

Case Study: Blue Heaven Science & Technology Campus

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Background

A regional light rail authority (“Authority”) in a large metropolitan area is involved in major extension of its services and is facing a funding shortage. The Authority has elected to raise additional funds from the sale or joint development of properties immediately adjacent to proposed light rail stations. One site under consideration is a 9.2-acre site adjacent to the Blue Heaven Station on its B-Line. The Authority issued a Request for Proposals (RFP) for development of the site by private developers, to include multi-modal transit facilities, 1,000 parking spaces for transit riders and appropriate related uses. In the RFP, the Authority suggested a price for the site of \$8 million and indicated a willingness to consider other proposals such as joint development.

The station is located on a busy line, with anticipated ridership of 38,000 passengers per day at its projected opening in 2003. The site is in an urban setting and offers an exciting opportunity to develop a variety of uses.

Current Use and Land Use Policies

Located at the southeast corner of Avenue Alpha and Boulevard Bravo in a prominent city, the site currently includes an historic building (a former company headquarters) with specially landscaped grounds, courtyard and pavilion, as well as various warehouses that were constructed during the period from 1958 to 1983. The former headquarters building and courtyard were designed by a noted architect and are listed on the National Register of Historic Places.

Proposals to develop the site needed to comply with City planning and zoning guidelines as well as other considerations included in the Specific Plan in preparation at the time the RFP was issued. Specific community issues relating to the subject site were to be appropriately addressed during the process of adopting that Specific Plan.

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Response to RFP

The opportunity to develop this particular site proved to be attractive to major developers. Steady growth in industry and population over recent years and the anticipated increase in activity resulting from the planned extension of light rail services made this an attractive opportunity for major local developers.

Allen Jeffries, an experienced developer, had spent the past year researching the space and facilities needs and the opportunities for the bioscience industry, and was convinced that this site offered special benefits for this “industry looking for a home”—especially given the number of prominent colleges, universities, research institutions and high-technology companies in the immediate and surrounding areas. He knew that the RFP competition would be tough, but was determined to be successful.

To respond to the RFP he put together a strong team of experienced architects, planners, engineers, and contractors, forming Blue Heaven Technology Partners, LLC (BHTP) as the entity to develop the site. Recognizing the critical need for a strong financial partner to add credibility to the proposal, Jeffries successfully negotiated financial participation and commitments with a prominent, reputable financial institution already actively involved in development in the same area.

BHTP put forth a proposal for a Science & Technology Campus (the Campus): a technology park including mixed-use office, technology, retail, and a multi-modal transit-parking center, with an emphasis on providing space and facilities to “incubate” and grow companies involved in the bioscience industry. The combination of experience, creativity, and strong financial backing won BHTP an exclusive right to negotiate with the Authority for acquisition and development of the site. Jeffries and his team were excited and optimistic—together they had prevailed against major competition!

The Science and Technology Campus

Development Concept

In making their proposal, BHTP placed great emphasis on the potential for synergetic linkages between existing universities, research organizations, and high-tech industries, creating excitement about the long-term potential for the City as the hub/core of bioscience industry in the region. At the same time the group worked closely with the City in adoption of their new Specific Plan, to insure positive reception and support from the City.

Their winning proposal included three major components:

A technology portion, consisting of research and development, laboratory and ancillary office spaces, targeted to firms active in biosciences and high technology activities as well as to the service businesses that support those industries. An important component of the technology portion was a new venture “incubator”. The incubator would provide early-stage biomedical and high technology companies with much needed research and development space, as well as value-adding business support services.

The retail portion included small-scale support retail shops that would service the needs of transit users, the tenants of the project, and the local community.

A parking structure serving the parking needs of both the transit users and the Campus tenants would be located on the southern portion of the site. It would also house the planned multi-modal transportation center—a transit facility designed to accommodate users arriving/departing via a variety of transit modes. It would be connected to the Campus by a landscaped, pedestrian-friendly piazza fronting ground level small-scale retail shops.

