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Hot Brokers 2003

Part 2



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Vulcan Balances Community Service, Financial Gain

By Dana Dubbs

Seattle—Not many developers are as focused on whether their projects are the right thing to do and the best thing for the community and environment as they are on financial return. But not many developers come out of the computer community, which is known for that sort of thinking. That makes Paul Allen, co-founder of Microsoft Inc., a unique player in commercial real estate.

"We are about place-making, and we're about being a visionary," said Ada Healey, who manages Allen's land and property holdings as vice president of real estate for his investment company, Vulcan Inc. "We're about taking places that have a huge amount of potential, that really have been under-invested in

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Vulcan Inc. vice president of real estate Ada Healey (r.) and director of real estate development Jim Mueller have kicked the firm's real estate strategy into higher gear, adding more staff so it can pursue more projects on its own.

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Place-making, Vulcan Style

Healey Finds Value for Seattle Developer In Creating Places Where People Want to Be

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and (whose) values have not been recognized by the community at large. As a result, the team I have in place is encouraged to think very broadly, to think out of the box, to think about driving value through creating a place that people want to be. And that is much more sophisticated and much more challenging than just building a box."

And challenging it is, because while Vulcan's myriad endeavors and initiatives seek to improve the way people live, work, learn and play, they are also businesses. Billionaire Allen founded Vulcan in 1986 to manage investments and holdings in such entities as the Portland Trail Blazers basketball team, the Seattle Seahawks football team, the Experience Music Project and six Paul G. Allen Foundations.



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"The idea that you can make money, you can do well and do good at the same time really is one of the things that drives not just the real estate activity but even our investment activity here," said Bill Savoy, president of Vulcan's portfolio and asset management division, of which real estate is a part.

Vulcan's real estate portfolio is a relatively small portion of the company's holdings, but rich with potential. It totals 100 acres and is valued at about \$500 million. Holdings are concentrated in the Pacific Northwest, with most in urban infill locations and lacking finished product.

The most notable portion, in South Lake Union—a neglected, funky, largely light-industrial part of Seattle with a burgeoning biotechnology cluster—encompasses 50 acres, roughly 25 to 30 percent of the neighborhood by Vulcan's calculations. Vulcan is underway with a massive redevelopment effort on those 50 acres, a jaw-dropping first step in Allen's desire to start turning his land holdings into income-generating property.

The company kicked its real estate strategy into high gear in November 2001, when it wooed Healey away from Clarion Partners, where she had been for 10 years, and charged her with turning its land, most of which it acquired in relation to its business endeavors, into income-producing property. She was expected to do it as quickly and efficiently as possible, and with the same amount of fiscal rigor

pension fund clients expect from Clarion.

When Healey arrived, Vulcan's existing real estate group consisted of two people: Jim Mueller, now director of real estate development, and Hamilton Hazlehurst, now one of Vulcan's real estate development managers and the firm's sustainable development, or "green," guru. They were beginning to move forward with the South Lake Union project and had engaged different development partners to help breathe life into Vulcan's plans.

Schnitzer Northwest, for example, is Vulcan's joint-venture partner on Interurban Exchange, a three-block project planned to comprise four new buildings totaling more than 500,000 square feet of biotech and Class A office space; a 14,000-square-foot tenant amenity building, including a state-of-the-art conference center and fitness facility; a 24,000-square-foot landscaped public plaza; and parking.

Milliken Development Corp. is Vulcan's partner on 2200 Westlake, a 506,000-square-foot mixed-use complex planned with a retail base, Class A office space, two towers of residential condominiums and parking. Tower Properties and the Seattle Biomedical Research Institute are Vulcan's partners at 307 Westlake, a five-story, 112,000-square-foot biomedical research building to be shared by Seattle Biomedical and the Children's Hospital and Regional Medical Center. Construction on 307 Westlake started last November and is slated for completion in spring 2004.

But while Vulcan had generally sought joint-venture partners to share in its development efforts, Healey has decided that her group will develop some projects themselves. As reasons for the decision, she cited the size of Vulcan's holdings, the complexities of meeting its triple-bottom-line criteria of community, environment and financial return, and uncertainty about whether every potential partner would embrace Vulcan's goals as wholeheartedly as Vulcan does.

To be able to go it alone, she expanded her staff. Her group now numbers 12 seasoned professionals, and she plans to hire five more this year. Collectively, they have expertise in real estate investment, development, asset management,

financing, leasing and marketing, with top managers drawing on their years at Cushman & Wakefield Inc., Koll Development (as well as the former Koll Real Estate Group), Wright Runstad and Norris, Beggs & Simpson. They have won praise from the local real estate community, particularly from those who know them.

