
PURCHASE OPTION ANALYSIS

This purchase option analysis is intended to provide our client, AHFC, relevant information about the manner in which a purchase option price can or should be evaluated and we conclude to a recommendation for an option price over the period of the ten year lease extension.

While a purchase option has been discussed between landlord and tenant (at tenant's request), no specific purchase option language has been prepared, and our analysis is not based upon any specific example. This is a financial analysis (only) and the specific terms and conditions of the option need to be established. Once that is complete, this analysis can be revisited to determine what changes, if any, are necessary, to conform the financial analysis with the (then) purchase option language.

We can note the following assumptions that are inherent in our financial analysis:

- The tenant has the right to exercise the option once a year annually, at the end of the lease year, through Year 10.
- The payment is made in cash at closing.
- The notice period for exercise of the option is reasonable.

The Analysis Process

As in the determination of our market rent estimate, the essence of this exercise is to determine an option price that is fair to both parties. An option price that is fair does not unfairly injure or diminish the expected return of the landlord, nor impose costs that would not be borne under the lease agreement upon the tenant. In this specific instance, wherein the tenant is a government agency, with the capacity to finance any purchase with tax-exempt debt, the tenant would most likely, through the entire term of the occupancy, have a financial capability to benefit from purchase of the property, simply because the tenant can change (lower) the effective cost of the investment as it moves from a private, taxable structure to a public, tax-exempt structure. This analysis *does not* consider that additional benefit available (only) to the tenant. The benefit does not inure to the landlord.

What is fair to landlord and tenant is to have a realistic understanding of the possible outcomes for the landlord with respect to extension or expiration of the lease agreement; this is the basis for this analysis of purchase option price. To a lesser extent, the outcomes for the tenant might also be considered, but, because of the special purpose nature of the building and occupancy, that analysis becomes "circular" and problematic.²²

²² Having concluded that the occupancy is specialized and the building special purpose, we have to assume that some event or condition "breaks the connection" between the specialized use and the cost of a building to occupy.

Thus our analysis focuses on the landlord's perspective, and their likelihood of investment return and outcome from their ownership of the building subject to the lease as agreed-upon. Somewhat like our market rent analysis, our recommendations are driven by our assessment of the suitability of the returns that result from the investment, should the purchase option be exercised. Our analysis begins with a reminder of the returns expected without option exercise.

We should also emphasize that this purchase option analysis is not based upon market rent conclusions provided earlier, but is based upon the actual terms of the lease as proposed by the developer, and generally agreed upon by the LAA on behalf of the Legislative Council.

The following are the steps in our analysis:

- Forecast cash flows to the landlord/developer under the actual lease terms.
- Test IRR and equity returns available based upon a 15 year investment holding period.
- Determine the relevant analysis scenarios.
- Determine the IRR for a 15 year investment under each scenario.
- Determine the suitable IRR/discount rate for pricing the purchase option.
- Determine the option price for each year of purchase under each scenario based on the IRR/discount rate selection.
- Probability weight the scenarios selected to indicate an expected value/weighted average option price by year.
- Having determined an option price by year as an expected value, solve for the resulting IRR/discount rate to test for reasonableness.
- Evaluate the landlord's costs associated with the forced sale of the property under the purchase option, including tax costs and investment replacement costs.
- Add lump sum adjustment for investment replacement costs to option price; recalculate IRR/discount rate based on adjusted option costs.

We note that while all of the above steps are included in our analysis, for brevity, we do not include a description or summary of all the steps in this narrative.

Scenarios/Outcomes

After evaluation, we have concluded that there are three principle outcomes that are likely at the end of the initial lease extension: (1) the option to extend is exercised, and rent continues on the prior pattern based upon a 2% annual increase, effectively replicating the first ten

years of this agreement; (2) the LAA vacates the building and the building is leased to a replacement government tenant, imposing lost rent and costs on the landlord but retaining some of the rental value of the specialized improvements of the building; and (3) the LAA vacates the building and the building is leased to generic office building tenants effectively reducing the value of the specialized improvements, for rental value purposes, to nil.

There are a vast number of possible permutations around these three scenarios; our analysis only scratches the surface, and may be regarded as preliminary as a consequence.

The reader should note that our analysis also takes a single perspective around the “base” scenario, that of a fifteen year hold of the investment, and the assumed sale of the property to a third-party investor at the end of the 15th year of the investment. We have selected this basic approach (common to all three scenarios) because it allows the assumed sale of the property after the lease extension or expiration and turnover is completed, and the building (regardless of scenario) is back in stabilized operation following that event at the end of year 10.