Development Strategies - Original Plan

Under the proposed concept, the detailed redevelopment and renovation strategies consisted of the following:

Restoration of the Former (Historic) Headquarters Building: The development team researched the history of the building and the work of the original architect. The team thoroughly understood the architectural and historical significance of the building and proposed to incorporate this knowledge into retention and restoration efforts.

Landscape Restoration: The development team located the original landscape contractor for the site and obtained the original plant material schedule. BHTP would retain the original landscape installation contractor and, as much as possible, adhere to the original landscape scheme.

Removal of Architecturally Non-Significant Space: The development team planned to remove warehouse space that was added after the original construction of the building but would not remove any architecturally significant space.

Office/Incubator/Laboratory Buildings: Two new five-story multi-use buildings would be constructed on the site. The first would be a five-story office, technology and biotech incubator building to be located on the northwest corner of the site. The building would be designed around a central, open-air courtyard and provide research

and development space appropriate for early stage companies in addition to more typical office space.

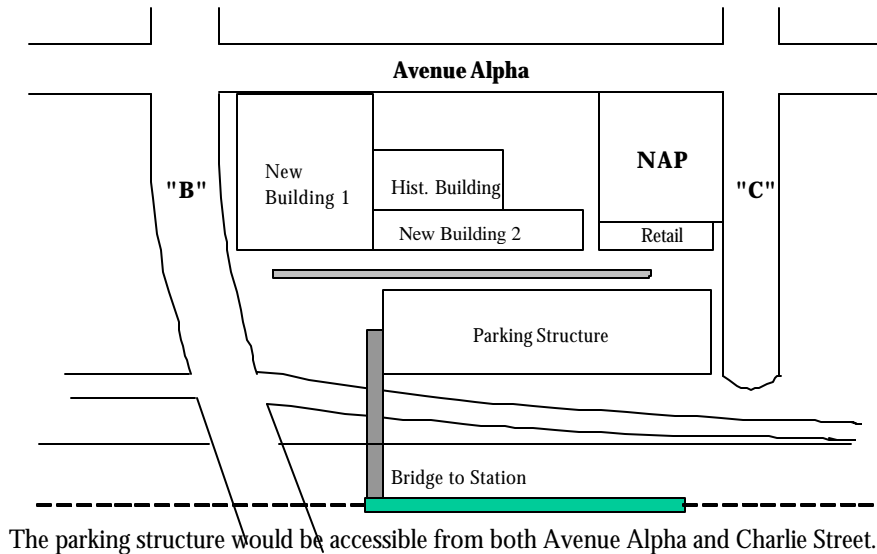
The second new building would also be a five-story, multi-tenant office and retail structure serving the same potential tenants and located immediately adjacent to the existing courtyard and pavilion. This second building would replace the southernmost, historically non-significant portion of the existing headquarters building. New retail structures would be located at the eastern and western portions of the site the vehicular entry points to the property. Proposed spaces are shown below and on the following page

Unit Type	GSF	RSF
New Building 1	286,000	271,700
Office/Tech Space	243,100	231,000
Incubator Lab Space	42,900	40,700
New Building 2	155,000	147,250
Historic Building	52,000	46,800
Retail	20,000	18,000
Total	513,000	483,750

The entire project would relate strongly to existing open space landscaping and the courtyard in the new building, all of which would be tied together to enhance the campus atmosphere of the redeveloped area.

Transit Area: In addition to the above spaces, the site would combine a charming environment with a safe and efficient transit area. The team proposed a design similar in concept to a large European transit center and gave careful consideration to pedestrian safety and access during the preliminary design process.

Original Site Plan



The parking structure would be accessible from both Avenue Alpha and Charlie Street.