"Vulcan has brought in people from the various disciplines of the development business who are considered to be among the tops in their trades from the Seattle area," said David Alexander, president of Alexander Commercial Real Estate, which has worked with Vulcan or represented tenants moving into their buildings on various brokerage deals. "They're good people, they're very positive, they're very creative, and they're extremely hard-working."

"They are a dynamic team focused on a strategy that is unique in Seattle's real estate, and because of that they have been able to assemble a team of people that are best in class," said Ann Klein, principal at Trammell Crow Co. Since last July, Trammell Crow has been handling property management at Vulcan's headquarters and Vulcan properties not currently under development in South Lake Union.

High Expectations

Healey has high expectations for her team despite the current tough economic climate. "In terms of a return on cost out of the box, we're looking at low double-digit returns (10 to 12 percent)," she said. "In terms of a long-term IRR, it's going to be mid- to high teens to low 20s (15 to 22 or even 25 percent, depending on product type)."

Other than some properties outside the Northwest that lack strategic importance and do not add value to the portfolio, however, the company does not plan to sell its projects anytime soon. "As a general matter, we are a long-term holder and a long-term investor," said Healey.

To fund its development, Vulcan aims to leverage construction projects at 75 to 80 percent loan-to-cost. The company does not disclose actual financing terms, but did say it is getting rates between 100 and 150 basis points below pro forma.

It also has access to capital internally. Vulcan's real estate group meets quarterly with an internal investment committee to review strategies and specific development plans, and obtain authorization for new capital expenditures. It is not constrained by specific annual capital allocations. "The nice thing about the way we're set up as a company is we have capital available to us for good transactions," said Mueller. "We have the luxury of being able to design a good transaction and then execute it without really worrying about having to capitalize it because we know the capital's available."

While South Lake Union comprises 50 percent of Vulcan's land holdings, they also include 20 acres along the Lake Washington shoreline in Renton, Wash., that were acquired through an affiliate; eight acres in Renton that the company purchased as a potential headquarters site for itself; a 575,000-square-foot business park in Issaquah, Wash., that it also bought as a possible campus for itself but instead leased to Microsoft; six acres adjacent to the Rose Garden in Portland, Ore., where Allen's Trail Blazers play; and the building Vulcan eventually developed as its headquarters in January 2001—a

Billionaire investor and Microsoft Inc. co-founder Paul Allen believes in doing good while he does well. His investment company, Vulcan Inc., aims to make money while improving the way people live, work, learn and play.



300,000-square-foot facility near Seattle's Seahawks Stadium.

Vulcan is tight-lipped about how it might develop its land outside South Lake Union, although management made it clear those plans will be guided by Allen's desire to be a positive influence in the world and the real estate group's triple-bottom-line goals.

The South Lake Union project, though, wins high marks among Seattle real estate players. "Brilliant" is how Jim Bowles, senior managing director at CB Richard Ellis in Seattle, described the strategy. "They've got credibility," he said. "And in our market today, that's a terrific attribute. There are plenty of people that would like to build buildings but simply aren't able to because they can't get financing, they can't get the tenant, they don't have the land, they can't get zoning. Just myriad issues, little speed bumps, any one of which can cause a problem. But (Vulcan has) the resources, they've got the property, they're smart enough, they're competitive enough that they're doing a good job."

While other development is taking place in the Puget Sound region, nowhere else in the area is a single organization attempting a project of South Lake Union's magnitude—in scale, scope, impact, quality of tenants or size of leases. The project's dominant landlord has a development capacity there of 10 million square feet, of which 500,000 is now under construction, with another half million planned. Tucked between Seattle's downtown business district and the southern shore of Lake Union, the community is on Vulcan's drawing boards to become a lively, artsy, pedestrian-friendly neighborhood blending scientific research facilities and office space with housing, retail, restaurants, nightlife, cultural amenities and open space.

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That may take awhile to evolve. Seattle's office vacancy rate has risen from the low single digits a couple of years ago to 14.6 percent in the fourth quarter of 2002, according to Colliers International, and some other developers have sidelined their plans in response. The city has been hurt by such losses as Boeing Corp.'s decision to move its headquarters to Chicago in 2001 and the general technology malaise since 2000.

