critical thinking, technical proficiency, and swift decision-making, all while using industry-standard tools and advanced financial concepts to make informed judgments. It's your opportunity to showcase the mastery of ARGUS Enterprise and the analytical skills you've honed throughout your education.

PROPERTY INFORMATION

The property in question is a modern medical office building, offering 56,928 square feet of leasable space. Situated on a sprawling 10.94-acre lot, the building was constructed in 2018, making it a relatively new addition to the commercial real estate market. With its contemporary design and strategic location, this facility provides a prime opportunity for investors to assess its potential for long-term financial performance.

TENANCY

The tenancy for Parker Medical Office, located in Gainesville, Florida, presents a dynamic investment scenario. As part of your financial analysis, you'll be tasked with determining an optimal holding period, not as a fixed duration, but as a flexible timeline shaped by your return objectives. Initially, you'll begin with a baseline of six years, though the ultimate holding period should evolve based on the returns you aim to achieve. Your challenge is to evaluate exit strategies along a continuum of returns, adjusting the holding period as necessary to align with your group's mission statement. Key performance indicators such as the minimum equity leveraged internal rate of return (IRR) and annual leveraged cash-on-cash returns will drive these decisions.

The analysis begins with today's month and year, marking the starting point for your fiscal year recoveries and inflation projections. A steep general inflation rate of 14% looms large, mirroring the expected expense inflation rate of 14% as well. Market inflation, by contrast, is projected to rise by 3% over the first two years, before leveling off to 2% annually in subsequent years. Additionally, consumer price index (CPI) inflation is expected to match the general and expense inflation at 14%.

As you move forward, these factors will play a critical role in shaping your financial projections and decision-making process for Parker Medical Office. The ability to navigate these variables and adjust your approach accordingly will be key to achieving the desired returns.

GROUND LEASE

The Parker Medical Office complex is built on leased land, adding another layer of complexity to your financial analysis. The ground lease, which began on January 1, 2019, spans a lengthy 75-year term, ensuring the property remains under lease for decades to come. Currently, the annual lease payment is $10,000, a fixed cost for the early years of the agreement. However, this stability is interrupted every 11 years, starting with the 11th year of the lease term, when the rent will increase by $5,000.

These scheduled rent hikes will need to be factored into your long-term financial models. As you analyze the property's potential for sustained returns, consider how these incremental increases in land rent might affect overall cash flow and profitability over time. Successfully managing this ground lease alongside the tenancy and inflation factors will be essential for ensuring that the Parker Medical Office remains a sound investment.

OPERATING EXPENSES

Operating expenses for the Parker Medical Office complex are largely influenced by the prevailing expense inflation rate, except for a few specific items outlined below. These costs will form a significant part of your financial analysis as they impact net operating income and, ultimately, the property's profitability.

Real estate taxes are charged at $2.99 per square foot and are paid annually in October. These taxes grow at a modest rate of 2.0% per year and are 100% fixed, ensuring stability in this area of your expense forecasting. Property insurance, on the other hand, is fixed at $0.49 per square foot, offering predictability with no inflationary growth.

For some services, the tenants themselves bear the responsibility. Janitorial services are directly paid by the tenants, as are utilities, which are separately metered, relieving the owner of these variable costs.

One key expense to consider is the management fee, set at 3.0% of the effective gross revenue. This fee is 100% recoverable, meaning it can be passed through to the tenants as part of the building's operational costs.

There are additional costs that require estimation, including common area utilities and common area maintenance, which you will need to forecast based on the building's specific needs and usage. Other expenses such as parking lot sweeping, extermination, and landscaping will also factor into the building's operational costs, though the precise amounts are for your group to estimate. Finally, there is a miscellaneous/admin expense of $1,000 per year that is not recoverable, meaning it will need to be absorbed by the owner rather than passed on to tenants.

As you prepare your analysis, careful consideration of these operating expenses and their growth over time will be crucial for producing an accurate cash flow projection and ensuring the financial viability of the property.

