DEVELOPMENT PROPOSAL FOR THE MARTENS PROPERTY

GERMANTOWN, MD

by

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A practicum thesis submitted to Johns Hopkins University in conformity with the requirements for the degree of Master of Science in Real Estate

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EXECUTIVE SUMMARY

This development proposal will consider the potential for multi-story office, retail, multifamily rental, and for sale townhomes on the Martens property (Martens Site). The objective is to determine the most profitable and feasible development opportunity while minimizing the risk to the Sponsor and equity partner.

The proposal will first provide a basic description of the site including size, location, existing condition and surrounding uses. Additionally, a land use analysis will provide an understanding of the current zoning designation, the master plan for the area, the entitlement process, and the planning department's vision for what the Martens Site should be.

The development proposal will then provide a market and feasibility analysis for each of the proposed asset classes above (i.e. office, retail, multifamily rental, and townhomes). The market and feasibility analysis will include research of each asset class specific to the Washington DC Metro market and, more specifically, the Germantown market. Further, an initial return on cost analysis will be provided for each asset class in order to determine the Martens Site's viable development opportunities. This analysis will reveal that both multifamily rental and for sale townhomes are viable developments.

The proposal will then discuss site and building design which will be used to determine the appropriate density for the site and will help with the projection of construction costs. These factors will then be used complete a full financial analysis of the townhome development, the multifamily rental development and a 10 year holding period for the multifamily rental portion. Finally, a development plan outlining the estimated schedule and development risks is included.
SITE ANALYSIS

The Martens Site is a 26.3 acre parcel located near the intersection of Wisteria Drive and Germantown Road (Route 118) in Germantown, MD offered for $11,500,000. The Martens Site, as it currently exists, is mostly vacant with only a small building on the southeast corner and a storm water management pond on the southwest corner, which serves the adjacent residential projects to the west (see Figure 2 below).

Figure 1: Martens Site Location Map and Aerial

(Source: Google Earth)
The Martens Site was originally part of a larger parcel all of which was owned by the Martens family. The residential project to the northwest was sold to Fairfield Residential who built and sold 400 stacked flat style condominiums. The residential project to the southwest was sold to Centex who has recently completed development of 200 2-over-2 townhome style condominiums.

Figure 2: Martens, Fairfield, and Centex Site Locations

(Source: Google Earth)

The Martens Site is bounded by CSX railroad tracks to the south, Waters Road to the east and Wisteria Drive to the north. Waterford Hills Boulevard, which will be extended to Waters Road as a part of the
site development, divides the site and currently extends from Father Hurley Boulevard through the adjacent residential projects to the west. Additionally the MARC Rail Station is located directly across Route 118 from the Martens Site.

Figure 3: Martens Surrounding Infrastructure Illustrative

(Source: Google Earth)
LAND USE ANALYSIS

The Land Use Analysis will briefly review the Sector Plan for the Germantown Employment Area and the vision for the Town Center District and, more specifically, the Martens Site. The zoning designation for the Martens Site will be reviewed and an analysis describing the Standard Method of Development and the Optional Method of Development and the process involved for each will be discussed. Finally, recommendations from the Montgomery County Planning Director will be used to help formulate a strategy for the entitlement process for the Martens Site.

The Martens Site is located within the West End neighborhood of the Town Center District as designated in the Sector Plan for the Germantown Employment Area. The Sector Plan for the Germantown Employment Area is an amendment to the approved and adopted 1989 Germantown Master Plan. The Sector Plan for the Germantown Employment Area, which was approved in 2009, changed the zoning designation for the Martens property to RMX-2.

As illustrated on the Germantown Land Use Concept below, high density office and commercial uses have been planned along both sides of Interstate 270. West of the intersection of I-270 and Route 118 is planned for a mix of uses including both commercial and residential uses.
The areas designated for Residential, Mixed-Use (Primarily Residential) and Commercial, Mixed-Use (Office, Retail) are located within the Town Center District which includes both the Town Center Core and the Town Center West End. The Town Center District runs along Route 118 on the west side of I-270 and encompasses the Germantown MARC station and Germantown Town Center. The Town Center Core and the Town Center West End are shown on the location map below.
As previously mentioned, the Land Use Plan, as envisioned by Montgomery County Planning – the Montgomery County division within Maryland-National Capital Park and Planning Commission (MNCPPC) – for the Town Center District is primarily planned for mixed-use developments with either a residential or commercial focus. The Martens Site is located in the Town Center West End and is planned for Mixed-Use, Residential as shown below.
Figure 6: Town Center/West End Land Use Plan

Town Center / West End Land Use

(Source: Sector Plan for The Germantown Employment Area)
The Sector Plan specifically recommends a redevelopment of the Martens and adjacent Waters Road Triangle properties to include a maximum of 420,000 square feet of commercial space and 400 dwelling units\(^4\). The density should be distributed to allow for up to 200,000 square feet of commercial uses and 300 residential dwelling units on the Martens property. Additionally, the Sector Plan allows for an increase in the residential density of the project with an offsetting decrease in commercial density so long as the maximum density does not exceed 0.8 FAR\(^5\).

The Residential Mixed Use Development Zone (RMX-2 Zone) outlines what is planned for the property and allows for two distinct methods of development: (1) the standard method of development; and (2) the optional method of development\(^6\). The standard method of development in the RMX Zone allows only for lower density residential development with a maximum of 11 dwelling units per acre. The optional method of development allows for higher density residential uses and general commercial uses but requires a project plan and site plan submission which must be approved by the Planning Board. Generally, the RMX-2 allows the following under the optional method:

- Commercial FAR: 0.5
- Residential FAR: 0.8
- Green Space: 50% requirement for residential
- Height Limit: 60 feet

The optional method will provide a more flexible, mixed use zone which will allow the Martens Site to obtain higher density residential uses and will more accurately reflect the Montgomery County Planning Department’s vision of a dense, mixed use property. The optional method will require the submission of a Preliminary Plan, a Project Plan, a Site Plan, and the recordation of a Record Plat, whereas a
development using the standard method would only require the submission of a Preliminary Plan, Site Plan and the recordation of a Record Plat.

The Preliminary Plan divides a tract of land into building lots, streets, and open space. This plan shows the relationship of a proposed development to its neighbors. The Preliminary Plan contains specific lot and street details as well as information on utilities and the adequacy of public infrastructure. The Preliminary Plan can be approved, approved with conditions or denied by the planning board; however, it must be approved prior to recordation of lots or before any building permits are issued. Typically the Preliminary Plan process will take approximately 9 months.

The Project Plan is required in certain zones under the optional method of development when the applicant is seeking additional density in exchange for additional public open space or amenities. According to Robby Brewer, a land use attorney with Lerch, Early & Brewer, the Martens Site would likely meet the requirement for additional public open space or amenities by dedicating a portion of and constructing a full section of Waters Road adjacent to the Martens Site. Again, the Project Plan can be approved, approved with conditions or denied by the planning board; however, it must be approved prior to filing the Record Plat or before any building permits are issued. Typically the Project Plan process will take approximately 9 months; however, it can be processed concurrently with the Preliminary Plan.

The Site Plan is a detailed review of the building location, landscaping, lighting and other elements of the proposed development. The Site Plan, like the Project Plan, is only required in certain zones or when exceptions to certain regulations are requested. For the Martens Site a Site Plan will be required to be approved by the planning board due to the additional density that will be requested under the
optional method of development. Typically, the Site Plan process will take approximately 12 months; however, it can be started after there is a reasonable level of comfort that the Project Plan and Preliminary Plan layout are close to being finalized.

The Record Plat is a formal recordation of a land subdivision and contains all the agreements of the public improvements that will be made on a piece of property. During this process a project name and the names of all streets must be approved prior to submission. The Record Plat cannot be processed until approval has been granted on the Preliminary Plan and the Site Plan. Typically, the Record Plat process will take approximately 9 months; however, work can be started while engineering is being completed but not recorded until everything is finalized.

During initial conversations with Rollin Stanley, Planning Director for Montgomery County Planning (within MNCPPC), it was clear that they were looking for a densely planned site. Ideally, they prefer planning that incorporates a mix of uses with a majority of the site dedicated to residential; however, they realize that the retail and office market may be prohibitive to development and consequently will be lenient when it comes to approving a plan that does not incorporate retail or other commercial uses. That said, if a mixed-use concept is required for approval a small section of retail could be provided on the first floor of the multifamily rental buildings. Additionally, it was clear that Montgomery County Planning has a preference for development projects that incorporate design concepts from more “urban” areas. In other words, a plan that solely incorporates townhomes is not as favorable as a plan with multistory apartment or condominium buildings with significantly more density.