BASIC CASH FLOWS - TENANT PERFORMS AND RENEWS

Year	Cash Flows	Reversion	Cash Flow & Reversion
0	-\$37,016,021 ▲	0	-\$37,016,021
1	\$2,973,099 ▲	0	\$2,973,099
2	\$3,032,561 ▲	0	\$3,032,561
3	\$3,093,212 ▲	0	\$3,093,212
4	\$3,155,076 ▲	0	\$3,155,076
5	\$3,218,178 ▲	0	\$3,218,178
6	\$3,282,541 ▲	0	\$3,282,541
7	\$3,348,192 ▲	0	\$3,348,192
8	\$3,415,156 ▲	0	\$3,415,156
9	\$3,483,459 ▲	0	\$3,483,459
10	\$3,553,128	0	\$3,553,128
11	\$3,624,191	0	\$3,624,191
12	\$3,696,674	0	\$3,696,674
13	\$3,770,608	0	\$3,770,608
14	\$3,846,020	0	\$3,846,020
15	\$3,922,940	\$50,736,697 ▼	\$54,659,637
	INVESTMENT IRR-100bps		9.101% ▼
	NPV OF CASH FLOWS; DR = IRR		\$40,347,366
Purchase at End of Year			
1	NPV		\$41,046,466
2	NPV		\$41,749,731
3	NPV		\$42,456,353
4	NPV		\$43,165,424
5	NPV		\$43,875,928
6	NPV		\$44,586,736
7	NPV		\$45,296,586
8	NPV		\$46,004,080
9	NPV		\$46,707,662
10	NPV		\$47,405,611

Source: Waronzof



ALTERNATIVE CASH FLOWS - A - REPLACEMENT GOVT TENANT

	Cash Flows	Reversion	Cash Flow & Reversion
0	-\$37,016,021 ▲		\$0 -\$37,016,021
1	\$2,973,099 ▲		\$0 \$2,973,099
2	\$3,032,561 ▲		\$0 \$3,032,561
3	\$3,093,212 ▲		\$0 \$3,093,212
4	\$3,155,076 ▲		\$0 \$3,155,076
5	\$3,218,178 ▲		\$0 \$3,218,178
6	\$3,282,541 ▲		\$0 \$3,282,541
7	\$3,348,192 ▲		\$0 \$3,348,192
8	\$3,415,156 ▲		\$0 \$3,415,156
9	\$3,483,459 ▲		\$0 \$3,483,459
10	\$3,553,128		\$0 \$3,553,128
11	-\$3,842,375		\$0 -\$3,842,375
12	\$2,842,502 ▼		\$0 \$2,842,502
13	\$2,927,778		\$0 \$2,927,778
14	\$3,015,611		\$0 \$3,015,611
15	\$3,106,079	\$40,171,957 ▼	\$43,278,037
	INVESTMENT IRR-100bps		6.931%
	NPV OF CASH FLOWS; DRR =IRR		\$40,366,009
PURCHASE AT:			
1	NPV		\$40,190,757
2	NPV		\$39,943,895
3	NPV		\$39,619,273
4	NPV		\$39,210,285
5	NPV		\$38,709,849
6	NPV		\$38,110,363
7	NPV		\$37,403,674
8	NPV		\$36,581,040
9	NPV		\$35,633,084
10	NPV		\$34,549,754

Source: Waronzof



ALTERNATIVE CASH FLOW - B - GENERIC TENANTS & LEASE UP

	Cash Flows	Reversion	Cash Flow & Reversion
0	-\$37,016,021	✓	\$0 -\$37,016,021
1	\$2,973,099	✓	\$0 \$2,973,099
2	\$3,032,561	✓	\$0 \$3,032,561
3	\$3,093,212	✓	\$0 \$3,093,212
4	\$3,155,076	✓	\$0 \$3,155,076
5	\$3,218,178	✓	\$0 \$3,218,178
6	\$3,282,541	✓	\$0 \$3,282,541
7	\$3,348,192	✓	\$0 \$3,348,192
8	\$3,415,156	✓	\$0 \$3,415,156
9	\$3,483,459	✓	\$0 \$3,483,459
10	\$3,553,128		\$0 \$3,553,128
11	-\$1,583,112		\$0 -\$1,583,112
12	-\$1,044,215		\$0 -\$1,044,215
13	\$2,027,556		\$0 \$2,027,556
14	\$2,088,383		\$0 \$2,088,383
15	\$2,151,034	\$27,820,046	\$0 \$29,971,080
	INVESTMENT IRR-100bps		4.916%
	NPV OF CASH FLOWS; DRR =IRR		\$40,266,097
PURCHASE AT:	1	NPV	\$39,272,581
	2	NPV	\$38,170,759
	3	NPV	\$36,954,119
	4	NPV	\$35,615,800
	5	NPV	\$34,148,585
	6	NPV	\$32,544,875
	7	NPV	\$30,796,671
	8	NPV	\$28,895,557
	9	NPV	\$26,832,677
	10	NPV	\$24,598,711