CAPITAL EXPENSES

Capital expenses for the Parker Medical Office are structured to address both ongoing needs and planned maintenance, ensuring the building remains in good condition throughout the holding period.

The first capital expense is the establishment of a replacement reserve account, a precautionary fund set aside to cover any unexpected structural repairs that may arise during ownership. This reserve will be funded annually at a rate of $0.20 per rentable square foot, growing each year with the expense inflation rate to keep pace with rising costs. This fund is critical to maintaining the long-term integrity of the property and safeguarding against unforeseen repair costs, making it a key component of the financial analysis.

In addition to the replacement reserve, there is a specific planned capital expense related to environmental maintenance. During the fifth year, in the third month from the start of your analysis, the building's onsite bio-retention pond will require a cleanout. The cost for this one-time expense is $43,750, which will also grow in line with the operating expense inflation rate. As with the replacement reserve, this capital item is fully fixed, meaning it’s a non-negotiable cost that must be factored into the overall financial plan.

Both of these capital expenses are crucial in maintaining the property's functionality and environmental compliance, and they should be incorporated into your cash flow projections to ensure accurate financial forecasting and planning.

MARKET LEASING ASSUMPTIONS (non Bio Tenants)

The market leasing assumptions for non-Bio tenants at the Parker Medical Office will play a critical role in shaping the financial performance of the building, especially at tenant rollover points. These assumptions will guide how you project future leasing scenarios, evaluate risks, and ensure financial stability throughout the holding period.

For any replacement tenants at rollover, the lease term will be set at seven years, aligning with standard market practices. However, to evaluate the investment's resilience, you must assess the renewal probability as a tool for risk management. For instance, under a worst-case scenario, if you assume a 0% renewal probability, can the property's cash flow still support the purchase price? This scenario challenges you to strategize on how to cover deficits in years where cash flow may be insufficient to meet operating expenses and debt service, pushing your financial modeling skills to the limit.

In the event of vacancy, expect the building to remain unoccupied for approximately six months before a new tenant is secured. Both new and renewal market rents are projected at $30.00 per square foot per year, with adjustments following the general market inflationary rate. Additionally, each lease will have fixed step increases of 2.0% annually, ensuring steady growth in rental income over time.

Incentives for new tenants include one month of free rent at the end of each lease year, covering both base rent and fixed rent entirely. However, renewal tenants will not receive free rent, providing an advantage in retaining tenants without additional concessions.

For recoveries, a new base year stop will apply. Regarding tenant improvements, new tenants will require $35.00 per square foot, while renewal tenants will receive $10.00 per square foot, both subject to the expense inflation rate. These figures represent the cost of customizing the space to meet tenant needs, a critical factor in attracting and retaining high-quality tenants.

Leasing commissions are another key consideration. For new leases, commissions are set at 6.0%, while renewals will incur a 3.0% commission, both as fixed rates. The commissions are to be split, with 50% paid in month 10 of the prior year and the remaining 50% paid in month 1 of the first year of the new or renewed lease. These expenses will need to be factored into your cash flow calculations to maintain a realistic projection of net income.

By integrating these leasing assumptions into your financial model, you'll develop a comprehensive view of how tenant turnover, rent adjustments, and capital costs will impact the long-term success of the property.

RENT ROLL

The **rent roll** for the Parker Medical Office details the current leasing arrangements with several prominent tenants, each with unique terms and conditions that will affect overall cash flow and property management. Here's a closer look at each tenant's lease specifics:

Biopharmaceutical Company

Occupying **23,584 square feet** in Suite 1, Biopharmaceutical company's lease was made available on **January 1, 2019**, and was executed on the same day. The lease officially commenced on **December 31, 2019**, and is set to expire on **December 31, 2027**. Biopharmaceutical company's base rent begins at **$27.84 per square foot annually**, remaining flat throughout the lease term. The recovery includes a **$3.50 stop amount per area**, with costs grossed up to **95% occupancy**. Biopharmaceutical company has three options for five-year extensions, which will be priced at fair market rent upon renewal. Importantly, upon expiration of the lease, Biopharmaceutical company is obligated to vacate 100% of the premises in accordance with the Office Master Lease Agreement (MLA).

