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Newmark Tower Case Study

SEATTLE, WASHINGTON

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SEPTEMBER 3, 2013

Introduction

This case study highlights how the developer, Intrawest, managed 'risk' in this project and how important this became as unforeseen circumstances triggered a series of events that could have seriously impacted the financial underpinnings of the company. At the time, Intrawest did not have the balance sheet to withstand the financial events that occurred with this project. Structuring the transaction with an outside third-party equity provider and securing non-recourse financing proved extremely important and provided the basis that allowed the company the ability to stay with the project through completion.

Project Background

The Newmark Tower, located on the southwest corner of 2nd Avenue and Pike Street, occupies the site of a former J.C. Penney department store, once one of the chain's largest. This J.C. Penney location was in operation from 1930 to 1982, at which point it ceased operations. After attempting, with then-Mayor Charles Royer, to keep J.C. Penney downtown, developer Intrawest tied up the property, completed a feasibility study, and gained control of the vacant building.

Newmark and adjacent Pike Place Market (right) and Russell Investments Center (left), as seen from 2nd and Pike

Drawing on the success of its Arbor Place residential project in downtown Seattle's Denny Regrade neighborhood, Intrawest pursued redevelopment plans for the site. Plans called for demolition of the existing building and construction of a 25-story tower with 194 apartments, three levels of retail space (including a movie theater), a resident's park, fitness facility, and six levels of below-grade parking.

To finance the $55 million project (including approximately $32 million in hard construction costs), Intrawest brought in a Saudi equity partner and assumed a $41 million non-recourse construction loan from Security Pacific Bank. The equity partner also committed to an additional $4 million investment in the project.

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PROJECT FACTS

- 25 stories, 194 rental apartments, 3-level 103,000 sf retail, 6 levels below-grade parking
- Total project costs of $55 million, including acquisition costs (funded by $41 million bank loan and equity partner)
- Construction costs of $41.6 million ($32 million hard costs plus sales tax and soft costs)
- After foreclosure, purchased back from bank for $24 million and the apartments converted to condominiums
- $30 million in revenues from condominium sales, IRR of 30%
- HAL purchased Intrawest's (Intracorp's) share of retail and parking for $4.6 million in 1998 (half of $9.2 million valuation), sold entire commercial space to Target for $15.5 million

Intrawest teamed up with builder/contractor SDL McCarthy, which had successfully completed other residential projects with Intrawest. The San Francisco office of Skidmore Owens Merrill did the design. Intrawest and SDL faced some construction challenges early in the building process, including the logistics of dismantling the large J.C. Penney store, reportedly one of the largest department stores of its time. Further complicat-ing construction was the presence of the Burlington Northern Santa Fe Railway Tunnel, an active railway tunnel that ran under the project site.

The former J.C. Penney site was demolished in 1989 and the Newmark Tower went up in 1991. The apartments were well received by the market, tapping into latent demand for downtown housing options. The units leased quickly at above-proforma estimates due to the location, views, and quality of the development.

The three-story retail component of Newmark was initially occupied by Pay N'Save Drug Store (anchoring the first floor), Cineplex Odeon Theaters and Restaurants Unlimited's pizza café Pantana (anchoring the third floor), and a handful of other small retailers on the second floor (including food establishments, a greeting card shop, and a jeweler). The surrounding neighborhood, with Pike Place Market to the west and a retail core to the east, was in a transitional phase. The success of the retail component depended upon the improvement of the immediate neighborhood from a visual and security standpoint.

By the time the Newmark Tower was completed, Seattle's economy, like the rest of the country, was in the midst of a recession. Nearby projects cratered, crime in the immediate neighborhood escalated, and retail sales downtown slumped with the rest of the economy. Added to these problems was the fact that cost increases during Newmark's construction had eliminated Intrawest's liquidity. Meanwhile, Intrawest's Saudi-based equity partner had failed to make the additional contributions needed to pay back the project's debt and, so, the building's ownership quietly returned to the bank. Around this time the project's lender, Security Pacific Bank, was acquired by BankAmerica (now Bank of America), which also owned Seattle's Seafirst Bank, which was encumbered by its risky oil loans in Texas. As a result, when the property was foreclosed on it went to Seafirst (BankAmerica), and Newmark was bundled with other non-performing loans. However, Intrawest continued to be committed to the project and teamed up with Seattle-based HAL Real Estate Investments to buy back the project from Seafirst in early 1993. Because of its contacts at the bank, Intrawest was able to separate the loan from the bundled fund of non-performing loans and, at the last moment, was able to purchase Newmark Tower for $24 million (negotiated down from Seafirst's asking price of $29 million).

Newmark CityTarget, as seen from 2nd and Pine

Sensing that the downtown residential market was changing, Intrawest and HAL decided to convert the apartments to condominiums. Because of the new, lower base-cost of the building and the less-expensive apartment-grade finishes and fixtures of its residential spaces (in comparison to other projects built originally as condominiums), Intrawest was able to price the units significantly lower than competitive projects. Prices for units ranged $150-$170 per square foot. In addition, the sales team, with a marketing budget of $1.7 million, effectively built up demand using their ability to sell an experience versus commodity-driven story to prospective buyers (learned from Intrawest's years of selling resort projects).

The result was a smashing success – the entire project sold out in about 90 days, with first-week sales of over 100 units. Many units were sold to people who worked for Intrawest and to former renters, for whom the effective cost of owning was now lower than the cost of renting. Revenues from the sales of the condominiums amounted to around $30 million, which more than paid for the acquisition and conversion costs. This revenue figure was close to the original proforma estimates, except the product was now condominiums instead of apartments. The project's IRR was around 30% on the residential portion, and Intrawest and HAL still owned the parking and retail components. In 1994, Intrawest decided to focus solely on resorts and resort real estate and sold its urban real estate company and its assets to Intracorp.