Although the entitlement process using the optional method of development is longer and potentially more expensive, the additional density gained is substantial. As previously discussed, an all townhome
plan will not be viewed favorably by Montgomery County Planning. However, a plan that incorporates a mix of townhomes and multifamily apartments will include significantly more density and will likely navigate the optional method of development process more smoothly. Additionally, as discussed in the Market and Feasibility Analysis, a mix of residential product types will diversify the development plan and reduce the overall absorption timeframe significantly.

In summary, the initial Project Plan submission for the Martens Site will incorporate a mix of townhomes with rear-load and front-load garages and multifamily buildings. Initially, no commercial uses will be incorporated; however, if the lack of commercial space becomes a stumbling block during the entitlement process a small section of retail could be incorporated into the first floor of the multifamily buildings.
MARKET AND FEASIBILITY ANALYSIS

The Market and Feasibility Analysis will give a general demographic and economic overview of the Germantown CDP and Montgomery County. Additionally, market overviews and return on costs analyses will be completed for the rental apartment market, the for-sale housing market, the office market and the retail market. These analyses will lead to a product mix analysis which will ultimately result in a conclusive determination of the highest and best use for the Martens Site.

GERMANTOWN CDP AND MONTGOMERY COUNTY OVERVIEW

Germantown, MD is located in Montgomery County approximately 25 miles north of Washington, DC. According to Forbes, Montgomery County was listed as the tenth richest county in the nation in 2010, with a median household income of $93,999. The population was estimated to be 971,600 people in 2009 which grew 11.3 percent from 2000.

According to American Community Services, Germantown has a population of 60,104 with approximately 22,000 households. Additionally, the median household income of 78,192 is significantly higher than the National median of $51,369 and Maryland’s median of $69,695 which is partly due to the high percentage of residents (46 percent) who have a bachelors degree or higher.

Germantown’s highly educated workforce has plenty of employment options with numerous Fortune 500 headquarters and federal research and regulatory agencies located in Montgomery County including Marriott International Corporation, National Institutes of Health, Lockheed Martin, Federal Drug Administration, MedImmune, Nuclear Regulatory Agency, GEICO, National Institute of Standards and Technology, and Discovery Communications just to name a few. The wealth of jobs in Montgomery
County has resulted in an unemployment rate of only 5.1 percent in February 2011 which is down from 5.9 percent in February 2010.

**RENTAL APARTMENT MARKET AND FEASIBILITY ANALYSIS**

**Market Overview**

As mentioned in the Delta Associates Mid Atlantic Class A Apartment report, the metropolitan Washington, DC rental apartment market is one of the strongest apartment markets in the nation. The metro DC market boasts an investment grade (Class A and B) vacancy rate of 3.8 percent while the national vacancy rate is substantially higher at 6.5 percent. Annual net absorption for Class A and B properties was 8,619 units with 7,179 units of Class A absorption. Additionally, rents increased 7.8 percent for the 12 months ending March 2011. 60 percent of the rent increase came from face rate adjustment with the balance from concession reductions. The improving fundamentals are driven by job growth in the region, the transient workforce which has produced a large group of Class A renters by choice, and the shift away from ownership and towards renting.

More specifically, the Germantown Class A apartment market boasts a vacancy rate of only 5.2 percent. Although the vacancy rate is higher than the metro DC average of 3.8 percent, the Germantown market is supply constrained with fewer than 250 units planned to be delivered in the next 36 months. The constrained supply and increasing demand create a very favorable market for new development.

According to Steve Varga with Enterprise Realty, the competitive rental market for relatively new, luxury product in Germantown is primarily composed of five properties:
• Milestone
  o 576 units
  o Constructed in 1996
  o 93% occupancy
  o Average rent per square foot of $1.46 per month

• The Pinnacle at Town Center
  o 286 units
  o Constructed in 2002
  o 95% occupancy
  o Average rent per square foot of $1.57 per month

• The Park at Kingsview Village
  o 326 units
  o Constructed in 2001
  o 98% occupancy
  o Average rent per square foot of $1.41 per month

• The Elms at Germantown
  o 316 units
  o Constructed in 2005
  o 94% occupancy
  o Average rent per square foot of $1.34 per month

• The Gables at Waters Landing
  o 300 units
  o Constructed in 1995
  o 95% occupancy
  o Average rent per square foot of $1.50 per month

The most recent development, The Elms at Germantown, was completed in 2005 which would make the rental apartment component of the Martens Site the first to be delivered in almost 10 years. The most direct comparable to the Martens Site would be The Pinnacle at Town Center due to its location.

Additionally, there is a limited supply of new rental product planned in the submarket. Based on the recently adopted Sector Plan for the Germantown Employment Area there are a number of potential opportunities which are summarized below.
• Totah Property  
  o 19 acre parcel  
  o Planned for up to a .75 FAR with a maximum of 40% residential  
  o Approximately 225 units  

• Lerner Property  
  o 80 acre parcel  
  o Planned for up to 1,200 active adult units  

• Milestone North  
  o Recommended for up to 225 units  

• Fox Chapel Shopping Center  
  o 12 acre parcel  
  o Recommended for up to 266 units upon redevelopment  

• Middlebrook Mobile Home Park  
  o 21 acre parcel  
  o Planned for up to 460 units  

Of the potential opportunities for rental apartment development listed above only the Totah Property is actively engaged in the entitlement process. Additionally, the Lerner property is planned for active adult (i.e. senior) housing and Fox Chapel Shopping Center and Middlebrook Mobile Home Park are redevelopment projects with no immediate plans for development.  

The limited supply of relatively well located product helps explain the 5.2 percent vacancy rate which is likely to continue to decrease due to supply constraints. The potential for new supply combined with the increasing demand due to job growth and the structural shift towards a propensity to rent bodes well for the future of the Germantown rental apartment market.  

Return on Cost Analysis  

Based on conversations with Steve Gang of Lessard Design, Inc., an architecture and planning firm, surface parked, garden style multifamily product with four levels should be able to reach a density of approximately 32 units per acre. According to Steve Varga, President of Enterprise Realty, the ideal unit
mix in a suburban location like Germantown would be 60 percent two bedroom units and 40 percent one bedroom units. With the larger number of two bedroom units and the desire for larger units in a suburban location Steve Gang would recommend an average unit size of approximately 1,150 gross square feet. With 21 net acres available for development, the Martens Site should be able to accommodate up to 672 units without exceeding the 0.8 FAR restriction.

According to Mike Henehan, Development Manager at Bozzuto and previously Business Development Manager at Bozzuto Construction, four story, wood frame apartments with conditioned interior corridors and elevators would cost approximately $88 per gross square foot (based on 85 percent efficiency) or $101,200 per unit\textsuperscript{21}. Major site work expenses would be $2,500,000, as discussed below.
## Rental Apartment ROC Analysis

### Revenue

<table>
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<tr>
<th>Description</th>
<th>Unit/SF</th>
<th>Price</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multifamily Rental Gross Revenue</td>
<td>672,000</td>
<td>$1.78</td>
<td>$14,353,920</td>
</tr>
<tr>
<td>less: Vacancy</td>
<td>5.0%</td>
<td></td>
<td>($717,696)</td>
</tr>
<tr>
<td>less: Expenses</td>
<td>672</td>
<td>$6,000</td>
<td>($4,032,000)</td>
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<tr>
<td>Multifamily Rental NOI</td>
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<td></td>
<td>$9,604,224</td>
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<tr>
<td>Capitalized Value</td>
<td>6.5%</td>
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<td>$147,757,292</td>
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<tr>
<td>less: Closing Costs and Commissions</td>
<td>1.5%</td>
<td></td>
<td>($2,216,359)</td>
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</table>

**Total Revenue** $145,540,933

### Costs

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<tr>
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<td></td>
<td>$11,500,000</td>
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<tr>
<td>Soft Costs</td>
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<td>$16,401,280</td>
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<tr>
<td>Hard Costs</td>
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<td></td>
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<tr>
<td>Overall Site Infrastructure</td>
<td></td>
<td>$2,500,000</td>
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<tr>
<td>Other Hard Costs</td>
<td>672</td>
<td>$101,200</td>
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<tr>
<td><strong>Subtotal Hard Costs</strong></td>
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<td>$70,506,400</td>
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**Total Costs** $98,407,680

**Total Profit** $47,133,253

**Return on Cost** 48%
FOR-SALE RESIDENTIAL MARKET AND FEASIBILITY ANALYSIS

Market Overview

Similar to the rental apartment market, the for-sale residential market in the metropolitan Washington, DC area is one of the strongest in the nation. Due to the metro area’s consistent job growth, the demand for housing remains strong. Although the traditional stacked-flat condominium market is stronger in locations inside of the beltway, it is still recovering in the Germantown submarket. That said, the market for townhome style condominiums and single family attached products (i.e. townhomes) remains robust.