Source: Waronzo



		BASIC CASH FLOWS - TENANT PERFORMS AND RENEWS	ALTERNATIVE CASH FLOWS - A - REPLACEMENT GOVT TENANT	ALTERNATIVE CASH FLOW - B - GENERIC TENANTS & LEASE UP
Purchase at EO Yr:	1	\$41,046,466	\$40,190,757	\$39,272,581
	2	\$41,749,731	\$39,943,895	\$38,170,759
	3	\$42,456,353	\$39,619,273	\$36,954,119
	4	\$43,165,424	\$39,210,285	\$35,615,800
	5	\$43,875,928	\$38,709,849	\$34,148,585
	6	\$44,586,736	\$38,110,363	\$32,544,875
	7	\$45,296,586	\$37,403,674	\$30,796,671
	8	\$46,004,080	\$36,581,040	\$28,895,557
	9	\$46,707,662	\$35,633,084	\$26,832,677
	10	\$47,405,611	\$34,549,754	\$24,598,711

Source: Waranzof

Probability of Occurance		70%	15%	15%	
		BASIC CASH FLOWS - TENANT PERFORMS AND RENEWS	ALTERNATIVE CASH FLOWS - A - REPLACEMENT GOVT TENANT	ALTERNATIVE CASH FLOW - B - GENERIC TENANTS & LEASE UP	Weighted Average
Purchase at EO Yr:	1	\$28,732,526	\$6,028,613	\$5,890,887	\$40,652,026
	2	\$29,224,812	\$5,991,584	\$5,725,614	\$40,942,010
	3	\$29,719,447	\$5,942,891	\$5,543,118	\$41,205,456
	4	\$30,215,796	\$5,881,543	\$5,342,370	\$41,439,709
	5	\$30,713,150	\$5,806,477	\$5,122,288	\$41,641,915
	6	\$31,210,715	\$5,716,554	\$4,881,731	\$41,809,001
	7	\$31,707,610	\$5,610,551	\$4,619,501	\$41,937,662
	8	\$32,202,856	\$5,487,156	\$4,334,334	\$42,024,345
	9	\$32,695,363	\$5,344,963	\$4,024,902	\$42,065,228
	10	\$33,183,928	\$5,182,463	\$3,689,807	\$42,056,198

Source: Waranzof



	NOI FROM RENTS	SALE AT EO YR 1	SALE AT EO YR 2	YR 3	YR 4	YR 5	YR 6	YR 7	YR 8	YR 9	YR 10
1	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099
2	\$3,032,561		\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561
3	\$3,093,212			\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212
4	\$3,155,076				\$3,155,076	\$3,155,076	\$3,155,076	\$3,155,076	\$3,155,076	\$3,155,076	\$3,155,076
5	\$3,218,178					\$3,218,178	\$3,218,178	\$3,218,178	\$3,218,178	\$3,218,178	\$3,218,178
6	\$3,282,541						\$3,282,541	\$3,282,541	\$3,282,541	\$3,282,541	\$3,282,541
7	\$3,348,192							\$3,348,192	\$3,348,192	\$3,348,192	\$3,348,192
8	\$3,415,156								\$3,415,156	\$3,415,156	\$3,415,156
9	\$3,483,459									\$3,483,459	\$3,483,459
10	\$3,553,128										\$3,553,128

	Option Payment
1	\$40,652,026
2	\$40,942,010
3	\$41,205,456
4	\$41,439,709
5	\$41,641,915
6	\$41,809,001
7	\$41,937,662
8	\$42,024,345
9	\$42,065,228
10	\$42,056,198

