International Research Journal of Applied Finance ISSN 2229 – 6891
Vol. IX Issue – 4 April, 2018 www.irjaf.com
Case Study Series

Employees' Annuity Corporation: Funding Request for a Public/Private Mixed-Use Project

Thomas Patrick* Julie M. Patrick

Abstract

CRP Campus Centers, LLC has been awarded a contract to build and operate a mixed-use project. This construction company will build a combination of college housing apartments and commercial establishments on the campus of The College of New Jersey (TCNJ). It has approached Employees' Annuity Corporation (EAC) for $60 million of the $90 million that this undertaking will cost. Students are asked to assume the role of a financial analyst and to make a recommendation to EAC as whether it should fund the private developer of this project. Students are also to develop a list of due diligence questions that EAC should consider.

EAC Background

Employees' Annuity Corporation (EAC) is one of the premier 401k pension fund managers in the United States. EAC receives funds daily that have been withheld from employee paychecks from client corporations in each of the fifty states. They also receive matching contributions from the employers themselves. Upon retirement, employees have the option of receiving a lump sum payout, an annuity, or some combination of the two. Given the tax implications of a lump sum payout, almost all of the employees opt for a monthly payout. EAC's corporate structure has groups that invest in publicly traded stocks, publicly traded bonds, real estate, high risk securities, natural resources, and private placements. The natural resources group invests in agriculture, mining, timber, and fishing.

Prior to retirement, an employee can direct how his or her funds are to be invested. When the stock market is rising, more funds are typically invested in publicly held equities. When the market is in decline, bonds and private placements gain favor. Upon retirement, many employees opt for an annuity and by doing so have left EAC free to invest these funds where the firm thinks they can earn the highest return. For several years, the portfolio of the natural resources group has outperformed the market.

This case involves a situation that has arisen in the private placement group (PPG). PPG has the responsibility of investing approximately $50,000,000 of new money each week. This is in addition to reinvesting the proceeds of any loan in the portfolio that reaches maturity. It is EAC's policy that the group's portfolio must maintain an average BB credit rating. In addition to conducting research and making recommendations on potential private placement opportunities, analysts are charged with monitoring their portfolios on an ongoing basis to check for any change in the borrower's credit rating as well as for any violations of the private placement covenants.

In addition to the credit rating restriction, PPG must maintain an expense ratio of less than .75%. This group's expense ratio is currently well below this limit. Since clients are guaranteed a minimum return of 3%, placements cannot be made that will not cover this return as well as associated expenses. EAC has also set limits on how much PPG can lend to a single borrower.

Given the volume of lending that is required, PPG considers only loans that are of a substantial size. Investment banking firms such as Goldman Sachs and Morgan Stanley frequently contact PPG and other potential lenders on behalf of corporations that are seeking considerable funding. Once a potential private placement has been identified, analyzed, and deemed acceptable, it is sent to in-house attorneys to determine any covenants to include in a potential loan agreement. EAC then makes an offer that consists of both the maximum amount that it is willing to lend and the interest rate it is seeking on the loan. There is no guarantee that EAC's offer will be accepted. If EAC's offer is accepted, it is not unusual for the investment banker to make a deal for less than the maximum that EAC is willing to extend. The investment bankers and thus PPG usually know the length of time that the borrower seeks the funds.

It should be noted that PPG does not make an offer on all deals that are brought to it by investment bankers or large banks. The potentials borrower's credit rating is the first hurdle that must be cleared. If the borrower does not have a credit rating, PPG uses an outside agency to determine if the borrower could be considered "investment grade". While the credit rating of the potential borrower prohibits PPG from getting involved in a considerable number of deals, there are also other considerations to be taken into account. PPG has banned deals to firms located in several countries due to economic and geopolitical uncertainty. While the potential borrower may have a good credit rating that does not mean that a deal is without considerable risk. EAC is not only concerned with the risk of a deal going bad, it must also consider the impact which foreclosing on a loan could have on its image. EAC does not want a headline to read, "EAC forecloses on city's only hospital." The in-house attorneys and risk assessment team have stopped several deals in their tracks.

Given the size of the loans that PPG makes, much time is spent in researching both the potential borrower as well as the purpose for which the extended funds will be used. If it appears that PPG is seriously interested in being part of the deal, a due diligence trip to the potential borrower is common.

Morgan Stanley has contacted the PPG to see if it would be willing to fund a public/private mixed-use project that has been awarded to CRP Builders LLC. This project would be built and operated on the campus of The College of New Jersey (TCNJ).