Despite the expiration of the first time homebuyer tax credit, sales activity continues to increase in Montgomery County with 499 sales in December 2010 – a 6 percent increase over the 470 sales that occurred in December 2009\textsuperscript{22}. The increase in sales has lowered inventory to just over 5 months in December 2010, which was a 27 percent decrease in the inventory year-over-year\textsuperscript{23}. With the exception of Prince George’s County and Charles County, the Metropolitan DC for sale residential market is within the healthy range of around 6 months of inventory on the market. Additionally, time on the market has decreased from 86 days one year ago to 63 days in the inner jurisdictions of Montgomery, Fairfax and Prince George’s Counties\textsuperscript{24}.

Home pricing has also shown signs of improvement. The 3 month average (through January 2011) median sales price in Montgomery County increased 2 percent over the 12 month average median sales price indicating upwards price pressure due to the decreasing inventory and improving market\textsuperscript{25}. As further evidence of upwards pricing pressure in Montgomery County, the average price rose 4.1 percent from the third quarter of 2009 to the third quarter of 2010\textsuperscript{26}. 

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Again, Montgomery County’s pipeline of supply for this type of product is extremely constrained. According to Brian Afnan of NVR\textsuperscript{27}, there are only a couple of projects that would directly compete with the Martens Site’s townhome component.

- **Parklands**
  - Located in Gaithersburg just west of I-270 near Quince Orchard Road
  - Approximately 100 units remain – should be sold out in 12 to 18 months
  - Currently averaging approximately $450,000 for a 20’ wide townhome with average sales of 3 – 4 units per month

- **Eton Square**
  - Located east of I-270 in Germantown (inferior location compared to Martens)
  - Approximately 35 units remain – should be sold out within 18 – 24 months based on their current sales schedule of 1 – 2 units per month
  - Currently priced at $380,000 for a 4-level 18’ wide townhome

- **Finmarc Property**
  - Located in Germantown, MD near the intersection of Clopper Road and Great Seneca Highway (inferior location)
  - Approximately 100 units with no immediate plans for development

Due to the strong demand and lack of supply for this type of product in the Germantown market, NVR would expect to start sales prices for a 20’ wide, rear-load townhome at approximately $400,000 and $430,000 for a 22’ wide, front-load townhome. Based on these sales prices they would be able to pay a finished lot price of approximately $155,000 and $170,000 respectively. Based on the lack of competition for new product in the Germantown market, they would expect to sell approximately 8 market rate 20’ townhomes and 5 market rate 22’ townhomes per quarter.

**Return on Cost Analysis**

Based on conversations with Steve Gang\textsuperscript{28}, a principal with Lessard Design Inc., a typical 20’ or 22’ wide single family attached product should be able to reach a density of approximately 14 units per acre and will have an average size of 2,000 square feet (excluding garage space). Based on 21 net acres the Martens Site should accommodate approximately 294 - 20’ or 22’ wide townhomes.

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Typical finished lot deals require the land developer to process all the engineering plans for the horizontal site work and record the subdivision plat in order to create separate legal lots. Additionally, it is the developer’s responsibility to install all of the utilities to the lot, and construct the recreation center or clubhouse, storm water management facilities, roads, alleyways, and sidewalks. The homebuilder then purchases the lots based on a pre-determined takedown schedule.

Based on conversations with David Burns of S.W. Rodgers Company, Inc., a local site work contractor, the typical costs to finish 20’ – 22’ wide townhome lots would be $17,500 to $22,500 per lot\textsuperscript{29}. Additionally, the costs to complete the major on-site and off-site roads are estimated to cost $2,500,000. Finally, the recreation center and tot lots are estimated to cost $1,000,000.
### Single Family Attached ROC Analysis

#### Revenue

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<td>$155,000</td>
<td>$45,570,000</td>
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<td>1.5%</td>
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<td>($683,550)</td>
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**Total Revenue** $44,886,450

#### Costs

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<th>Units</th>
<th>Cost</th>
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<tbody>
<tr>
<td>Land</td>
<td>$11,500,000</td>
</tr>
<tr>
<td>Soft Costs</td>
<td>20% $4,176,000</td>
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</table>

**Hard Costs**

- Overall Site Infrastructure $2,500,000
- Lot Finishing Costs 294 $20,000 $5,880,000
- Site Amenities-Tot Lots and Rec Center  $1,000,000

**Subtotal Hard Costs** $9,380,000

**Total Costs** $25,056,000

**Total Profit** $19,830,450

**Return on Cost** 79%
OFFICE MARKET AND FEASIBILITY ANALYSIS

Market Overview

The office market in the Washington, DC Metropolitan area continued to rebound in 2010 due to continued job growth in the region. The Washington, DC MSA added 37,600 jobs during the year which was more than any other MSA in the nation\textsuperscript{30}. The unemployment rate, although still 2.1 percentage points above the historical average, declined to 6.0 percent which makes it the lowest among major metropolitan areas\textsuperscript{31}.

Figure 7: New Deliveries, Net Absorption, Vacancy Rate in the DC Metro Office Market\textsuperscript{32}

Office Sector: Deliveries – Net Absorption - Vacancy

(Source: Cassidy Turley – The State of Real Estate 2011 – Washington DC Metro Area)

In 2010, 5.7 million square feet were absorbed in the Metro DC area which is close to absorption levels last seen in 2006 and 2007\textsuperscript{33}. A majority of this absorption was driven by Federal Government leasing and diminished delivery of new office space.
The office market in Suburban Maryland also rebounded in 2010 with positive absorption of 107,000 square feet and no new deliveries\textsuperscript{34}. That said, the vacancy rate remained at 15.2 percent – significantly higher than Metro DC's average of 13.0 percent\textsuperscript{35}.

**Figure 8: Deliveries, Net Absorption, Vacancy in Gaithersburg/Germantown Office Market\textsuperscript{36}**

![Graph showing Deliveries, Net Absorption, Vacancy in Gaithersburg/Germantown Office Market](image)

(Source: Cassidy Turley – Survey of Office Space – Suburban Maryland – Fourth Quarter 2010)

More specifically, the Gaithersburg/Germantown submarket absorbed 209,440 square feet in 2010\textsuperscript{37}. This is largely due to the lack of new deliveries and a few notable lease/sale transactions (i.e. MedImmune and LRS). Due to this positive absorption the vacancy rate has dropped to 14.2 percent – its lowest rate in four years\textsuperscript{38}. However, average asking rents for all classes of office space declined slightly to $24.20 per square foot\textsuperscript{39}. Additionally, Class A properties have a total vacancy rate of 20.2 percent and rent of $26.82 per square foot\textsuperscript{40}.)
Return on Cost Analysis

Typically, mid-rise multi-story office buildings with surface parking can reach a maximum FAR of .35. With 21 net acres the Martens Site should be able to accommodate up to 320,166 square feet of office space.

Based on conversations with Matt Shea, President of Hubert Construction, a Class A multi-story office building would cost approximately $100 per square foot to build. Additionally, the building would require tenant improvements. According to Andy Klaff, Senior Vice President of Grubb and Ellis, tenant improvement allowances for new office transactions have recently ranged from $40 per square foot to $60 per square foot. Although it is atypical for interior construction to actually cost $60 per square foot the tenant improvement allowance has become another form of concession which has driven up the cost for landlords.

Although leasing activity and demand for space has started to recover, the capital market and investment market for suburban office buildings still has a long road to a full recovery. Despite the high prices demanded for well located office buildings inside the beltway, suburban office buildings in second tier markets like Germantown are extremely difficult to finance and do not attract enough investor interest to drive capitalization rates down. However, if it were able to be financed the cap rate for a Class A office building in Germantown would likely be 7.5 percent to 8.5 percent according to conversations with Andy Klaff.

