Blue Heaven Case Response

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Overview

The issue at hand regarding The Science and Technology Campus being developed by Blue Heaven Technology Partners, LLC (BHTP) is how to deal with several problems that have arisen since the developer was awarded the exclusive right to negotiate the acquisition and development of the site. These problems significantly change the cost, profitability, and risk profile of the project and need to be analyzed carefully to determine the appropriate course of action. In addition, key questions need to be answered about the initial financing arrangement for the project and whether or not the arrangement was fair and equitable to all parties when it was first negotiated.

Project Challenges

An initial review of the cash flow proformas in Appendix C and D (see Case) seems to indicate that Blue Heaven has been able to mitigate many of the ill effects resulting from the revised site plan. Although the additional cost of constructing the parking garage increased the cost per square foot for the entire project, BHTP is able to recoup some of these costs through parking fee revenue. Also, the Retail component of the project, which was generating the least amount of revenue ($30/sq. ft.), was eliminated, thus offsetting a reduction in Building 1 rents from $35/sq. ft. to $33/sq. ft. and resulting in a higher overall value ratio for the remaining spaces. These and other factors produced a leveraged internal rate of return (IRR) of 19.8% for the revised plan, just 2% less than that projected in the original plan. In a normal investment environment, the relatively small reduction in IRR would probably not be a 'show stopper' in terms of proceeding with the project per the revised site plan, especially given the fact that BHTP has already expended a substantial amount of cash to this point.

However, the contamination issue represents the biggest risk to the project, and its ramifications may not be adequately accounted for in the revised cash flow projection. The plan is for BHTP to reduce their offer price for the land from $8M to $6M and in return accept a small share of the remediation costs. Since these costs are unknown at this time, there is obviously some downside potential that still exists should the total figure balloon to much larger than expected. Table 1 shows the sensitivity of both unleveraged and leveraged IRR's to rising remediation costs (the existing proforma in Appendix D has included remediation costs as one line item titled 'Land + Contamination Costs'). Every $1M in unexpected remediation costs results in a 2% reduction in the leveraged IRR. Although these findings seem to indicate that IRR is not very

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sensitive to contamination costs, the fact that the total costs are still unknown, and that the Regional Light Rail Authority (Authority) unilaterally refuses to accept any responsibility, make the lower-return scenarios look more probable.

Sensitivity of IRR to Change in Land Price / Contamination Costs

Land Price + Contamination Costs	$6,000,000	$7,000,000	$8,000,000	$9,000,000	$10,000,000
Unleveraged IRR	15.40%	14.60%	13.90%	13.20%	12.50%
Leveraged IRR	19.80%	17.80%	15.80%	13.70%	11.80%

What to do?

One way for BHTP to approach the situation would be to limit their share of the remediation costs to a fixed amount, which would be included in the $2M reduction in land purchase price. While this would cap their risk, it would probably not be effective as a bargaining tool with the Authority. Saying that the developer will accept a maximum dollar amount in remediation costs, and then reducing the offer price on the land by the same amount, is essentially placing all risk back on the Authority. A better solution might be to explore other sources of funding to cover the remediation costs. There are many federal, state, and local programs that supply capital in the form of tax credits, grants, loans, and others to aid in cleaning up 'brownfield' sites. The City, which remains fully supportive of the project, could be a key ally in either providing funds directly, or facilitating arrangements with state and/or federal entities that administer similar programs. This could be a significant opportunity to turn a potentially bad situation into a successful public/private venture.

In the absence of a solid agreement for how the contamination issue will be resolved, BHTP should seriously consider withdrawing from the project. It appears that the best case scenario will net Blue Heaven a 19.8% return on equity, which is at the low end of the spectrum for a project of this nature. If BHTP were to withdraw from the project as a result of the Authority's intransigence on the contamination issue, they would have a case for bringing legal action against the Authority not only to recover cash costs invested but also to seek compensation for good-faith time and effort invested in the project. Blue Heaven won the exclusive right to negotiate with the Authority for the acquisition and development of the site. BHTP's original response to the RFP had made it clear that any contamination and related remediation costs would be the responsibility of the Authority. Unless the Authority specifically stated upon award that this point was not open to negotiation, either as a restatement of the RFP or as a new condition, a reasonable court should rule in favor of BHTP. Helping Blue Heaven's case is the fact that the land is currently owned by the Authority, which was either responsible

for contaminating the land or was at least in a much better position than BHTP to understand the environmental status of the property at the time of award.

Project Financing

The initial financing of the project also merits closer scrutiny. Mesa Real Estate Company (MREC) was brought in not only to provide debt and equity capital, but also to lend credibility to the proposal as a strong financial partner with knowledge of the local market. In return for its support, MREC was able to secure a very favorbale financial arrangement wherby they would receive 85% of the sale proceeds. While Blue Heaven may have felt these concessions were necessary for winning the initial right to negotiate, with the new developments and the change in the ground situation, it seems the focus of the project's viability has shifted away from the strength of the financial partner and more to the environmental concerns, thereby giving BHTP more latitude when negotiating a new financing structure. BHTP's recent discovery of a new (potential) financial partner that is willing to make the same commitment to the project as the original partner should serve as an opportunity to secure more equitable share in the proceeds from the project.

Conclusion

The major lessons learned from this experience are to 1) understand the circumstances and stipulations that are part of any award or contract, and 2) have a disciplined investment strategy that requires action before a situation becomes out of control.

BHTP expected a reasonable (6 month) negotiation period to conclude site acquisition and start construction, but found out early on that there were several obstacles to meeting this schedule. It is now 2 years later and they and their partners have continued to expend considerable time and money, yet they are no closer to resolving the major issue of contamination than they were on the day of award.

With the benefits of hindsight, BHTP should have set a firm date for themselves (less than 2 years) as the point in time to decide whether or not to withdraw from the project, based on their efforts to resolve the environmental issues.