Biotechnology Company

Biotechnology Company leases **5,848 square feet** in Suite 2, with the lease available from **January 1, 2019**. The lease was executed on **January 1, 2020**, and the term commenced on **November 7, 2020**, lasting for **five years**. The base rent is set at **$21.00 per square foot annually**, starting on the lease commencement date. The rent remains flat for the first two years, followed by increases of **2.5% per year thereafter**. Biotechnology Company's recovery structure is net of all expenses, with a gross-up to **95% occupancy**. They have three options for five-year extensions starting at **$23.64 per square foot**, with a **1% annual increase** for each lease year. At lease expiration, you will select the option in ARGUS at rollover, applying **100% of market rent** for new rent and using a base year stop for recovery.

In addition, Biotechnology Company has borrowed **$602,000** from ownership at the time of lease execution, with a **6.39% interest rate** over a **five-year term**. The annual payment for this loan, which will also need to be included as a separate line item, can be calculated for accurate financial forecasting.

Sloan Therapeutics

Sloan occupies **13,748 square feet** in Suite 3. The lease was available from **January 1, 2019**, and executed on **January 1, 2020**. The lease commenced on **April 30, 2020**, with a term of **ten years**. The base rent begins at **$21.50 per square foot annually**, remaining flat for the first year and then increasing by **2.5% per year thereafter**. The recovery includes a **$2.50 stop amount per area**, excluding net taxes, and is grossed up to **95% occupancy**. Sloan has three options for five-year renewals at fair market rent. Notably, Sloan is currently **120 days behind** on both rent and reimbursement payments, a factor that may need to be addressed in your financial modeling.

Grey Pharma Company

Also occupying **13,748 square feet** in Suite 4, Grey's lease follows a similar timeline. Available from **January 1, 2019**, and executed on **January 1, 2020**, the lease started on **April 30, 2020**, with a **twelve-year** term. Like Sloan, the base rent is **$21.50 annually**, with fixed steps beginning flat for the first year and increasing by **2.5% per year thereafter**. The recovery structure mirrors that of Sloan, featuring a **$2.50 stop amount per area**, with exclusions for net taxes and a **95% gross-up**. Grey also has three five-year options at fair market rent, with the decision on renewal left for your group to determine. Currently, Grey is **17 days behind** in their rent and reimbursement payments, another aspect requiring careful attention during financial assessments.

Each tenant's lease structure, including their unique recovery terms and current arrearages, will significantly impact the overall revenue and cash flow of the Parker Medical Office. It's essential to consider these factors when analyzing the property's financial performance and potential for growth.

Space Absorption

In evaluating the space absorption for the Parker Medical Office, participants will need to research and analyze the financial news and leasing status of comparable companies within the pharmaceutical and biotechnology sectors. By assessing the creditworthiness of these potential tenants, the groups can determine the implications of any defaults on the building's occupancy and how much vacant space needs to be absorbed.

Participants should focus on researching pharmaceutical and biotechnology firms that lease office or lab space similar to the Parker Medical Office. They need to gather recent financial news regarding these companies, paying attention to market performance, revenue trends, and credit ratings to assess the risk of lease defaults. Additionally, reviewing lease agreements for terms and any rent arrears will provide insight into occupancy stability.

It's essential to analyze how defaults or lease expirations could impact the occupancy of the Parker Medical Office and estimate the time needed to fill vacancies based on current market demand. Participants should calculate the occupied space relative to the total leasable area of 56,928 square feet and evaluate scenarios where financial difficulties may lead to vacated spaces. Finally, analyzing local market conditions and tenant credit profiles will help estimate how quickly any vacant space might be filled, considering historical leasing trends. By conducting focused research, participants can better assess the space absorption needs of the Parker Medical Office, accounting for both risks and opportunities.