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## Office ROC Analysis

### Revenue

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<th>Description</th>
<th>Unit/SF</th>
<th>Price</th>
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<td>Office Gross Revenue</td>
<td>320,166</td>
<td>$26.50</td>
<td>$8,484,399</td>
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<td>less: Vacancy</td>
<td></td>
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<td>less: Expenses</td>
<td></td>
<td>$9.00</td>
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<td>Office NOI</td>
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<td>$9.00</td>
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<tr>
<td>Capitalized Value</td>
<td></td>
<td>7.5%</td>
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<td>less: Closing Costs and Commissions</td>
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<td>1.5%</td>
<td>($950,893)</td>
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### Total Revenue

- $62,441,975

### Costs

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<thead>
<tr>
<th>Description</th>
<th>Unit/SF</th>
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<tbody>
<tr>
<td>Land</td>
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<td>$11,500,000</td>
</tr>
<tr>
<td>Soft Costs</td>
<td></td>
<td>20%</td>
</tr>
</tbody>
</table>

#### Hard Costs

<table>
<thead>
<tr>
<th>Description</th>
<th>Unit/SF</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall Site Infrastructure</td>
<td></td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Office Space (Rentable + Common)</td>
<td>320,166</td>
<td>$100</td>
</tr>
<tr>
<td>Tenant Improvements</td>
<td>320,166</td>
<td>$40</td>
</tr>
</tbody>
</table>

### Subtotal Hard Costs

- $47,323,240

### Total Costs

- $70,587,888

### Total Profit

- ($8,145,913)

### Return on Cost

- -12%
RETAIL MARKET AND FEASIBILITY ANALYSIS

Market Overview

The retail market in the Metropolitan DC market has rebounded over the past two years. Steady population growth, high median household incomes, continued job growth and a lack of new retail space under construction are the main drivers behind the recovering market.

Figure 9: Shopping Center Vacancy – Select Metropolitan Markets

![Shopping Center Vacancy – All Types Select Metro Areas First Quarter 2010](image)

(Source: Delta Associates Washington Area Retail Outlook – Spring 2010)

As illustrated above, Metropolitan DC's retail vacancy rate of 5.7 percent is significantly lower than the national average of 9.5 percent and is the lowest among large metro areas. Additionally, there is only 1.2 millions square feet currently under construction of which 79.2% is preleased. Relatively strong
fundamentals have driven additional investor activity to the metropolitan Washington DC market which has decreased capitalization rates on retail real estate from 7.93% in 2009 to 7.67% in 2010\textsuperscript{47}.

The Germantown retail market is comprised of over 2.9 million square feet with a vacancy rate of 3.4%, which increased slightly due to 28,316 square feet of negative absorption in 2010\textsuperscript{48}. The quoted or asking rental rate averaged $29.86 per square foot\textsuperscript{49}. The Germantown retail market segment that consists of community centers, neighborhood centers, and strip centers is almost 1.2 million square feet with a vacancy rate of 8.3% and an average quoted rental rate of $31.35\textsuperscript{50}. This segment of the market had negative absorption of 35,153 square feet and accounts for over 50% of all vacant retail space\textsuperscript{51}.

Although the retail market is showing signs of a modest recovery, a higher than average vacancy rate in the Germantown retail market segment comprising community, neighborhood and strip centers does not bode well for a retail development on the Martens Site. Although the quoted rental rate for this segment is $31.35 based on conversations with local retail brokers, it is estimated that the effective rental rates are actually much lower\textsuperscript{52}. Additionally, the Martens Site is not an ideal retail location due to its limited visibility along Route 118 and its proximity to numerous other retail shopping centers with superior locations.


Return on Cost Analysis

Based on discussions with Steve Gang at Lessard Design a prototypical retail center would be able to reach a maximum FAR of approximately .25. With 21 net acres the Martens Site should be able to accommodate approximately 228,690 square feet.

According to Matt Shea of Hubert Construction a retail center of this size should average approximately $125 per square foot\(^53\). Additionally, tenant improvement allowances of approximately $20 per square foot are common. Typically the tenant improvement allowances are used by the tenant for fixtures and other improvements necessary for the operation of their retail business.

Although community, strip and neighborhood retail centers in Germantown are currently averaging over $30 per square foot in rent, according to Matt Locraft, Principal with KLN Retail, it would be difficult to attain that level of rent today\(^54\). As previously discussed, the Germantown retail market is relatively saturated and it is likely that the addition of a shopping center over 200,000 square feet would drive rents down and vacancy up.

Similar to suburban office buildings, retail centers have struggled to gain traction in the capital and investment markets. According to Matt Locraft with KLN Retail, capitalization rates for retail centers with a reasonable tenant mix have ranged from 7.5 percent to 8.5 percent\(^55\).
# Retail ROC Analysis

## Revenue

<table>
<thead>
<tr>
<th>Description</th>
<th>Unit/SF</th>
<th>Price</th>
<th>Revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Gross Revenue</td>
<td>228,690</td>
<td>$22.50</td>
<td>$5,145,525</td>
</tr>
<tr>
<td>less: Vacancy</td>
<td></td>
<td>10.0%</td>
<td>($514,553)</td>
</tr>
<tr>
<td>less: Expenses</td>
<td></td>
<td>$0.00</td>
<td>$0</td>
</tr>
<tr>
<td>Retail NOI</td>
<td></td>
<td></td>
<td>$4,630,973</td>
</tr>
</tbody>
</table>

| Capitalized Value                        | 7.5%    |        | $61,746,300   |
| less: Closing Costs and Commissions      | 1.5%    |        | ($926,195)    |

## Total Revenue

| Total Revenue                             | $60,820,106 |

## Costs

<table>
<thead>
<tr>
<th>Description</th>
<th>Unit/SF</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Land</td>
<td></td>
<td>$11,500,000</td>
</tr>
<tr>
<td>Soft Costs</td>
<td></td>
<td>$9,797,914</td>
</tr>
<tr>
<td>Hard Costs</td>
<td></td>
<td>$37,489,570</td>
</tr>
<tr>
<td>Overall Site Infrastructure</td>
<td></td>
<td>$2,500,000</td>
</tr>
<tr>
<td>Retail Bldg</td>
<td>228,690</td>
<td>$125</td>
</tr>
<tr>
<td>Tenant Improvements</td>
<td>320,166</td>
<td>$20</td>
</tr>
<tr>
<td>Subtotal Hard Costs</td>
<td></td>
<td>$58,787,484</td>
</tr>
</tbody>
</table>

## Total Costs

| Total Costs                               | $58,787,484 |

## Total Profit

| Total Profit                              | $2,032,622  |

## Return on Cost - Sale

| Return on Cost - Sale                     | 3%         |
PRODUCT MIX ANALYSIS

Based on the analyses completed above, both for sale townhomes and rental apartments are viable developments for the Martens Site. That said, as previously mentioned, MNCPCC prefers a mix of uses for the Martens Site. Although both are residential uses a mix of townhomes and apartments is preferred. Additionally, a development program consisting of 672 apartments is far too many units to be built in one phase and could take almost four years to absorb (based on absorption of approximately 15 units month). Likewise, 294 townhomes could take five years or more to absorb (based on absorption of approximately 14 units per quarter).

Both residential development scenarios (i.e. for sale townhomes and rental apartments) provide attractive returns; however, the investment strategy for each could be drastically different. For sale townhomes will provide a short-term return without the ability to realize upside in the future, while rental apartments could be held for a long-term investment or sold upon stabilization. That said, a development program that encompasses both product types could provide the benefits of both investment strategies while reducing the overall land basis in the project through development and sale of the finished lots for a homebuilder. Concurrently, the rental apartment development, once stabilized, could provide cash flow and allow for the realization of future appreciation in real estate prices.

According to Mike Henehan of Bozzuto and Steve Varga of Enterprise Realty, the ideal rental apartment development is currently between 250 and 300 units. A development of this size is developable in one phase and will be able to attract a wide pool of equity and debt sources. With that in mind, the rental apartment component will target 275 units. Based on a density of 32 units per acre, this portion of the
development will require approximately 8.5 acres. The remaining 12.5 acres should accommodate approximately 175 townhomes based on 14 units per acre.

