UNIVERSITY OF WASHINGTON REPORT ON METROPOLITAN TRACT

BRIEFING REPORT (REPORT 00-2)

JANUARY 6, 2000

STATE OF WASHINGTON

JOINT LEGISLATIVE AUDIT AND REVIEW COMMITTEE

PREPARED BY

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University of Washington Report on Metropolitan Tract

OVERVIEW. *In its 1999 session, the Legislature directed the University of Washington to report to JLARC, every other year, on management of its Metropolitan Tract in downtown Seattle. JLARC reviewed the University's 1999 report on January 6, 2000; it is attached for your information* ***(Attachment A)****. JLARC staff analyzed the financial context of this management, drawing attention to some of the factors associated with the current return on investment picture for the Tract* ***(Attachment B)****. JLARC is distributing this information with the recommendation that the University not renew its leasing arrangements for the Metropolitan Tract under the current terms and conditions.*

Background. ESHB 1991 (C 346 L 99), enacted in the 1999 Legislative Session, authorizes the Board of Regents to lease the Metropolitan Tract for up to 80 years and gives the Board full control to manage, operate, lease, borrow funds, and incur indebtedness as with any other UW property. A new nonappropriated bond retirement account was created, and the net proceeds from leases on the Metropolitan Tract will be deposited in this account. In turn, funds in this account in excess of debt services needs must be transferred to the UW Building Account.

JLARC Responsibility. Under the legislation enacted in 1999, the UW Board of Regents will be reporting on all leases and transactions of, or any improvements to, the Metropolitan Tract to JLARC during odd-numbered years. In October 1999, Senator Gardner, JLARC's Chair, outlined seven topics to be addressed in their 1999 report in a letter to the University. The University responded to those seven topics in their attached report.

If you have questions or concerns regarding JLARC's role in this reporting effort, please get in touch with me at 360.786.5175.

Attachment A

University of Washington
Report to the Joint Legislative Audit and Review Committee (JLARC)

UNIVERSITY OF WASHINGTON METROPOLITAN TRACT

January 6, 2000

Outline

I. Adjustments to Committee Staff financial analysis are necessary (Exhibit A).

II. There are a number of key issues affecting management of the University's position.

III. Strategic Alternatives are current being pursued.

IV. Conclusions.

Exhibit A

Income Return Comparisons - Office Portion

Actual Vs. Pro Forma
(Amounts in Millions)

	Fiscal Year 1999		
	Partial Fee (UW Position)	Adjustments	Full Fee (UW + UNICO)
Net Cash Flow	$ 12.2	$ 7.4 *	$ 19.6
Value	$ 180.0	$ 105.0 **	$ 285.0
Income Return on Investment	6.78%	7.05%	6.88%

Notes:
* - Estimated Net Cash Flow retained by UNICO (Rents - $14.0 million,less estimated operating costs - $6.6 million)

** - Estimated value of existing UNICO leasehold

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UNIVERSITY OF WASHINGTON

Metropolitan Tract Office

December 15, 1999

The Honorable Senator Georgia Gardner, Chair
Joint Legislative Audit & Review Committee
506 16th Avenue SE
Olympia, WA 98501-2323

Re: Supplementary Report: The Metropolitan Tract

Dear Senator Gardner:

On behalf of the Board of Regents of the University of Washington, I am pleased to provide this Report to the Legislature's Joint Legislative Audit and Review Committee in response to your October 18, 1999 request. As agreed in our subsequent meeting, it is provided as a supplement to the regular Biennial Report on the Metropolitan Tract for the Legislative Year 1999, issued on December 31, 1998.

We have, as you requested, organized this report based on the topics contained in Attachment #I to your letter. Should you or other Committee members wish additional background or detailed information on the Metropolitan Tract, the Biennial Report, as well as more summary information and physical and geographic descriptions of the Tract, may be accessed via our web page at http://www.washington.edu/about/themet/biennial/index.html.

Please do not hesitate to contact me or the staff at the Metropolitan Tract Office should you have any questions on this information. We look forward to the opportunity to discuss this report with the Committee at the brief presentation requested for its January 6, 2000 meeting.