The BHTC Team

Allen Jeffries is currently President of his own real estate development and service firm. He has nearly 30 years of experience as a developer, owner, and operator of commercial real estate. He has been directly involved in the planning and development of millions of square feet of office, R&D and industrial space throughout California. In addition, he has managed development of numerous hotel properties throughout the U.S. as well as developing, acquiring and overseeing an operating portfolio of more than 22,000 apartment units in the western U.S. Jeffries recently decided to re-enter the development business, and sees this project as an opportunity to re-establish himself and his company as significant players in the emerging bioscience industry.

Phil Torbell is a real estate consultant to the biomedical industry and its major trade organization. His primary objective is to facilitate the development of incubator and multi-tenant laboratory facilities.

Joe Maxwell is President of his own locally based firm, providing consulting and strategic planning for real estate. With nearly 30 years of planning and development experience, he has worked for many years in the City and with its Transportation Commission. He is a current member of the Light Rail Station Design Review Committee.

MREC

Mesa Real Estate Company (MREC), an affiliate of a major banking institution, expressed in writing its intent to provide the necessary capital and to act as a co-developer of the Campus. It is familiar with the local market and is currently developing a Corporate Park adjacent to the subject site. In return for its support, MREC negotiated a very attractive financial arrangement (See Appendix B). Given the absence of a current track record and their desire to establish BHTP as a viable player in the bioscience development world, Jeffries and his associates were agreeable to MREC's terms.

Financial Analysis

Current Market Situation and Potential Tenants

The local office market was quite good at the time the RFP was issued. The market rent for buildings similar in quality to proposed new buildings was estimated at \$33/s.f. In case of incubator lab space, rents went as high as \$51/s.f. due to strict construction requirements. Since the site is adjacent to a major station on the B-Line, there would be a large flow of pedestrian traffic during the day. This represented a real opportunity for convenience retail shops. The market rent for retail was estimated at \$30/s.f.

BHTP principals enjoyed a good relationship with both local real estate brokers, prospective tenants, and with local companies in the biotechnology industry. They expected to pre-lease a portion of the Campus to significant existing and new bioscience companies and their related supporting companies.

Financial Proposal by the Developers

The total project cost for the proposed development of the Campus was estimated at approximately \$94 million or \$184 per square foot. (See Appendix A) Of this total, \$23.5 million (25%) was anticipated to be provided as equity arranged or provided by MREC, with the remaining \$70.5 million (75%) to be provided in the form of debt arranged and/or provided by MREC. BHTP would pay the \$8 million asking price for the property and be responsible for all design and construction, but required the Authority to pay for construction costs of the parking structure.

A Successful Proposal, But...

After a brief but intensive period of proposals and discussions, and thanks to a creative, thorough proposal with strong financial backing by MREC, BHTP won exclusive rights to negotiate for acquisition and development of the site. The City strongly supported their proposal. BHTP expected a reasonable (6 month) negotiation period to conclude site acquisition and to then start construction.

However, a variety of developments following the initial award of exclusive negotiating rights has resulted in significant delays (adding up to over 24 months) and there is still no signed purchase and sale agreement! As a result, BHTP is confronted with the following serious problems:

In the original plan, BHTP proposed building a joint parking structure in which the parking spaces were to be shared between private and public users. Following extensive negotiations subsequent to the RFP award, the Authority has decided to retain land and responsibility for construction and operation of a transit-related parking structure. BHTP has revised their plans to provide for their own parking structure of 336,000 square feet. These revisions have added 6 months to the construction period.