SUMMARY

In summary, due to the relatively large size of the Martens Site, a mix of uses or product types is preferred. However, as illustrated above, the office and retail markets continue to struggle due to relatively low demand and ample supply. They are, therefore, not viable options for the project. However, both for sale townhomes and rental apartments offer viable development opportunities for the Martens Site. Based on the desire for a long-term investment the Martens Site will target a rental apartment development of 275 units which will allow the residual land to be developed into 175 townhome lots.
BUILDING AND SITE DESIGN

This section will summarize the site design, building design and the development team chosen to take the project from initial entitlements through construction and lease-up.

SITE DESIGN

In order to accurately determine the maximum feasible density for the Martens Site while maintaining a marketable layout, it was necessary to have a land planner work on the initial layout. The proposed layout, which was done by Steve Gang of Lessard Design, incorporates 275 rental apartments in 4 – 4 story buildings in addition to 175 townhomes which includes 96 – 20’ wide rear-load townhomes, 58 – 22’ wide front-load townhomes, and 21 – 20’ wide Moderately Priced Dwelling Units (see Exhibit A).

With a site this densely planned it is important to make sure that there is sufficient parking provided. As illustrated below over 700 parking spaces will be required for the Martens Site.

Figure 10: Parking Requirements for Martens Site

<table>
<thead>
<tr>
<th>Unit Type</th>
<th>Parking Required</th>
<th># of Units</th>
<th>Subtotal</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 BR - MPDU</td>
<td>0.625</td>
<td>14</td>
<td>8.75</td>
</tr>
<tr>
<td>1 BR</td>
<td>1.25</td>
<td>59</td>
<td>73.75</td>
</tr>
<tr>
<td>1 BR + Den</td>
<td>1.25</td>
<td>37</td>
<td>46.25</td>
</tr>
<tr>
<td>2 BR - MPDU</td>
<td>0.75</td>
<td>20</td>
<td>15</td>
</tr>
<tr>
<td>2 BR</td>
<td>1.5</td>
<td>89</td>
<td>133.5</td>
</tr>
<tr>
<td>2 BR + Den</td>
<td>1.5</td>
<td>56</td>
<td>84</td>
</tr>
<tr>
<td>Townhomes</td>
<td>2</td>
<td>175</td>
<td>350</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>711.25</td>
</tr>
</tbody>
</table>

With that said, the townhomes will meet their requirement with their built-in 2 car garage alone; however, additional parallel parking will be provided for visitors, etc. The multifamily portion of the Martens Site will require approximately 350 spaces which will all be provided with surface parking.
BUILDING DESIGN

As discussed above, the initial land plan will accommodate 275 rental apartment units within 4-4 story buildings. Based on conversations with Steve Gang of Lessard Design, the average unit size in a suburban market similar to Germantown would be 1,150 square feet based on a 40 percent – 60 percent split between one bedroom units and two bedroom units. Further, there would be one bedroom with den and two bedroom with den units to further diversify the unit mix. A summary of the unit mix and the gross and net square footage for each type of unit is provided below.

Figure 11: Unit Mix and Square Footage

<table>
<thead>
<tr>
<th>Unit Type</th>
<th>Net Area per Unit</th>
<th>Gross Area per Unit</th>
<th># of Units</th>
<th>Unit Mix</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 BR</td>
<td>816</td>
<td>960</td>
<td>66</td>
<td>24%</td>
</tr>
<tr>
<td>1 BR + Den</td>
<td>901</td>
<td>1,060</td>
<td>44</td>
<td>16%</td>
</tr>
<tr>
<td>2 BR</td>
<td>1,020</td>
<td>1,200</td>
<td>99</td>
<td>36%</td>
</tr>
<tr>
<td>2 BR + Den</td>
<td>1,126</td>
<td>1,325</td>
<td>66</td>
<td>24%</td>
</tr>
<tr>
<td>Total/Average</td>
<td>978</td>
<td>1,150</td>
<td>275</td>
<td>100%</td>
</tr>
<tr>
<td>Efficiency</td>
<td>85%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

DEVELOPMENT TEAM

In order to successfully execute the proposed development it is essential to have a competent development team in place. A summary of the major team players is included below.

Architect and Land Planner: The Sponsor has selected Lessard Design Inc. (Lessard) to act as the architect of record and the land planner for the Martens Site. The land planning will be done for the overall Martens Site; however, building architecture will only be necessary for the rental apartment building as the homebuilder will use their architecture. Lessard’s team will be led by Steve Gang, a principal with the firm. Lessard has worked on numerous other land planning projects and multifamily projects.
**Civil Engineer:** The Sponsor has selected Loiederman Soltesz Associates Inc. (Loiederman) to act as the civil engineer for the Martens Site. Loiederman will be involved in the engineering of the Martens Site in addition to the initial entitlement process. Loiederman has been active in Montgomery County development projects for over 20 years. Carlos Ostria and Phil Isaja will lease the Loiederman team for the proposed development project.

**Land Use Attorney:** The Sponsor has selected Lerch, Early, & Brewer Chtd. (Lerch Early) to serve as the land use attorney for the Martens Site. Robert G. Brewer, a principal with the firm, will lead Lerch Early’s team. Robby works on the critical components of major development projects including development applications, rezonings, special exceptions, site plans and subdivisions. Robby has been active in Montgomery County for over 30 years.

**Building Construction:** The Sponsor has selected Bozzuto Construction to act as the general contractor for the vertical construction of the rental apartment buildings. Bozzuto Construction was founded in 1988 and has built more than 19,000 multifamily units valued at over $2,000,000,000. Initial discussions with Bozzuto Construction were with Mike Henehan; however, a full team will be assigned to the proposed development project during the negotiation process.

**Site Construction:** The Sponsor has selected S.W. Rodgers Company Inc. (S.W. Rodgers) to act as the sitework contractor for the overall Martens Site. S.W. Rodgers, which was founded over 30 years ago, is a site development, heavy highway, utility and concrete contractor with offices in Gainesville, VA and Fredericksburg, VA. David Burns will be the primary contact for the Sponsor at S.W. Rodgers.
Management and Leasing: The Sponsor has selected Kettler Management to serve as the management team responsible for overseeing the day-to-day management and lease-up of the multifamily portion of the Martens Site. Kettler Management was founded over 30 years ago and currently manages over 18,000 rental apartment units of which 9,000 are managed for third-party clients.
FINANCIAL ANALYSIS

REVENUE SUMMARY

The Revenue Summary will examine the assumptions used on the revenue side of the analysis for the proposed townhome development and the proposed rental apartment development. Rentals rates, sales prices, operating expenses, Moderately Priced Dwelling Units, and absorption will be discussed.

Apartment Rental Rates: As discussed above, rental rates for comparable apartment projects in Germantown range from $1.34 per square foot to $1.57 per square foot. The most comparable project to the proposed Martens rental apartment project – The Pinnacle at Town Center – averages $1.57 per square foot. Additionally, The Pinnacle at Town Center was delivered in 2002 which will make the Martens rental apartment project more than 10 years newer when it delivers. Based on the survey of market comparables, the average rental rate at Martens is estimated to be $1.65 per square foot in 2012 which will escalate, based on a 3 percent escalation factor, to $1.78 per square foot by the time the project begins lease-up in 2013.

Townhome Lot Sales Prices: As discussed above, based on discussions with Brian Afnan, Land Manager for NVR, the lot sales prices for townhomes are estimated to be $155,000 for a 20’ wide townhome lot and $170,000 for a 22’ wide townhome lot. Additionally, according to Brian Afnan, it is typical to include a modest escalation clause which will result in fixed lot price increases of 3 percent. Based on the proposed layout discussed above, the townhome portion of the proposed development is anticipated to yield approximately 96 20’ wide townhomes, 58 22’ wide townhomes and 21 Moderately Priced Dwelling Units.
**Moderately Priced Dwelling Units:** According to the Montgomery County Department of Housing and Community Affairs, both the townhome and rental apartment sections of the Martens Site would require that 12.5 percent of the units are set aside as Moderately Priced Dwelling Units (MPDUs). MPDUs are reserved for residents who make no more than 65 percent of the median income of the Washington Metropolitan Statistical Area. The rental rates for MPDUs cannot exceed 25 percent of the gross monthly income.