School Background

TCNJ is a highly selective institution that has been named as one of the ten "public ivies" in the United States. The college was founded in 1855 and is one of nine state colleges in New Jersey. It is ranked by *Money* magazine as one of the top 15 public colleges "most likely to pay off financially," and *U.S. News & World Report* rates it the No. 1 public institution among regional universities in the northeast. It has a most successful Division III sports program that has won 40 team and 49 individual NCAA championships. TCNJ enrolls approximately 7,400 students including 6,790 undergraduates and 610 graduate students. This school is located between Philadelphia and New York City.

While the college has one of the highest per student debt burdens in the nation, it is rated A2 by Moody's. This relatively high rating is the result of dedicated streams of revenues for interest and principal payments. The college has found itself in a position whereby it prefers not to take on any additional debt.

At the same time as the lower than normal number of high school graduates, TCNJ is facing what has become an annual reduction in the percent of its annual budget that is funded by the State of New Jersey. TCNJ is trying to make up for this state support reduction by increasing the number of tuition paying students.

When high school juniors and seniors visit a college campus, they are increasingly interested in the amenities that a school has to offer. Now a days college tours have spent an increasing amount of time displaying their student centers, fitness centers, dorms, and dining halls. Students are usually well informed about a college's curriculum, entrance requirements, graduation rate, graduate placement, and cost. When these high schoolers come to tour a campus, they are looking for the "wow factor".

TCNJ is located in a residential part of Ewing, New Jersey. Unlike schools such as Princeton and Chapel Hill, there is not a street opposite the campus that offers everything a student could look for in eating, shopping, and entertainment. TCNJ is considering building its own campus Town. Unfortunately, it does not have the endowment nor the ability to take on the amount of debt that this enterprise would require. Thus, it is considering some sort of public/ private partnership.

Current Campus Housing Situation

Housing is an issue for upper level students. TCNJ students are guaranteed housing for their first two years. Transfer students are not guaranteed housing. Nor are provisionally admitted students guaranteed a place to live. Early in the second semester, freshmen, as well as other students, may enter a lottery to determine if they will have housing made available to them for the following year. While freshmen usually end up getting campus housing, most of the apartment style housing is reserved for rising juniors and seniors. These students often cannot be assured of the possibility of living on campus. Due to an increase in the size of the freshmen class, some lounges have been converted into freshmen dorm rooms. Rooms also have been made available to freshmen in dorms that are traditionally used for upperclassmen. Rising juniors and seniors who have been successful in the lottery have a good chance of moving into an apartment type living arrangement. These quarters provide room suites with bathrooms and modified kitchens. Occupancy in this style of living still requires the residents to purchase a campus meal plan. While these living accommodations are popular with students, there are not enough of them to go around.

Many students choose to move off campus and rent student housing from private providers. As many as eight students may rent a house and many pay up to $500 a month plus utilities to live off campus. Most leases are for twelve months. Some students feel that this is cheaper than living on campus and that they have more freedom since they are not restricted by campus policies. Many of the available off campus houses are within walking distance of TCNJ. While students may enjoy the freedom of living off campus affords, often, their neighbors do not particularly enjoy have eight noisy students who come and go at all hours of the night living next door. While the college has tried to rein in its students, this has led to a community relations issue.

TCNJ has about 12.5 acres on its border, which it would like to develop with a private company providing the financing. It is considering the construction of several apartments being constructed over commercial establishments. This way students would be offered an alternative to living off campus. The apartments would be new and contain many amenities. Each apartment would have a full kitchen, replacing the need for a campus meal plan. Each unit would also have a washer and dryer. These apartments would have a responsible landlord to fix things that go wrong and to keep the halls clean. Current off campus housing might be considered rundown and landlords are not in any hurry to address maintenance issues. Needless to say, the cost of living in this new project would be higher than living off campus.

Current Retail Situation on Campus

There is a limited amount of retail business on the TCNJ campus. The student center contains the college bookstore. This establishment sells textbooks, clothing with the college name and or logo inscribed, some paperback books and a limited amount of snack items. The student center also has a snack bar that is open to students, college employees and the public. The snack bar is open from early morning until after dinner time. In addition to the offerings at the student center, there is a Starbucks in the campus library. This coffee shop is open until late in the evening. A few of the dorms have very small convenience stores located within them. The Schools of Education and Engineering also have a lunch cart that has limited hours of operation and a very small selection of items for sale.