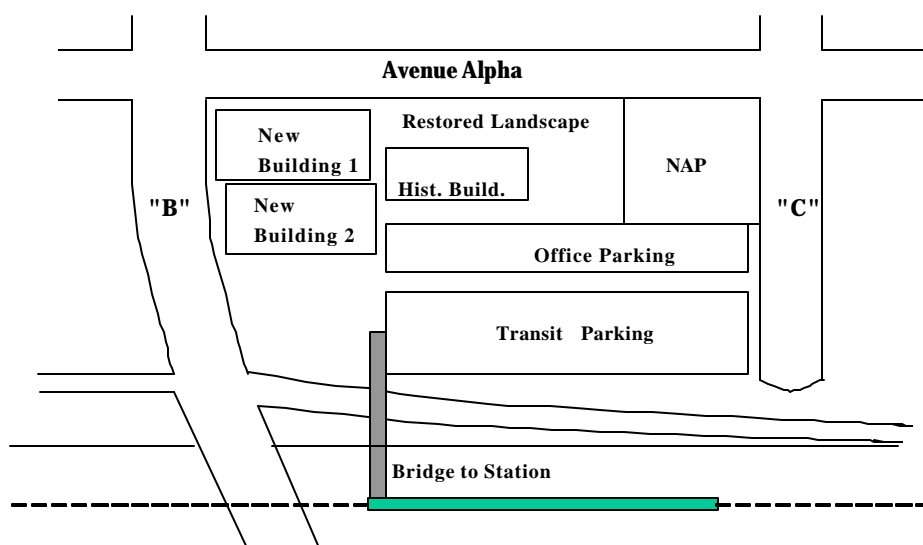
A second and more serious issue involves discovery of contamination on the site. BHTP's original response to the RFP made it clear that any such contamination and related remediation costs (known or unknown) would be the responsibility of the Authority. However, the Authority has unilaterally refused to accept such responsibility. The extent of and costs for remediation of existing contamination are unknown at this time. BHTP has suggested that it would accept a limited amount of such costs, with the balance to be borne by the Authority. BHTP is still attempting to negotiate with the Authority, but is making little or no progress.

The final problem is that the original financial partner, MREC, has informed BHTP that they will no longer be able to participate in the project because of deterioration in the real estate market after the events of 9/11/01 (Following the events of 9/11, most institutional investors reduced their investment in real estate due to falling stock market prices, and funds for new investments seem to be frozen). BHTP now needs to find a new financial partner and is presently negotiating with institutional investors showing limited interest.

In an effort to salvage the personal time and monies invested in the project, BHTP has prepared a revised plan in which it has reduced the overall scale of the development project to accommodate Authority's separate parking structure. The changes include reduction in the amount of proposed office space, elimination of the retail portion of

the plan, and the addition of a separate parking structure for office users. To account for the added costs of constructing a new parking structure and a small share of contamination remediation costs, BHTP expects to pay less for the land. Specifics of the new plan are shown below. The cost estimation based on revised plan is shown in Appendix C.

Revised Site Plan



Unit Type	Revised GSF	Revised RSF
New Building 1	158,000	150,100
New Building 2	158,000	150,100
Headquarters Building	30,000	27,000
Retail	-	-
Parking Structure	1,200 spaces	1,200 spaces
Total	346,000	327,200

Decision Time

While “negotiations” between two parties continue, there has been no recent progress. In addition to cash expenditure totaling over \$400,000, none of the partners or principal consultants to BHTP have been compensated for their time, looking instead to their share of profits from this and future ventures. On the Authority’s side, the passage of time has changed the make-up of its Board of Directors.

Recently, Jeffries found a (potential) new financial partner of similar institutional stature that is willing to make the same commitment to the project as the original partner. There is nothing yet in writing. The City remains fully supportive of the project.

Several questions need to be addressed:

1. How should BHTP respond to the cost and profit implications of the revised site plan?
2. How should BHTP approach resolution of the contamination and remediation issues with the Authority?
3. Should BHTP withdraw from the project?
4. If BHTP withdraws as a result of the Authority’s intransigence on the contamination issue, should it bring legal action against the Authority to recover cash costs (\$400,000+) invested as well as compensation for good-faith time and effort invested in this project?
5. What are the “lessons learned” from this experience?
6. Would you be willing to accept the MREC financing proposal in the same situation?

