

Making it in Real Estate:

Sell vs. Hold

John McNellis

Dallas

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Background Information

- YouTube ULI/John McNellis Video:
**“Starting Your Own
Development Company”**
- **“Making it in Real Estate”**
series published by SF Registry
Magazine and McNellis.com

Making It in Real Estate

Starting Out as a Developer

John McNellis

"Put aside other real estate textbooks! John McNellis is a Picasso of storytelling, bringing the real estate process to life through humorous and compelling anecdotes and insights. With material as eclectic as the times in which we live, McNellis captures the fascinating odyssey of real estate investment, ownership, and development. Newbies and wily, cantankerous veterans alike will find this gripping primer on the real estate deal process to be a catalyst in turning creative ideas and big dreams into tomorrow's built environment."

—Jim Curtis, Managing Partner, Bristol Group

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—James S. Fassio, President and Chief Development Officer, Ross Stores Inc.

"John McNellis's book on real estate development and investment is extraordinarily insightful and full of wisdom. His wit makes it an easy read. I would highly recommend this book to both experienced and beginning real estate developers and investors."

—George M. Marcus, Chairman of the Board, Marcus & Milichap Inc. and Esser Property Trust Inc.

"John McNellis fills his book with rich insight, great advice, humor, and inspiration—sharing his deep experience and wisdom, helping us think more clearly about real estate and assorted business issues. A must-read."

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About the Author



John McNellis is a principal with McNellis Partners, a commercial development firm he cofounded in the mid-1980s in northern California.

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Your Long-Term Goal?

Think 20 Years ahead

Big Company or Big Net Worth?

Or simply economic
independence.

Strategy vs. Tactics

Two Business Models

Merchant vs. Investment Building

Merchant Building

Build to Sell.

Akin to construction company.

Much greater volume.

Cash today.

Investment Building

Build to keep.

Higher yield needed.

Fewer deals.

More equity required.

Long-term view (Irvine Company)

Yield Requirements

- Merchant: 100 basis points (bps)*
greater than cap rates.
- Investment: 200 bps (or 2%)
greater than cap rates.

*100 bps = 1%

Merchant Build Example

Assume sales caps are 5%. Then to achieve that 100 bps spread, your return on total cost must be at least equal to 6%. If your cost is \$1,000,000 and your return is \$60,000, then you will gross \$1,200,000 ($\$60,000 / .05$) if your project sells at a 5 cap.

A nice profit of \$200,000 after your \$1,000,000 cost...

...But You can't hold it

\$1,200,000 value at 70% LTV equals a loan of \$840,000, requiring additional equity of \$160,000 above your \$200,000 profit. With a 4.5% interest rate, a 10 year term amortized over 30 years, the annual loan payment is \$51,000, leaving \$9,000 in cash flow, a 2.5% cash-on-cash return.

= You sell.

Investment Build Example

Assume sales caps are 5%, then to achieve that 200 bps spread, your return on total cost must be at least equal to 7%. If your cost is \$1,000,000 and NOI is \$70,000, then you could sell your project at a 5 cap ($\$70,000 / .05$) and gross \$1,400,000. A \$400,000 profit after your \$1,000,000 cost.

Or...

...Hold it

\$1,400,000 value at 70% LTV equals a loan of \$980,000, requiring equity of \$420,000, basically your profit. With a 4.5% interest rate, 10 year loan amortized over 30 years, annual loan payment is \$59,000, leaving \$10,000 in annual cash flow with \$20,000 in the deal. This is the same low yield but without any money in the deal.

McNellis Partners Approach

We develop on an investment build model—a 200 bps or better spread—but still sell about 2/3rds of our projects.

Why?

We needed to eat.

We wanted independence. If you
never sell, you will always have
financial partners.

Properties are often at their best on
day one.

Our Strategy?

- No outside partners
- Grow net worth not overhead
- Increase portfolio's quality rather than size
- Management fees cover overhead

Our Tactics?

Sell When:

- The return is too low;
- Barriers to entry (physical or political) are low;
- Tenants or neighborhood are questionable.

Our Tactics?

