**Alternative Investment -II**

**September 2024 Examination**

**Q1. Sarah, an investor, is evaluating the valuation of an apartment building on behalf of her company, Real Estate Investments Inc. She is tasked with conducting a thorough valuation of an apartment building using a capitalization rate of 12% via the Net Operating Income (NOI) methodology. Delving into the specifics, the apartment building comprises a total of 70 units, with 50 units currently leased at a monthly rate of $1,200 each. Additionally, each leased unit generates an additional annual income of $800. Operating expenses, which amount to 30% of the effective gross income, and a property management fee of 10% of the effective gross income, are crucial factors. Furthermore, the property bears a significant interest expense of $500,000. Moreover, a significant income tax rate of 40% applies to the property's financials. Sarah, as the investor, will utilize these details to compute the property's value utilizing the NOI approach with the provided capitalization rate on behalf of Real Estate Investments Inc. (10 Marks)**

**Ans 1.**

**Introduction**

Valuing real estate assets, particularly income-generating properties like apartment buildings, is crucial for making informed investment decisions. One widely recognized method for such valuations is the Net Operating Income (NOI) approach, which is pivotal in determining the property's worth based on its ability to generate income. In the context of Sarah's assignment at Real Estate Investments Inc., she is tasked with evaluating an apartment building's value using a capitalization rate of 12%. The building in question houses 70 units, with 50 currently leased, generating both rental and additional income.

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**Q2. Omega Capital, a well known PE fund house, runs a fund with a committed capital of $250 million, operates under the guidance of GP. The GP is ready to pay a 20% carried interest if the fund's Net Asset Value before distributions surpasses the committed capital. Omega Capital applies a management fee of 3% based on paid-in capital. Below is a table presenting the fund's capital calls and performance over the first 7 years of its existence.**

|  |  |  |  |
| --- | --- | --- | --- |
| **Year** | **Capital Called****Down ($M)** | **Operating****Results ($M)** | **Distribution($M)** |
| **1** | **70** | **-30** |  |
| **2** | **50** | **-12** |  |
| **3** | **30** | **5** |  |
| **4** | **20** | **70** |  |
| **5** | **20** | **80** | **40** |
| **6** | **10** | **100** | **80** |
| **7** | **10** | **155** | **120** |

**You are supposed to find paid-in capital, management fees, NAV before distributions, carried interest, and NAV after distributions for each of the 7 years. (10 Marks)**

**Ans 2.**

**Introduction**

Private equity (PE) funds, like Omega Capital, are investment vehicles that pool capital from investors to acquire stakes in companies or projects, with the goal of generating significant returns. These funds are managed by General Partners (GPs), who are responsible for making investment decisions and managing the fund's operations. A critical aspect of PE fund management is the structure of fees and incentives, particularly the management fee and carried interest. Management fees are typically charged as a percentage of the capital committed by investors and are used to cover the operational expenses of the fund. Carried interest, on the other hand, is a share of the profits earned by the fund, which is paid to the GP if certain performance

**Q3. The commodity and commodity derivatives instruments are used to diversify the portfolio risk and enhance the return for investors.**

**a) Explain the contrast between the valuation of commodities and that of equities and bonds. (5 Marks)**

**Ans 3a.**

**Introduction**

Commodities, as tangible assets like gold, oil, and agricultural products, play a vital role in diversifying investment portfolios and enhancing returns. Unlike equities and bonds, which represent ownership in companies or debt obligations, commodities have distinct valuation methods. The valuation of commodities involves factors such as supply and demand dynamics, geopolitical events, and market speculation. Understanding the contrast between the valuation of commodities and traditional financial instruments like equities and bonds is crucial for investors aiming to manage risk

**b) Explain how to mathematically value forward commodity derivatives using the Theory of Storage in real-life situations? (5 Marks)**

**Introduction**

The valuation of forward commodity derivatives is a crucial aspect of managing risks in commodity trading. The Theory of Storage, which links the spot price of a commodity to its forward price, plays a significant role in this valuation. This theory considers factors like storage costs, convenience yield, and interest rates. Understanding how to apply the Theory of Storage in real-life situations allows investors and traders to accurately price forward contracts and make informed decisions in the volatile