Source: Waronzo

0	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021	-\$37,016,021
1		\$43,625,125	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099	\$2,973,099
2		\$0	\$43,974,571	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561	\$3,032,561
3		\$0	\$0	\$44,298,668	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212	\$3,093,212
4		\$0	\$0	\$0	\$44,594,785	\$3,155,076	\$3,155,076	\$3,155,076	\$3,155,076	\$3,155,076	\$3,155,076
5		\$0	\$0	\$0	\$0	\$44,860,092	\$3,218,178	\$3,218,178	\$3,218,178	\$3,218,178	\$3,218,178
6		\$0	\$0	\$0	\$0	\$0	\$45,091,542	\$3,282,541	\$3,282,541	\$3,282,541	\$3,282,541
7		\$0	\$0	\$0	\$0	\$0	\$0	\$45,285,854	\$3,348,192	\$3,348,192	\$3,348,192
8		\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$45,439,501	\$3,415,156	\$3,415,156
9		\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$45,548,686	\$3,483,459
10		\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$45,609,326
IRR		17.85%	13.08%	11.55%	10.80%	10.36%	10.07%	9.87%	9.73%	9.62%	9.54%

Source: Waronzo

Tax Cost	\$1,130,175.70	\$1,321,402.61	\$1,508,827.23	\$1,692,054.97	\$1,870,661.12	\$2,044,188.59	\$2,212,145.51	\$2,374,002.63	\$2,529,190.52	\$2,677,096.52
DD Costs-Replacement	\$406,520	\$409,420	\$412,055	\$414,397	\$416,419	\$209,045	\$209,688	\$210,122	\$210,326	\$210,281
Total Lump Sum Adj	\$1,536,696	\$1,730,823	\$1,920,882	\$2,106,452	\$2,287,080	\$2,253,234	\$2,421,834	\$2,584,124	\$2,739,517	\$2,887,378
B Fwd Option Base	\$40,652,026	\$40,942,010	\$41,205,456	\$41,439,709	\$41,641,915	\$41,809,001	\$41,937,662	\$42,024,345	\$42,065,228	\$42,056,198
Indicated Option Price	\$42,188,722	\$42,672,833	\$43,126,338	\$43,546,161	\$43,928,995	\$44,062,234	\$44,359,496	\$44,608,470	\$44,804,744	\$44,943,575
Rounded	\$42,200,000	\$42,700,000	\$43,100,000	\$43,500,000	\$43,900,000	\$44,100,000	\$44,400,000	\$44,600,000	\$44,800,000	\$44,900,000

Source: Waronzo



0	-\$37,016,021												
1		-\$37,016,021											
2		\$45,173,099											
3			\$2,973,099										
4			\$45,732,561										
5				\$3,032,561									
6				\$46,193,212									
7					\$3,093,212								
8					\$46,655,076								
9						\$3,155,076							
10							\$47,118,178						
								\$3,218,178					
									\$47,382,541				
										\$47,748,192			
											\$48,015,156		
												\$48,283,459	
													\$48,453,128
IRR		22.04%	15.24%	13.00%	11.92%	11.29%	10.82%	10.53%	10.30%	10.14%	10.00%		
Imputed Cap Rate		7.045%	7.102%	7.177%	7.253%	7.331%	7.443%	7.541%	7.657%	7.776%	7.913%		

Source: Waronzo

Option Purchase Price Conclusion

Year	1	2	3	4	5	6	7	8	9	10
Option Price	\$42,200,000	\$42,700,000	\$43,100,000	\$43,500,000	\$43,900,000	\$44,100,000	\$44,400,000	\$44,600,000	\$44,800,000	\$44,900,000
Imputed Cap Rate	7.045%	7.102%	7.177%	7.253%	7.331%	7.443%	7.541%	7.657%	7.776%	7.913%
Project IRR	22.04%	15.24%	13.00%	11.92%	11.29%	10.82%	10.53%	10.30%	10.14%	10.00%
Option Price Change		\$500,000	\$400,000	\$400,000	\$400,000	\$200,000	\$300,000	\$200,000	\$200,000	\$100,000

Source: Waronzo

Option Purchase Price Conclusion

Year	Option Price	Imputed Cap Rate	Project IRR	Option Price Change
1	\$42,200,000	7.045%	22.037%	-
2	\$42,700,000	7.102%	15.241%	\$500,000
3	\$43,100,000	7.177%	13.005%	\$400,000
4	\$43,500,000	7.253%	11.922%	\$400,000
5	\$43,900,000	7.331%	11.293%	\$400,000
6	\$44,100,000	7.443%	10.824%	\$200,000
7	\$44,400,000	7.541%	10.532%	\$300,000
8	\$44,600,000	7.657%	10.302%	\$200,000
9	\$44,800,000	7.776%	10.136%	\$200,000
10	\$44,900,000	7.913%	9.997%	\$100,000

Source: Waronzo