Appendix A

Development Cost Analysis (Original)	
Site Acquisition Cost	\$8,000,000
Hard Costs	
Demo & Site Prep	\$2,292,000
New Bldg 1 Core & Shell	\$23,570,000
New Bldg 2 Core & Shell	\$11,940,000
Retail Space Core & Shell	\$1,539,000
Stuart Building Rehab	\$2,709,000
Landscape & Hardscape	\$1,914,000
Tenant improvements	\$23,011,000
Subtotal	\$66,975,000
Soft Costs (except financing costs)	
Arch & Eng'g	\$3,135,000
Legal, Title	\$1,388,000
Permits & Fees	\$1,005,000
Marketing & Leasing	\$5,605,000
Project Management	\$2,086,000
Others	\$6,000,000
Subtotal	\$19,219,000
TOTAL PROJECT COST	\$94,194,000
	GSF 513,000
	\$ per SF \$184

Appendix B: Consolidated Cash Flows (Original Plan)

		Year 01	Year 02	Year 03	Year 04	Year 05
Absorption (% Cumulative)	RSF					
Building 1	271,700			30%	60%	100%
Building 2	147,250		25%	60%	100%	100%
Retail	18,000		75%	100%	100%	100%
Historical Building	46,800		25%	60%	100%	100%
	483,750					
Income						
Building 1	35			2,852,850	5,705,700	9,509,500
Building 2	33		1,214,813	2,915,550	4,859,250	4,859,250
Retail	30		405,000	540,000	540,000	540,000
Historical Building	33		386,100	926,640	1,544,400	1,544,400
Potential Gross Income			2,005,913	7,235,040	12,649,350	16,453,150
Vacancy Allowance	5%		(100,296)	(361,752)	(632,468)	(822,658)
Effective Gross Income			1,905,617	6,873,288	12,016,883	15,630,493
Expenses:						
Operating Expenses	35%		(666,966)	(2,405,651)	(4,205,909)	(5,470,672)
Net Operating Income			1,238,651	4,467,637	7,810,974	10,159,820
Hard Cost Spending (%)	GSF					
Building 1	286,000		50%	50%		
Building 2	155,000	25%	75%			
Retail	20,000	75%	25%			
Historical Building	52,000	25%	75%			
Weighted Spending	513,000	13%	59%	28%		
Soft Cost Spending (%)		50%	30%	20%		
Construction Costs						
Land	8,000,000	(8,000,000)				
Hard Costs	66,975,000	(8,714,583)	(39,590,972)	(18,669,444)		
Soft Costs	19,219,000	(9,609,500)	(5,765,700)	(3,843,800)		
Total Construction Costs	94,194,000	(26,324,083)	(45,356,672)	(22,513,244)		
Disposition						
Gross Sales Proceeds					119,527,296	
Sales and Closing Costs					(4,781,092)	
Net Sales Proceeds					114,746,204	
Unleveraged Cash Flow		(26,324,083)	(44,118,021)	(18,045,607)	122,557,177	
Unleveraged IRR	16.5%					
Construction Loan		Totals				
Construction Loan Draw	75%	70,645,500	19,743,063	34,017,504	16,884,933	
Principal Repayments						(70,645,500)
Loan Outstanding			19,743,063	53,760,567	70,645,500	
Origination Fees and Costs	1.5%		(1,059,683)			
Interest Expense	8%	(17,183,570)	(1,579,445)	(4,300,845)	(5,651,640)	(5,651,640)
Net Cash Flow from Financing			17,103,935	29,716,659	11,233,293	(76,297,140)
Leveraged Cash Flow		(9,220,148)	(14,401,362)	(6,812,314)	46,260,037	
Leveraged IRR	21.7%					
Distribution of Proceeds						
MREC	85%		(9,220,148)	(14,401,362)	(6,812,314)	39,321,032
BHTP	15%					6,939,006