Keep When:

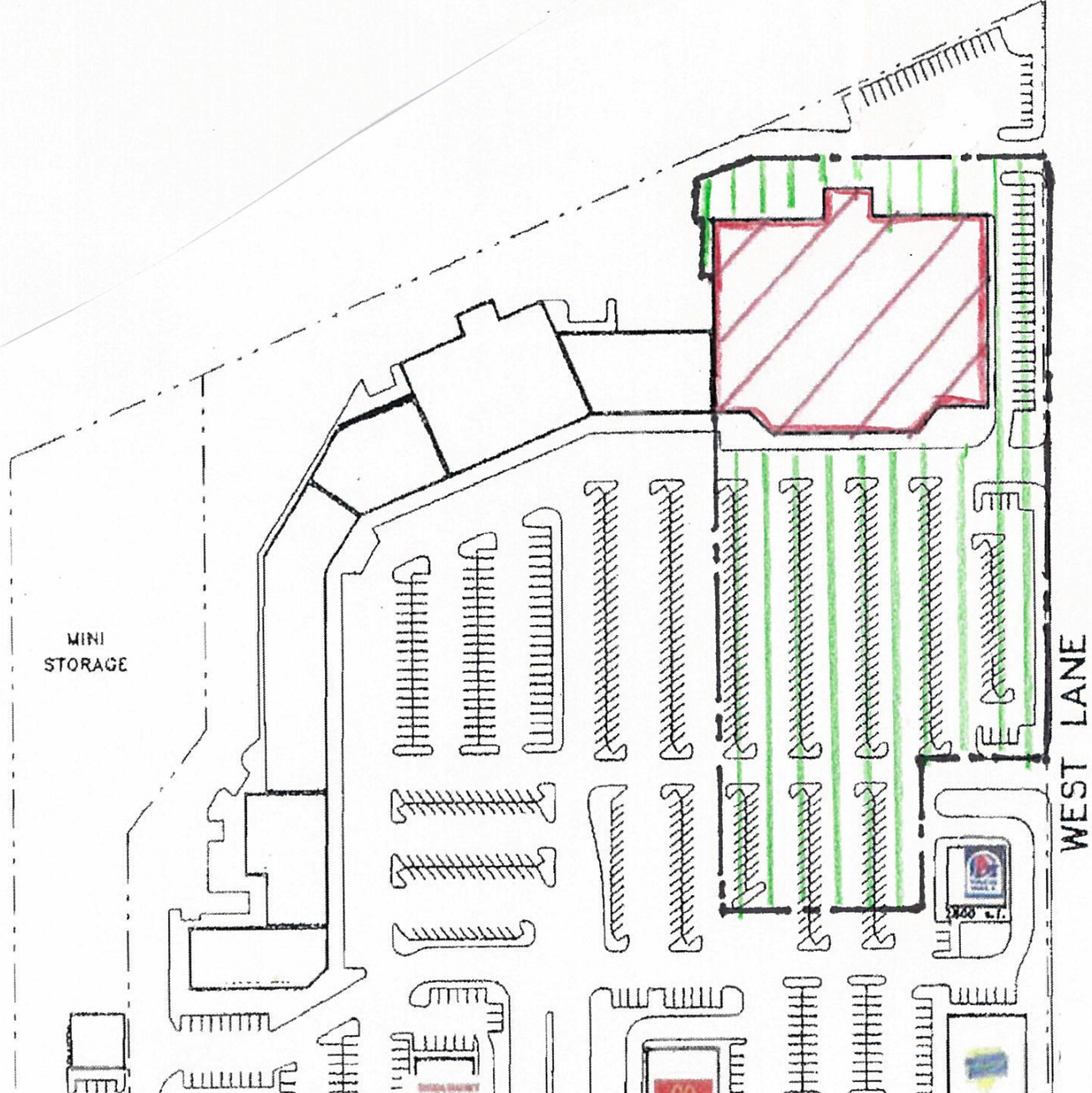
- The return permits favorable financing;
 - Barriers to entry are high;
- The tenants and neighborhood are first rate.

Examples

A tale of two Wal-Marts

Stockton







Walmart
Neighborhood Market

Pharmacy

Now Open!

4352752

6TIR893

47TP220

Modesto

A satellite map showing a residential neighborhood with a grid of streets. A red pin is placed at the intersection of Coffee Rd and E Orangeburg Ave. The text "Coffee Rd & E Orangeburg Ave" is overlaid on the map. Various map icons are visible, including a shopping bag, a heart, and a location pin.

Coffee Rd & E Orangeburg Ave

AVAILABLE





Grocery

Walmart 
Neighborhood Market

Pharmacy

Keep or Sell?

The same “AAA” tenant in both centers;

Similar C+ towns;

Similar low barriers to entry;

- Both high yield deals—i.e. both lent themselves to “financing out”.

The difference?

The *immediately* surrounding
neighborhood in Modesto much
better.

Leslie's Pools

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