**Figure 12: Maximum MPDU Rents for Garden Apartments – 2010**

<table>
<thead>
<tr>
<th>Unit Size</th>
<th>0 BR</th>
<th>1 BR</th>
<th>1 BR + Den</th>
<th>2 BR</th>
<th>2 BR + Den</th>
<th>3 BR</th>
</tr>
</thead>
<tbody>
<tr>
<td>Household Size</td>
<td>1</td>
<td>1.5</td>
<td>2</td>
<td>3</td>
<td>3.5</td>
<td>4.5+</td>
</tr>
<tr>
<td>a) MPDU Maximum Annual Gross Income</td>
<td>$47,000</td>
<td>$50,500</td>
<td>$54,000</td>
<td>$60,500</td>
<td>$64,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>b) Monthly Gross Income</td>
<td>$3,917</td>
<td>$4,208</td>
<td>$4,600</td>
<td>$5,042</td>
<td>$5,333</td>
<td>$5,833</td>
</tr>
<tr>
<td>c) 25% of Monthly Gross (rounded up to the next highest $5) = MPDU Rent</td>
<td>$980</td>
<td>$1,055</td>
<td>$1,125</td>
<td>$1,265</td>
<td>$1,335</td>
<td>$1,460</td>
</tr>
</tbody>
</table>

Source: Montgomery County Department of Housing and Community Affairs

In order to more accurately project future rental rate growth for the proposed rental apartment development, MPDU rents for 34 MPDU rental apartment units were assumed to be approximately 65 percent of market rate rents. The ratio was determined by averaging the current MPDU maximum rents for 1 bedroom, 1 bedroom and den, 2 bedroom, and 2 bedroom and den units and comparing the average to the rents projected for market rate units. Based on conversations with Brian Afnan regarding the MPDUs in the townhome portion of the development, 21 lots were set aside to be sold to NVR at $20,000 per lot.

**Absorption:** The absorption pace for rental apartment projects in the initial lease-up phase is a critical factor to getting the property stabilized. According to Delta Associates’ State of the Mid Atlantic Class A
Apartment Market report the average absorption pace for projects in initial lease-up is 16 units per month\textsuperscript{60}.

**Figure 13: Washing Metro Absorption Pace Per Project Per Month\textsuperscript{61}**

![Absorption Pace Per Project Per Month For Projects in Initial Lease-Up Washington Metro](image)

Source: Delta – State of the Mid Atlantic Class A Apartment Market

As illustrated above, the average absorption pace in the Washington Metro area ranges from 14 to 20 units per month. To remain on the conservative side, the absorption for the rental apartments was projected to be 15 units per month. Based on conversations with Brian Afnan, the absorption of townhome lots was estimated to be approximately 8 - 20' wide townhome lots per quarter, 5 - 22' wide townhome lots per quarter and 1 to 2 MPDU lots per quarter.

**Operating Expenses and Vacancy:** Operating expenses are estimated to be approximately $6,000 per unit per year upon stabilization. Prior to stabilization the taxes and common utilities will be lower which will result in a lower operating expense number of approximately $4,500 per vacant unit per year.
These operating expense estimates have been formulated based on discussions with Steve Varga, a local investment sales broker specializing in multifamily properties\(^6\). Based on his knowledge of the local market, he has recommended budgeting the numbers outlined above. A vacancy factor of 5 percent has been applied upon stabilization. As discussed above, the Germantown Class A apartment market boasts a vacancy rate of only 5.2 percent which is anticipated to remain stable or drop based on the constrained supply in the market.

**Reversion:** Based on conversations with Steve Varga, the terminal cap rate at the end of the development period (for analysis purposes only) was estimated to be 6.5 percent\(^6\). The terminal cap rate at the end of the 10 year holding period was estimated to be a little higher, due to age of the project and more historical norms, at 8.0 percent.

**LAND COST SUMMARY**

The land cost for the Martens Site is estimated to be $11,500,000 or approximately $10.00 per gross square foot based on the offering package and the current 2011 assessment of $10,524,000. The property, which is currently owned by the Martens Family Trust, is the last piece of their Germantown land holdings, which previously include the Fairfield Site and the Centex Site discussed earlier. As discussed above, the Martens Site will be developed with two distinct product types – townhomes and multifamily rental apartments. The development pro formas for the townhome section and rental apartment section of the Martens Site are attached hereto as Exhibits B and C respectively.

The townhome section will assume the burden of $8,000,000 of the $11,500,000 total land cost. Based on the Martens For Sale Townhome Pro forma the value of the townhome portion of the land is approximately $9,624,399 ($8,000,000 + $1,624,399) when discounted back at a 20 percent unlevered
discount rate. According to Steve Varga, President of Enterprise Realty Services, Inc. (a residential land and multifamily investment sales brokerage), a 20 percent discount rate is generally acceptable to purchasers actively looking for entitled and engineered townhome lots\textsuperscript{64}. Based on the discounted value, the plan is to sell the townhome section concurrently with the closing of the purchase of the overall Martens Site. With $8,000,000 assigned to the townhome section there is still potential “profit” possibility if the prospective purchaser uses a 25 percent discount rate instead of a 20 percent discount rate.

The multifamily rental section will assume the remaining burden of $3,500,000 of the total land cost. Additionally, it is assumed that the residual profits ($1,624,399) from the bulk sale of the townhome section will be used to further lower the land price attributable to the multifamily rental section of the proposed development to $1,875,601 ($3,500,000 - $1,624,399).

**SOFT COST SUMMARY**

Soft cost estimates for the townhome and multifamily section of the proposed development were compiled with the help of Russ Gestl, Executive Vice President of Buchanan Partners, LLC\textsuperscript{65}. Due to the close relationship of the two product types, the townhome section of the development is assumed to take on the burden of the engineering and entitlement costs for the entire project. Additionally, the townhome section will bear the burden of the overall plan submission and permitting fees as well as a majority of the site work bonding expenses.

**Architectural/Engineering/Design/Legal Land Use:** As discussed above, the engineering, design and legal land uses expenses are the costs necessary to entitle and engineer the entire Martens Site. Based on past experiences with Montgomery County development projects and discussions with Russ Gestl,
Executive Vice President of Buchanan Partners, LLC, it is anticipated that these costs will total approximately $1,000,000\textsuperscript{66}. This will include approximately $50,000 for initial land planning, $150,000 for legal land use fees, and $800,000 for engineering expenses. Again, the engineering, design and legal land use expenses for the townhome and multifamily rental section will be a cost attributable to the townhome section. The architectural expenses for the apartment section are estimated to cost approximately $700,000 – almost $2.25 per square foot.

**Permit/Submission Fees and Impact Fees:** The permit and submission fees for the overall Martens Site are estimated to be $400,000. These include the submission fees for the Preliminary Plan, Site Plan, Project Plan and Record Plat as well as the permits necessary for the site work. Again, the permit and submission fees for the overall Martens Site will be the responsibility of the townhome section of the development. The impact fees are expenses to be paid to Montgomery County by the multifamily section of the development for school impact fees and transportation impact fees. These impact fees are $7015 per market rate one-bedroom unit and $14,061 per market rate two-bedroom unit which totals $2,712,285\textsuperscript{67}. The impact fees for the townhome section are assumed to be a cost of the townhome builder and are not included as a part of this analysis.

**Project Overhead and Marketing:** The project overhead expenses are used for day-to-day costs like mileage reimbursements, meals, and other general expenses incurred by the development team. The marketing expenses are used for website hosting, event expenses and other general marketing expenses. The rental apartment pro forma has assumed $65,000 in total project overhead and marketing expenses and the townhome section has assumed $50,000 in project overhead and marketing expenses.
**Real Estate Taxes, Insurance, and Operating Deficit:** The real estate tax expenses and insurance are budgeted to cover the taxes and insurance prior to sale of the townhome lots or the initial lease-up period for the apartments. The operating deficit is budgeted for the rental apartments to cover utility expenses and other operating expenses prior to the initial lease-up period. The real estate taxes for the townhome section of the development are budgeted for $335,000 which is based on an estimated improved payment of approximately $135,000 which will phase out as lots are sold to the end purchasers. The insurance for the townhome section is estimated to cost $5,000 per year for four years or $20,000. The real estate taxes and insurance for the apartments are estimated at only $37,500 which is based on $12,500 every six months for the first eighteen month period before initial lease-up has commenced. Once the initial lease-up period has commenced the expenses are included in the operating expense estimates which are the first expenses to be paid by rental revenue. Similarly, the operating deficit for the rental apartments is estimated to cost $10,000 per quarter for five quarters in order to cover a portion of the expenses while the rental apartment building is still in the lease-up phase. The operating deficit is meant to act as an operating contingency.