Appendix C

Development Cost Analysis (Revised Plan)	
Site Acquisition Cost	\$6,000,000
Hard Costs-Building	
Demo & Site Prep	\$2,054,000
New Bldg 1 Core & Shell	\$12,400,000
New Bldg 2 Core & Shell	\$12,400,000
Stuart Building Rehab	\$1,885,000
Landscape & Hardscape	\$1,444,000
Parking Structure	\$10,080,000
Tenant Improvement	\$9,675,000
Subtotal	\$49,938,000
Soft Costs	
Arch & Eng'g	\$2,683,000
Legal, Title	\$710,000
Permits & Fees	\$832,000
Marketing & Leasing	\$3,654,680
Project Management	\$1,558,508
Others	\$3,500,000
Subtotal	\$12,938,188
TOTAL PROJECT COST	\$68,876,188
	GSF
	346,000
	\$ per SF
	\$199

Appendix D: Consolidated Cash Flows (Revised Plan)

		Year 01	Year 02	Year 03	Year 04	Year 05
Absorption (% Cumulative)	RSF					
Building 1	150,100			30%	60%	100%
Building 2	150,100		25%	60%	100%	100%
Historical Building	27,000		25%	60%	100%	100%
Parking (spaces)	1,200		30%	60%	80%	100%
Income						
Building 1	33			1,485,990	2,971,980	4,953,300
Building 2	33		1,238,325	2,971,980	4,953,300	4,953,300
Historical Building	33		222,750	534,600	891,000	891,000
Parking (spaces)	1,200 /car/year		432,000	864,000	1,152,000	1,440,000
Potential Gross Income			1,893,075	5,856,570	9,968,280	12,237,600
Vacancy Allowance	5%		(94,654)	(292,829)	(498,414)	(611,880)
Effective Gross Income			1,798,421	5,563,742	9,469,866	11,625,720
Expenses:						
Operating Expenses	35%		(629,447)	(1,947,310)	(3,314,453)	(4,069,002)
Net Operating Income			1,168,974	3,616,432	6,155,413	7,556,718
Hard Cost Spending (%)	GSF					
Building 1	158,000		50%	50%		
Building 2	158,000	25%	75%			
Historical Building	30,000	25%	75%			
Parking (spaces)	336,000	75%	25%			
Weighted Spending	682,000	44%	45%	12%		
Soft Cost Spending (%)		50%	30%	20%		
Construction Costs						
Land	6,000,000	(6,000,000)				
Hard Costs	49,938,000	(21,893,639)	(22,259,754)	(5,784,607)		
Soft Costs	12,938,188	(6,469,094)	(3,881,456)	(2,587,638)		
Total Construction Costs	68,876,188	(34,362,733)	(26,141,210)	(8,372,245)		
Disposition						
Gross Sales Proceeds					88,902,565	
Sales and Closing Costs					(3,556,103)	
Net Sales Proceeds					85,346,462	
Unleveraged Cash Flow			(34,362,733)	(24,972,236)	(4,755,813)	91,501,875
Unleveraged IRR	15.4%					
Construction Loan	Totals					
Construction Loan Draw	75%	51,657,141	25,772,050	19,605,908	6,279,183	
Principal Repayments						(51,657,141)
Loan Outstanding			25,772,050	45,377,958	51,657,141	
Origination Fees and Costs	1.5%		(774,857)			
Interest Expense	8%	(13,957,143)	(2,061,764)	(3,630,237)	(4,132,571)	(4,132,571)
Net Cash Flow from Financing			22,935,429	15,975,671	2,146,612	(55,789,712)
Leveraged Cash Flow			(11,427,304)	(8,996,565)	(2,609,200)	35,712,163
Leveraged IRR	19.8%					
Distribution of Proceeds						
MREC	85%		(11,427,304)	(8,996,565)	(2,609,200)	30,355,338
BHTP	15%					5,356,824