GENERAL VACANCY

In this investment analysis, it's important to acknowledge that there is zero static vacancy. Instead, the focus will be on the dynamic nature of actual vacancy rates, which fluctuate based on market conditions and tenant behavior. Understanding the "ebb and flow" of vacancy is crucial, as it presents a real challenge for the investment. By evaluating these variable factors, participants can gain a clearer picture of potential occupancy issues and the associated risks for the Parker Medical Office.

COLLECTION LOSS

When evaluating the potential collection loss, it's essential to consider the financial stability of the tenants and their ability to meet lease obligations, particularly in light of recent news. Participants should assess the risk of collection losses and incorporate these findings into the Collection Loss tab, accounting for any potential impacts on cash flow from tenant defaults or payment delays.

One approach is to "ghost" the tenant in your ARGUS analysis, effectively treating the space as vacant. This strategy helps prevent overpaying the seller for tenants who may not remain. However, if tenants do stay and you negotiate a deal for any outstanding payments while ensuring they remain current, this can create added value for the investment. By carefully analyzing tenant stability and implementing these strategies, participants can better navigate the risks associated with collection loss.

INVESTMENT AND VALUATION

In evaluating the investment and valuation of the Parker Medical Office, participants will rely on Gains Trust to provide a loan structured around key financial metrics: loan-to-value (LTV), loan-to-cost (LTC), debt service coverage (DSC), and debt yield (DY) requirements. The loan will be based on the minimum criteria of these four tests, with specific examples provided for reconstruction to determine the loan amount for this asset. The mortgage will commence on the analysis start date, amortizing over 360 months with a 120-month balloon payment. The interest rate will be set at 9.25%, utilizing a 70% LTV, and will begin to amortize upon funding. This loan will be non-recourse, with a 1% fee charged by the lender.

In addition to the primary loan, ClearFund Commercial Pace Capital will provide an additional loan of $1,100,000 at an interest rate of 7.00% over a 25-year term. It's important to note that tenants will not incur extra real estate tax payments to cover this annual cost, so participants should create a separate tax line item in operating expenses.

For valuation purposes, participants will apply an annual present value discount rate, utilizing both primary and secondary rates, with monthly discounting applied. The direct capitalization rate will be determined based solely on the LTV sizing.

When it comes to resale, the analysis will capitalize the year of sale at a predetermined terminal capitalization rate, incorporating a $25,750 legal fee and a 2.0% broker fee as selling costs. By carefully structuring the financing and considering these factors, participants can effectively assess the overall investment potential.

CRITICAL THIKING TYPE QUESTIONS:

As you complete your analysis of the Parker Medical Office case, consider the following critical thinking questions to deepen your understanding and assessment of the investment:

1. Investment Risks: Identify two significant risks associated with this investment. How might these risks impact the overall valuation and decision-making process?

2. Parallel Internal Rate of Return (IRR): Reflect on the concept of a Parallel IRR. What is your opinion regarding the reported “parallel” Internal Rate of Return? What does this ratio indicate in relation to the return on investment versus the return of the investment?

Engaging with these questions will not only enhance your analytical skills but also provide valuable insights into the complexities of real estate investment analysis.

CONCLUSIONS AND EXPECTATIONS

As participants complete the university challenge, it is essential to clearly outline the expectations for the final submission. Each group is required to submit a comprehensive report in PDF format that encapsulates their findings throughout the analysis. This report should include:

- Market Value References: Cite relevant sources that validate your market value assessments and analyses.
- Graphics and Tables: Incorporate visual aids that illustrate key data points, trends, and comparisons to enhance the clarity of your findings.
- ARGUS Enterprise Files: Include the completed ARGUS Enterprise AVUX files that you utilized in your analysis. This is critical for demonstrating the methodologies and calculations behind your conclusions.

In addition to these components, ensure that your report addresses the various aspects of the case study, such as tenant analysis, collection loss assessments, capital expenses, and the overall investment and valuation. This comprehensive approach will not only showcase your understanding of the material but also align your work with the evaluation criteria set forth for the challenge.