However, the building's sizable 103,000 square foot retail component continued to face challenges. The surrounding area's too-gritty character in the early 1990s did not encourage many shoppers to visit the various retailers and restaurants in the three-story center, and vacancy rates rose. When Pay N'Save was bought by Payless Drug in 1994, the pharmacy exited Newmark and left a very visible vacancy in its ground floor. Although Payless did not occupy the space, they did continue to pay rent per their contractual terms for two more years. Cineplex Odeon remained as the center's main anchor until 1997, when they too vacated the property (but continued to pay rent for another year). With the two anchor tenants gone, the remaining small tenants on the second floor suffered and the commercial component of the property was offered for sale, for an asking price of $9.2 million.

Unable to find a third-party buyer, HAL bought out Intrawests half-ownership in the retail center for $4.6 million in 1998, and converted the space into an office and retail center with Washington Mutual as the main tenant. Washington Mutual remained in the space from 1998 until that bank's collapse in 2008. In 2010, Target bought the entire commercial space, including 250 below-grade parking stalls, for $15.5 million in order to develop a small-format department store. In 2013 Target opened City Target, one of the first of this urban format Targets in the country.

At the time of its development, in the midst of an economic recession, Newmark Tower was surrounded by a still-gritty downtown location. In retrospect, the project was slightly ahead of its time. Fast forward to today, and the neighborhood that surrounds the Newmark Tower is now one of the most desirable downtown Seattle locations, with a renovated and expanding Pike Place Market, Benaroya Hall (home of the Seattle Symphony), Seattle Art Museum and other upscale developments such as Harbor Steps and Four Seasons Hotel and Residences located close by. As a result, the residential population around the Newmark has exploded, growing over 100% from 1990 to 2010.

PROJECT TIMELINE

1989 Demolition of former J.C. Penney

1991 Construction of Newmark Tower as apartments and retail center

1992 BankAmerica, owner of Seafirst Bank, acquires Security Pacific Bank

1993 Newmark goes back to bank in foreclosure, is purchased back by Intrawest and HAL, and the residential portion is converted to condominiums which sell out in 90 days

1994 Payless Drugs buys Pay N'Save, vacates Newmark retail center

1994 Intrawest sells urban real estate assets, including remaining stake in Newmark, to Intracorp

1997 Cineplex Odeon vacates Newmark retail center

1998 Intracorp sells its portion of retail and parking to HAL, which converts the space to office and leases to Washington Mutual Bank

2008 Washington Mutual collapses and vacates the Newmark commercial center

2010 HAL sells commercial space and parking to Target

2013 City Target, one of the first small-format urban Targets in the country, opens in the former Newmark commercial center

Lessons

Deal structure is extremely important. The Newmark was financed using a mix of equity (in the form of investor Letter of Credit to bank) and debt. The debt portion was a non-recourse loan, which protected Intrawest's assets when the company and its equity partner had trouble re-paying the loan. If the debt had been recourse, the failure to pay could have brought down Intrawest itself.

Be persistent. Despite the financial challenges, Intrawest stuck with the project. As the project's equity partners and loan providers changed, Intrawest soon became the only player involved that truly understood the project and its potential. Through its continued involvement and, therefore, its ongoing understanding of the situation, it was prepared to buy the project back after its foreclosure.

Be flexible. The development process is inherently messy and flexibility is a key element in maintaining a project's momentum. In the case of Newmark, flexibility was especially important during the design and demolition phase and this ability to think laterally – to consider all the possibilities – also enabled Intrawest to envision an apartment-to-condominium product that met the market's changing demands.

Capitalize on your strengths. Intrawest had a unique approach to the design and operation of its presentation and sales/leasing centers, and it was able to use these facilities and the company's "storyselling" sales culture to quickly sell the condominiums. In addition, many company executives and staff purchased some of the first condominiums, acting as a catalyst for sales and instilling confidence in other buyers.

A simple act can become a reassuring statement. When the Newmark lost its two anchor retail tenants, all retail spaces (although empty) continued to be meticulously maintained. It sent an important message to the neighborhood, to the residents of the building and to prospective tenants. The message was, "this is a well-designed, well-located space going through an unfortunate but understandable cycle in Seattle's retail economy. But, as you can see, we the owners of the space have not lost faith in the future of the Newmark and the neighborhood that surrounds it."

Perception is not reality. The Newmark was publicly perceived by many as a 'troubled project' because of the vacant retail spaces. The reality was that the residential portion did well, both as apartments and later as condominiums, and the anchor retail tenants were paying rent even after they vacated their spaces. In evaluating opportunities, it is essential to dig deep, to see what others can't see.

Wrap Up

In the end, the Newmark Tower was a financial success. At the time the project was conceived and developed none of us could have foreseen the decision of the equity partner to not continue with the obligation to put the remaining equity into the project. As noted in the Introduction to the Case Study, how this project was structured was fortuitous and provided the platform for this success.

In preparing the Case Study, input was provided by Joe Constance, Moh Faris, Mike Miller and Laurel Spelman, who, along with Robert Holmes, were with Intrawest when The Newmark was developed

Brit Slone, who was with SDL McCarthy (the contractor) and Tom Graff of Ewing and Clark (retail leasing) also contributed

Dana Behar, HAL Real Estate Investments, provided input and the photographs used in the Case Study.