**Bonding Expenses:** The bonding expenses for the townhome section of the proposed development are budgeted for $200,000 which is based on a $50,000 payment for four years. Typically, bonds would cover a portion of the overall site work for a shorter period of time; however, this assumes four years worth of carry for an average of $4,000,000 worth of site work outstanding at an expense of 1.25 percent. The bonding expenses for the rental apartment section are included in the general contractor package.

**Development Fees and Contingency:** The development fee is included to cover overhead expenses for the Sponsor. The rental apartment development fee is budgeted for 3.5 percent of hard costs or
$974,050. The townhome development fee is budgeted as a flat fee of $25,000 per quarter during the construction and sales period. The development fee for the townhomes is not included in the net present value analysis that was used to determine the bulk sales price to a homebuilder. There is a soft contingency of $250,000 for the rental apartment section and a hard cost contingency of 5 percent of hard costs, or $1,391,500. Additionally, there is a soft and hard contingency of 5 percent for the townhome portion of the development.

HARD COST SUMMARY

Hard cost estimates were compiled based on discussions with local contractors active in the metropolitan Washington DC region. S.W. Rodgers, Inc., a local site work contractor, helped with the site work estimates and Bozzuto Construction, a regional multifamily apartment contractor, helped with the vertical construction estimates for the rental apartment buildings.

Site Work: S.W. Rodgers, Inc. and Charlie Turner, Vice President of Land Design and Construction at Buchanan Partners, LLC, helped with site work estimates. Based on our discussions, the common site work for the entire Martens Site would cost approximately $2,500,000. The common site work would include construction of 2 lanes of Waters Road (with parallel parking), 4 lanes of Waterford Hills Boulevard, improvements to the existing stormwater management pond, and rough grading the entire Martens Site. The lot finishing costs for the townhome lots are estimated to cost $17,500 per lot to $22,500 per lot which includes private roads and alleyways, utilities (electric conduit, gas, water, and sewer), sidewalks, testing and inspections, stakeout, and landscaping. All remaining site work would be completed by the homebuilder. Based on the estimated range of pricing $20,000 per lot was budgeted. Additionally, $50,000 was budgeted for a tot lot/park area and a hard cost escalation factor of 3.5 percent was used.
Building Construction: The building construction costs were estimated based on discussions with Bozzuto Construction Company – a general contractor specializing in multifamily apartments. According to Mike Henehan with Bozzuto, four story wood frame apartment buildings with conditioned corridors and elevators would cost approximately $88 per square foot[^69]. This price includes bonding estimates and assumes the project will be surface parked.

EQUITY AND DEBT SUMMARY

Debt Summary: Although the capital markets are still somewhat challenging there are loans being made for well located apartment developments. According to Jon Mullen of Phillips Realty Capital, the two most viable options for a construction loan are banks or the Department of Housing and Urban Development (HUD)[^70]. Although HUD loans offer the convenience of a construction loan that rolls into a permanent loan they can take up to 18 months to close and include costly upfront fees. With that said, a local or regional bank is the most likely candidate for a construction loan of this size. Based on conversations with Jon Mullen, a construction loan for a project like the proposed rental apartment development would typically be 75% loan-to-cost (LTC)[^71]. Additionally, interest rates will float at approximately 200 to 250 basis points above LIBOR and will likely have a floor of approximately 4.5 percent. Typically a construction loan like this will be offered for a term of 2 to 3 years with 2 – 6 month options to extend and will require some recourse in the form of a personal guaranty. The development pro forma (see Exhibit C) assumes a construction loan of approximately $31,000,000 (approximately 80% LTC) with an average interest rate of 5.5 percent over the term.

As discussed above, the construction loan term will last 3 to 4 years which should allow the project to reach stabilization after lease-up. Once the proposed development is stabilized it will be an appropriate
time to take out the construction loan with permanent financing. Based on discussions with Phillips Realty Capital, permanent financing is available from two primary sources: (1) life insurance companies, and (2) government agencies (FNMA and Freddie Mac)\textsuperscript{72}. Both options are actively pursuing new loans and will offer non-recourse loans with the following terms:

- Loan-to-value: 75 – 80 percent
- Debt Service Coverage Ratio: 1.25X
- Rate: 5.5 percent
- Amortization: 30 years
- Term: 10 years

Based on the estimated terms above, the 10 year stabilized pro forma (see Exhibit D) assumes a $35,000,000 loan which will be approximately 65 percent LTV at a 6.5 percent cap rate and provide a DSCR of almost 1.50X.

**Equity Financing, Returns and Partnership Structure:** As discussed in the Land Cost Summary and Development Plan, the equity requirement is lowered due to a concurrent closing on the townhome portion of the development. This concurrent closing lowers the land basis significantly. The equity requirement of $8,500,000 will be required initially to fund approximately $1,250,000 worth of entitlement expenses which are attributed to the townhome development. As illustrated in the townhome lot development pro forma (see Exhibit B), the first 18 months worth of expenses – before closing on the land occurs – will need to be funded out of equity. In reality, the townhome development pro forma is solely used to determine a net present value for the townhome portion of the project so it can be sold off to a homebuilder. Once the townhome portion has been sold, the initial equity expenses
will be returned in addition to profits from the sale which can be used to lower the land basis to only $1,875,601.

Ideally, the rental apartment component of the proposed development will be held as a long-term investment. Due to the sponsor’s desire to create a long-term investment the most likely candidates are either: (1) an institutional equity source, or (2) wealthy individuals with a long-term focus. The proposed equity structure is a 90 percent – 10 percent equity contribution which will both earn a 10 percent non-compounding preferred return. All cash flow after return of equity and preferred return will be split 60 percent – 40 percent.

As illustrated in the development pro forma (see Exhibit C), with a sale at the end of stabilization the Sponsor will receive an internal rate of return of 104 percent and the investor partner will receive an internal rate of return of 35 percent. Additionally, the 10 year pro forma (see Exhibit D) is based on a recapitalization at the end of stabilization which will provide permanent financing of $35,000,000. This recapitalization will return equity of approximately $4,000,000 and leave $4,500,000 of equity in the long-term deal. Based on the reduced equity amount and a sale at the end of the 10 year period, the Sponsor will receive an internal rate of return of 80 percent and the investor partner will receive an internal rate of return of 43 percent. For additional information on profits and equity multiples please review the development and 10 year pro forma which are attached hereto.

Sensitivity Analysis: To analyze the impacts of an increased land price, increased interest rates, and increased construction costs a sensitivity analysis was completed on the multifamily development pro forma (see Exhibit F). Although increases in land prices, interest rates and construction costs clearly have an impact on the returns, the prospective development still appears viable.
DEVELOPMENT PLAN

The Development Plan section will discuss the development schedule and the risks associated with the proposed development.

DEVELOPMENT SCHEDULE

Based on conversations with various members of the development team (outlined in the Building and Site Design section above) a general development schedule was created (see Exhibit E). As illustrated on the development schedule attached, the proposed development project is estimated to take just over 3 years from the commencement of the entitlement process to delivery and approximately 4 ½ years from entitlements to stabilization. Once the project has been stabilized it will be recapitalized with permanent financing and held for a 10 year period.

The entitlement process in Montgomery County can be a very lengthy process. As discussed in the Land Use Analysis the proposed development will require a Project Plan, Preliminary Plan, Site Plan, civil engineering plans and a Record Plat. The Project Plan and Preliminary Plan, which can be processed concurrently, are the first plans submitted to MNCPPC and can take 9 months to get through the approval process. Following the Project and Preliminary Plans is the Site Plan. The Site Plan process can also take 9 months; however, once the Project and Preliminary Plan are getting close to their final form the Site Plan can be submitted for the first review. Finally, there is the Record Plat and engineering that needs to occur. Once the Site Plan is close to be finalized and the Project and Preliminary Plan are approved the Record Plat and engineering plans can begin to be processed. As shown on the Development Schedule they can take 9 months and 12 months respectively. Although each of these processes can take a significant amount of time they can be processed with some overlap to reduce the timeline. It is projected that the entitlement for the Martens Site will take 18 to 21 months.
Once the entitlements and engineering have been finalized the purchase of the Martens Site will occur. As a part of the purchase it is anticipated that a homebuilder will concurrently settle on the townhome section of the Martens Site which will reduce the overall land basis significantly. As discussed above, the extended period between execution of the sales contract and settlement will allow all of the engineering and entitlements to be completed. During this period, the Sponsor will enter into a contract with a homebuilder to help with the land plan for the townhome portion of the Martens Site.