Sincerely,

Weldon E. Ihrig
Executive Vice President

WEI:fb
cc: Thomas M. Sykes, Legislative Auditor
David P. Haworth, Metropolitan Tract Representative

Metropolitan Tract
Supplementary Report to the Joint Legislative Audit and Review Committee

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Supplementary Report to the Joint Legislative Audit and Review Committee

1. *Display the financial data for the last biennium and the current fiscal year to date, and the methods used to calculate that data, to illustrate the following:*
   a)the net proceeds from leases on the Metropolitan Tract that have been deposited into the UW facilities bond retirement account;
   b)the amounts in the facilities bond retirement account that are in excess of debt services needs and, as legislatively mandated, have been transferred to the UW Building Account; and
   c)those specific capital projects(s) at the University to which the amounts from the facilities bond retirement account transferred to the Building Account (reported in 1b above) have been deployed.

In the past, funds transferred to campus from the Metropolitan Tract have not been transferred to either a bond retirement account or the University of Washington Building Account. With respect to the current biennium, the University is in the process of coordinating the effort necessary to establish a non-appropriated local fund to be used exclusively for the purpose of erecting, altering, maintaining, equipping or furnishing buildings at the University of Washington as stipulated in ESHB1991. Once established, a mechanism will be developed to facilitate the flow of net proceeds from the sale or lease of land in the Metropolitan Tract into that account. Funds in excess of amounts reasonably necessary for payment of debt service will be subsequently transferred by the Board of Regents into the University of Washington Building Account.

Given the current schedule and projected cash flow needs for the Law School Building, we anticipate that the need for bond proceeds will not arise until winter, 2001. Based on this schedule, and the State Treasurer's tentative schedule to sell bonds in February, 2001, the first interest and principal payments associated with Law School debt would not be required until the 2001-2003 biennium, 6 months and 1 year respectively after the issue date. Therefore, the University anticipates using the funds projected to be available in the current biennium as follows: $7 million for minor repairs programs (program and building renewal projects) and $9 million for improvements to general assignment classrooms throughout campus. This allocation includes some Health Science classrooms that are used by and for the benefit of the entire campus community. We are currently working with Legislative Staff and Office of Financial Management Staff to incorporate language into the supplemental budget that will allow for appropriation of these funds directly from the University of Washington Building Account, which is already in existence. Should the need for Law School debt surface earlier than projected, we will reprioritize our allocations and work closely with Legislative and OFM staff to satisfy any related appropriation or allotment challenges.

During the 1997-99 biennium the University of Washington allocated funds transferred from the Metropolitan Tract to specific capital projects as follows (000's):

Minor Repairs & Renewal Projects	$6,000
Miscellaneous Small Projects	2,000
General Physical Development Plan	1,100
UWEB (Bagley Hall Research Lab)	2,700
Sand Point/Gerberding Hall, Relocations	2,200
Major Project Supplements	600
Technology Initiatives	500
Life Sciences Pre-designs	400
UST Remediation	100
Major Project Contingency	400
Total 1997-1999	$16,000

2. *Supplement the conventional accounting information, such as that provided in the University's December 31, 1998 report on the Metropolitan Tract that describes the value of the property, sources and uses of revenue, and return on investment. Such supplementary information should add comparisons from prior years and also comparisons of such data on similar property with long-term leases managed by other firms.*