There is a Seven Eleven convenience store about four blocks from the campus entrance, but it is not in walking distance from most campus residential facilities. TCNJ is literally surrounded by a residential community.

Project Particulars

TCNJ is going to develop 12.5 acers on the edge of campus. This project would be named Campus Town. This project will create 83,000 square feet of commercial space and 195,000 square feet of residential space to be rented to students. The retail space would be developed for use by restaurants, and service providers that would be of interest to students. Off campus access would be developed to encourage local residents to also make use of the commercial establishments. Non-student use of the commercial space is considered critical so that the businesses in Campus Town would be viable during vacation times when the student population falls off considerably.

To entice a developer, TCNJ is willing to agree to move both its fitness center and the Barnes and Noble campus bookstore to Campus Town. The fitness center is currently in a cramped space in the student recreation center. If it moves to Campus Town, it will be able to occupy a substantially larger space. The bookstore is currently located in the student center. A move to Campus Town would enable it to be both expanded and be more accessible to the local community. The closest bookstore easily accessible to the local public is about ten miles away. TCNJ expects this project to include the type of restaurants that would cater to student budgets.

The residential part of the proposed Campus Town would contain apartments that would be available to TCNJ students. There would be housing for 446 students in single, double, and quadruple configurations. Each unit would contain a full kitchen and the occupants would not be required to purchase a campus meal plan. Each unit would also contain a washer and dryer. Units designed for two or four students would contain two bathrooms. Students would be allowed to opt for either an academic or calendar year lease. Student parking would be made available for a fee. While the building would be owned by the developer, the TCNJ campus police would be responsible for both public safety and maintaining law and order. Students living in Campus Town would not be required to follow TCNJ housing guidelines or restrictions. Some units might even allow pets. While campus dorms close during

Thanksgiving and Christmas brakes, Campus Town would remain open year-round. Housing in Campus Town would be made available on a first come, first served basis. Freshmen would not be allowed to reside in Campus Town.

Plan Details

CRP has agreed to the following specifications:

- 97 four-bedroom, two-bathroom units, which if fully rented, would gross $4,268,000 for ten months
- 25 two-bedroom, two-bathroom units, which if fully rented, would gross $575,000 for ten months
- 8 one bedroom, one-bathroom units, which if fully rented, would gross $108,000 for ten months
- Additional income can be generated by renting out residential units during June and July when summer classes are in session.
- 318 residential parking spaces which if fully rented would gross $95,400 per year
- There would be 83,000 square feet devoted to retail space and 195,000 square feet for residential space. The campus bookstore would move from the student center to Campus Town. The bookstore currently pays a $475,000 base commission to TCNJ. After it moves to Campus Town, the bookstore would pay CRP a $625,000 base commission. This commission increase is due mainly to the increased space made available for the bookstore. Since Barnes and Noble has a policy of only renting from colleges and universities for campus bookstores, CRP will lease the bookstore space to TCNJ and the school will collect the rent from Barnes and Noble and they remit these funds to CRP.
- TCNJ's fitness center would move to a larger facility in Campus Town. The college expects to pay $195,500 rent to CRP for the first year. TCNJ would be responsible for staffing, furnishing and maintaining the fitness center. Currently students are not charged a fee for using the fitness center.
- CRP would set the rents for the remaining 53,178 square feet of remaining retail space and be responsible for selecting an appropriate mix of retail tenants. The developer charges an annual rent of $20.50 per square foot plus an additional $8.50 per square foot for maintenance of the outside areas including the parking lot, sidewalks, and grounds.
- CRP expects to pay $50,000 a year to have a representative on campus to handle housing applications.
- $100,000 per year will be allocated to CRP staff to handle retail rental inquiries and to solve any retail client issues.
- CRP expects to pay $40,000 a year for insurance on Campus Town.
- There will be 215 retail parking spaces that would not directly generate income.
- TCNJ would not bear any responsibility for any possible vacant retail space.
- CRP would pay TCNJ $400,000 to lease the college owned land that Campus Town would sit on. This amount would increase by $25,000 each year. These payments will start after Campus Town construction is completed.
- In lieu of property taxes, CRP has reached an agreement with Ewing Township to contribute a "host fee" of $400,000 per year. These payments will start after Campus Town construction is completed.
- After fifty years, CRP would give all the buildings to TCNJ.