Once settlement has occurred the overall site work for the Martens Site can be commenced. Although this is shown as an expense of the homebuilder (i.e. it is an expense shown on the townhome development pro forma) it will likely be managed by the Sponsor of the proposed multifamily rental development to ensure it is completed timely. The site work is estimated to take approximately 9 months; however, after 4 to 6 months building construction on the rental apartment building can begin. It is estimated that the building construction will take approximately 12 months to complete. Once the land has been purchased it will take approximately 18 months for the finished rental apartment building to be delivered.

Finally, the lease-up period is expected to take approximately 15 months (based on the absorption discussed in the Financial Analysis). Once the multifamily rental development has been stabilized it will be recapitalized with permanent financing and held for a 10 year period. In summary, from commencement of the entitlement process through development, lease-up and stabilization, the process is expected to take almost 5 years.
DEVELOPMENT RISKS

Similar to any development project the development of the Martens Site will not be without risks. That said, the necessary steps have been take to ensure that all risks have been mitigated to a reasonable level.

Entitlement Risk: As discussed in the Land Use Analysis above, the proposed development for the Martens Site will require approval by MNCPPC. Although there is always risk with a process that requires the approval of MNCPPC, the initial conversations with Rollin Stanley indicate that a densely planned site with multiple residential uses is desirable. There is the additional risk that MNCPPC will require a “true” mixed-use project that incorporates another asset class (i.e. retail). In the event this cannot be avoided a minimal amount of street level retail can be incorporated into the first floor of multifamily rental buildings. It is anticipated that the retail will be able to be incorporated without the loss of any retail density.

Financing and Interest Rate Risk: Although the capital markets have improved drastically over the past year or so, obtaining a construction loan and, ultimately, a permanent loan will remain a challenge. That said, LTC and LTV ratios for the construction and permanent debt were conservatively estimated at approximately 80 percent and 65 percent respectively. Additionally, historically low interest rates have served as a great benefit to many real estate projects over the past couple of years. If interest rates were to increase it could have a negative impact on the financial performance of the project (see Exhibit F - Sensitivity Analysis). As a risk mitigation technique it may be worth purchasing a swap on the construction loan interest rate. Although the DSCR on the permanent loan is projected to be more than sufficient at 1.50x an increased interest rate would reduce the net cash flow and negatively impact the IRR.
**Market Risk:** Although the market for townhomes and rental apartments appears to be favorable in both the immediate and near term, there is always a possibility that the market deteriorates prior to delivery in the next 4 to 5 years (see Sensitivity Analysis – Exhibit F). As a mitigation technique the townhome portion of the development will be sold off immediately which will leave only the rental apartment development. Although there is no way to fully mitigate the market risk, rental apartments typically outperform other commercial real estate asset classes in times of distress.

**Construction Cost Risk:** With any development project there is risk of increased costs during the construction period (see Sensitivity Analysis – Exhibit F). To adequately mitigate this risk the Sponsor has budgeted a hard cost contingency of 5 percent for both the townhome and multifamily developments in addition to a construction cost escalation factor of 3.5 percent for the townhome development. Additionally, the Sponsor will look to negotiate gross maximum price (GMP) contracts with the site work and general contractors.
CONCLUSION

In summary, it has been determined that the highest and best use for the Martens Site is residential. Although for sale townhomes appear to provide the best return on cost, it was determined that a single product program would be difficult to get approved during the entitlement process and would have far too long of a development and sale timeframe. Consequently, the development proposal reflects a mix of for sale townhomes and rental apartments which appears to provide above market returns based on the research and assumptions provided.
EXHIBIT A

PROPOSED LAND USE PLAN FOR MARTENS SITE
EXHIBIT B

TOWNHOME DEVELOPMENT PRO FORMA
EXHIBIT C

MULTIFAMILY RENTAL DEVELOPMENT PRO FORMA
<table>
<thead>
<tr>
<th>Marwan Rental Apartment Profesiona - Construction and Lease-Up Phase 4 &amp; 8 2011</th>
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<tbody>
<tr>
<td><strong>Unit</strong></td>
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<tr>
<td>----------</td>
</tr>
<tr>
<td>600</td>
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<td>800</td>
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<td>2,500</td>
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**Note:**
- The table represents rental prices for different unit sizes.
- Lease-up Phase 4 & 8 are ongoing projects.
- The total amount includes both monthly rent and site development costs.

**Additional Information:**
- Monthly Rent: $2,500 for 600 sq. ft.
- Monthly Rent: $3,200 for 800 sq. ft.
- Monthly Rent: $4,000 for 1,000 sq. ft.
- Monthly Rent: $4,800 for 1,200 sq. ft.
- Monthly Rent: $6,000 for 1,600 sq. ft.
- Monthly Rent: $7,000 for 2,000 sq. ft.
- Monthly Rent: $8,000 for 2,500 sq. ft.

**Notes on Lease-Up Phase:**
- Phase 4 & 8 are scheduled to be completed in Q4 2011.
- Lease terms start from Q1 2012.
EXHIBIT D

MULTIFAMILY RENTAL 10 YEAR PRO FORMA
## Martens Rental Apartment Proforma - 10 Year Run 4 28 2011

<table>
<thead>
<tr>
<th>FY</th>
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<td>Martens Rental</td>
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### Rental Income

- **Income**
  - **Residential:** $1,282,000

### Expenses

#### Operating Expenses

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</table>

### Financial Ratios

- **Return on Equity (ROE)**
  - FY2022: 15.3%

### Summary

- **Net Income:**
  - FY2022: $1,282,000

### Breakdown

- **Income Sources:**
  - **Residential:** $1,282,000

### Notes

- **Additional Notes:**
  - Income variations due to market conditions and projected growth.

---

This proforma provides a detailed financial overview for the Martens Rental Apartment, focusing on income, expenses, and key financial ratios over a 10-year period, starting from FY2022 to FY2032.
## DEVELOPMENT SCHEDULE

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<thead>
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<th>Description</th>
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EXHIBIT F

SENSITIVITY ANALYSIS – MULTIFAMILY DEVELOPMENT PRO FORMA

Land Price Increased to $3.0MM
Deal Level IRR 42%
Investor IRR 33%
Sponsor IRR 98%

Land Price Increased to $3.5MM
Deal Level IRR 41%
Investor IRR 32%
Sponsor IRR 95%

Land Price Increased to $4.0MM (additional equity of $500k)
Deal Level IRR 38%
Investor IRR 30%
Sponsor IRR 89%

Interest Rate Increased to 6.5%
Deal Level IRR 43%
Investor IRR 34%
Sponsor IRR 101%

Interest Rate Increased to 7.5%
Deal Level IRR 42%
Investor IRR 33%
Sponsor IRR 98%

Interest Rate Increased to 8.5% (additional equity of $500k)
Deal Level IRR 39%
Investor IRR 30%
Sponsor IRR 91%

Construction Costs Increased 2.5%
Deal Level IRR 43%
Investor IRR 33%
Sponsor IRR 100%

Construction Costs Increased 5.0% (additional equity of $500k)
Deal Level IRR 39%
Investor IRR 31%
Sponsor IRR: 92%

Construction Costs Increased 7.5% (additional equity of $1MM)

Deal Level IRR: 36%
Investor IRR: 28%
Sponsor IRR: 85%
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5 Sector Plan for the Germantown Employment Area: An Amendment to the Germantown Master Plan – The Maryland – National Capital Park and Planning Commission, Montgomery County Planning Department (see Detailed Bibliography)

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Conversations with Andy Klaff, Senior Vice President of Grubb and Ellis

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Delta – Washington Area Retail Outlook – Spring 2010 – Sponsored by The Rappaport Companies (see Detailed Bibliography)


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Conversations with Matt Shea, President of Hubert Construction

Conversations with Matt Locraft, Principal of KLN Retail

Conversations with Matt Locraft, Principal of KLN Retail

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Conversations with Steve Varga of Enterprise Realty Services

Conversations with Steve Varga, President of Enterprise Realty Services

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Conversations with Russ Gestl, Executive Vice President of Buchanan Partners, LLC

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Conversations with Mike Henehan of Bozzuto

Conversations with Jon Mullen of Phillips Realty Capital

Conversations with Jon Mullen of Phillips Realty Capital

Conversations with Jon Mullen of Phillips Realty Capital
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