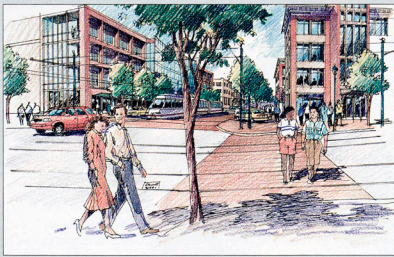
However, there is growth in the biotechnology sector on which Vulcan is focused. Furthermore, the city of Seattle has initiatives planned that are expected to encourage growth in South Lake Union, including improvement of its power grid, streets, transportation infrastructure and waterfront. Overall redevelopment in the area is expected to attract 17,000 new jobs and result in 8,000 new housing units by 2020, according to city estimates.

Meanwhile, Vulcan's build-to-suit approach should keep it from outpacing the market.

As it moves forward with the South Lake Union project, Vulcan continues to buy small parcels of land on an incremental and opportunistic basis, provided they complement its strategy. It might, for example, buy the rest of a block where it already

owns two-thirds or purchase a piece of property for an existing tenant with a need it is not able to fulfill with space it already owns. However, it has no major acquisitions on its radar screen. For now, said Healey, Vulcan has enough critical mass that it is content to develop what it owns, inside and outside South Lake Union.

Vulcan Forges a Neighborhood



Vulcan Inc. has such command of Seattle's South Lake Union, it is hard to believe the firm's presence there had inadvertent beginnings. Yet that's the way it happened. In the early 1990s, Paul Allen lent an estimated \$20 million to a grassroots effort that wanted to create an 80-acre park in the area. The money was used to buy land that would fall within the footprint of that park, dubbed the Seattle Commons. But the Commons was a public-private effort, and it failed to pass muster with voters. Allen, the largest creditor to the effort, wound up with 10 acres in South Lake Union on his hands.

"We realized that what we had at that time was a concentration of real estate in the South Lake Union area, but not quite a critical mass to actually influence some of the other trends that we were observing," said Bill Savoy, president of Vulcan's portfolio and asset management division, which includes real estate. One of those trends was city fathers trying to reverse a decade-long exodus of residents to the suburbs. Another was an expanding presence of biotechnology and biomedical businesses—a new class of business moving into the area, and one that likes to set up shop in clusters, needs laboratory space and is not well suited to office towers in a CBD.

"That really was the seeds, if you will, that resulted in the recognition that if we added to the collection of real estate that we had from the Commons effort we could actually have a significant influence in both of those trends that we saw emerging in the Seattle marketplace," said Savoy. Vulcan will not disclose costs, but Ada Healey, vice president of real estate, confirmed the company spent more than \$200 million expanding its holdings in South Lake Union to the 50 acres it has there today.

Seattle's double-digit vacancy rate has not deterred Vulcan from its plans, mostly because it is focused on building scientific research and

laboratory facilities—a type of space in strong demand and for which there are limited available options. It also helps that an illustrious list of life science businesses—such as the Fred Hutchinson Cancer Research Center, the University of Washington, Immunex, ZymoGenetics and Harborview Medical Center—already occupy the area and are bound to attract more such tenants.

And tenants are moving into Vulcan's space. Not only will the Seattle Biomedical Research Institute and Children's Hospital and Regional Medical Center be moving into Vulcan's new building at 307 Westlake, pharmaceutical giant Merck & Co. signed a lease last July—the largest inked in Seattle since March 2001—to put subsidiary Rosetta Inpharmatics into an entire 133,173-square-foot building at Interurban Exchange. And the University of Washington School of Medicine moved into a building Vulcan renovated for it in 1999, and is in negotiations to lease another Vulcan property, a 100,000-square-foot, four-story building at 815 Mercer St. that Vulcan will renovate to provide wet and dry labs.

Vulcan is also moving forward with Class A office buildings, although only when it leases enough space to merit development. In January, architecture firm NBBJ announced an agreement to start negotiating a lease for 85,000 square feet of space in a 400,000-square-foot, mixed-use complex that it will design in South Lake Union for joint-venture partners Vulcan, Harbor Properties and PEMCO Insurance.

"I'm incredibly impressed," said Jim Bowles, senior managing director at CB Richard Ellis Inc. in Seattle. "Our vacancy rates today in the area are pretty high, and they have been able to draw some really significant tenants to their projects. That probably speaks to the quality of the projects, but also speaks to the quality of their development and their marketing."

"What they're really doing is hitting the niches that are hot right now," said Tom Abbott, senior director at Cushman & Wakefield of Washington Inc. "Two or three years from now, when your more typical office demand comes back from tenants, they're going to be positioned to take advantage of that. The scope of the project allows them to take advantage of what is needed in that area at this point in time."