- CRP would be required to give TCNJ students first right to the residential space. However, if there is insufficient demand, the excess units could be made available to non-students.
- TCNJ would maintain the right to replace CRP, with cause, if it is unsatisfied with Campus Town operation.
- CRP would maintain the buildings, grounds and parking lots. A maintenance contract has been signed with a third party for the maintenance of the student housing portion of the project. This contract starts out at $300,000 for the first year.
- It is estimated that the cost to build Campus Town project will be around $90 million and that it will take three years for construction to be completed.

The Developer

CRP Campus Centers, LLC a member of The CRP Group, is a multi-faceted manager, builder, developer and real estate broker for a broad spectrum of real properties, including all forms of residential (single, multi-family, and mixed use), commercial office, retail, and light industrial properties. CRP has been operating since1960. This will be the largest project undertaken by CRP. Their previous largest project was an office complex, which cost about $67,000,000. While the developer has not been rated by Moody's, it has an outstanding credit record. It has never been delinquent or defaulted on any loans. CRP will have to pay taxes on its earnings. Commercial and rental property are depreciated on a 27.5-year life. CRP has set up a LLC for its public/private partnerships. Since it regularly needs to keep a substantial amount of profits, it has elected to be taxed as a corporation. This means that retained earnings are taxed at a lower rate than the pass-through earnings to the LLC owners. To simplify matters, assume that any profits generated by this project are going to be taxed at 27%.

CRP has been brought to EAC by Morgan Stanley. It needs $60,000,000 long-term funding (30 years) for the Campus Town Project. It will use its own funds for the remaining estimate of $30,000,000. CRP does not expect to make any principal payments on the loan for the first three years. It realizes that it would be expected to make interest payments during the construction period. Thus, it is requesting a loan large enough to use $60,000,000 for construction cost and use the remaining principal to make interest payments during the three-year construction period. Since CRP is a privately held company, it is not able to issue tax-free bonds. It expects to pay 6% on a thirty-year loan. Commercial and rental property are depreciated on a 27.5-year life.

It should be noted that EAC is lending money to the project, not to CRP. EAC's primary concerns should be: can CRP deliver the project in time and at the contracted price, and will the project be successful. The primary focus should not be on the economic viability of CRP in the long term. Once Campus Town has been completed, it is its financial success, not the long-term viability of CRP that is of primary importance.

Your Assignment

Before Marie, a newly promoted director of PPG, can make a recommendation to the managing directors, as to whether they should fund the Campus Town project, she must consider many other circumstances surrounding this decision. Marie's group has experienced pressure to get money out the door. Funds waiting to be invested often only earn the Federal Fund's interest rate. This is currently substantially less than the 3% EAC investors have been guaranteed as a minimum return on their investment. If PPG cannot invest its approximate $50,000,000 of new pension contributions in addition to any money that has to be reinvested due to loans reaching maturity each week, this group will see funds diverted to another group within EAC that can move money out the door. Managing directors spend considerable time lobbying for more funds to invest. They do not want to have these funds taken away from them. We are dealing with people with substantial egos at this firm.

Interest rates are near an all-time low and finding companies with a high credit rating that need substantial funds and are willing to pay an interest rate significantly above 3% are few and far between.

Like many senior analysts in Marie's position, a substantial amount of her compensation comes in the form of an annual bonus. Among other things, Marie is evaluated on the performance of her portfolio, how much money she gets out the door, how many new contacts she can establish, and the quality of the advice she provides to the managing directors. When Marie presents a recommendation to senior management, she wants to be sure that she has left no stone unturned. It is the kiss of death for Marie to say too often, "Gee, I never thought of that".

Marie has asked you, a junior analyst, to make a recommendation to her on whether to offer funding for this project. Your recommendation is to be backed up with financial data. You are to determine the size of the loan that would provide funds for both construction and three years of interest payments. You are also expected to make a list of questions that should be asked of CRP to tie up any loose ends.

While it is up to Marie to come up with the recommendation to present to the managing directors, she would like you to express your opinion on this situation. It is 9:00 am Tuesday morning and Marie wants your report before you leave for the weekend. The managing directors have told Marie that they want her recommendation at 10:30 AM Monday. She wants to spend the weekend looking over your findings.

Authors

Thomas Patrick*
Professor of Finance, The College of New Jersey, tpatrick@tcnj.edu

Julie M. Patrick, CFA
Director, Private Infrastructure, Nuveen Private Markets

*corresponding author