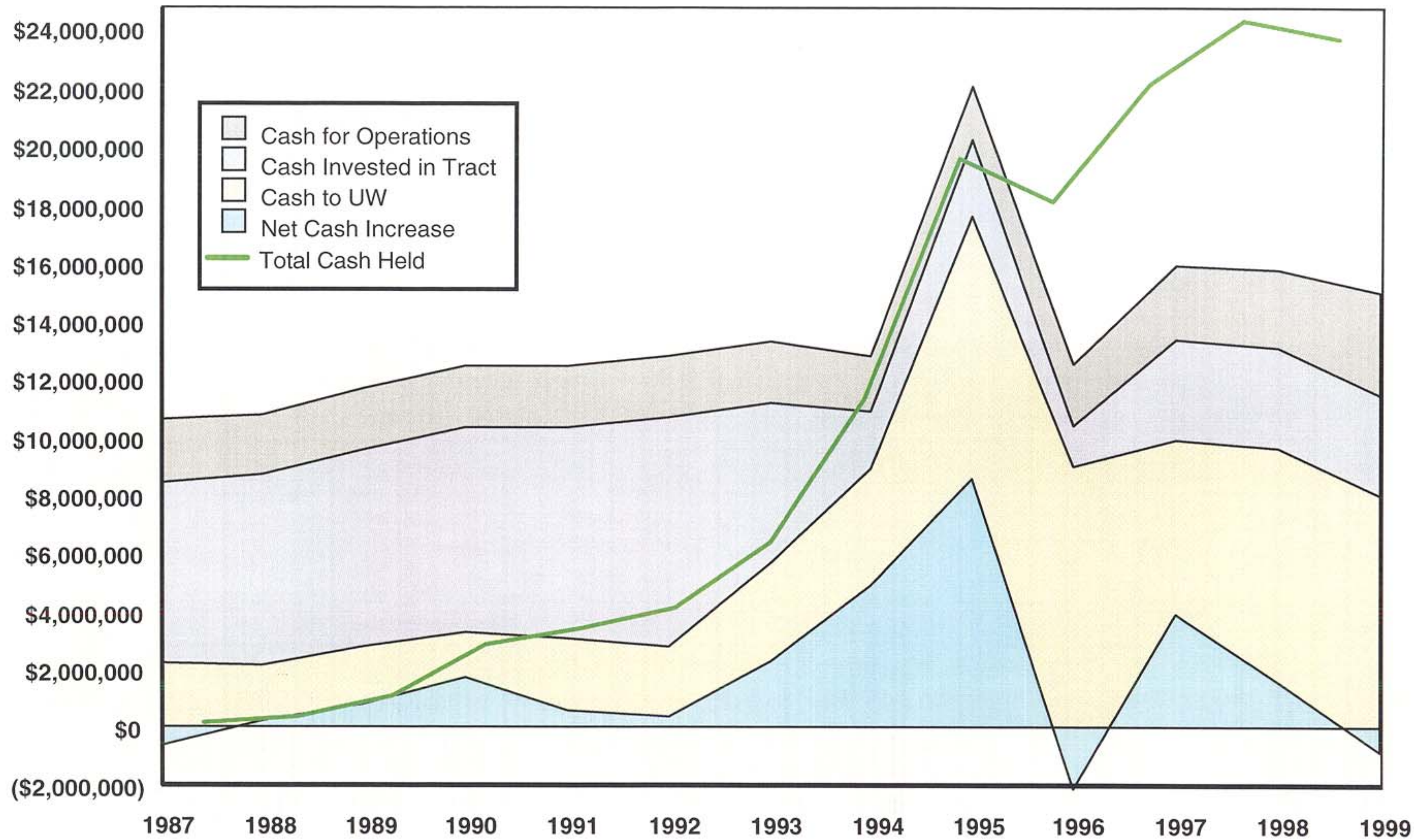
   Since the December 31, 1998 report, Deloitte & Touche, the auditor for the Metropolitan Tract has completed a subsequent fiscal year's audit. The accompanying "Metropolitan Tract Cash Flow" graph, containing comparisons of financial results for Fiscal Years 1987 through 1999, was prepared by Deloitte & Touche as part of their presentation of this audit to the Capital Assets Committee of the University's Board of Regents.

   A copy of the most recent audit is also enclosed. In the "Statements of Revenues and Expenditures" and "Statements of Cash Flows" contained in that audit and in the financial information in the December 31, 1998 report are sources and uses of revenue as identified for Fiscal Years 1997 through 1999.

   As part of its on-going strategic planning, the University has continually reviewed the value of its investment in the Metropolitan Tract. This investment represents less than the total property, or fee, value as the Metropolitan Tract is encumbered by the two existing long-term master leases for the Four Seasons Olympic Hotel and office building (UNICO) portions. The components of this total value are schematically illustrated on the "Breakdown of Property Interest" graphic illustration, with the University's encumbered fee portion shown as the shaded elements. The most recent update, based on projections and analysis by Heitman Real Estate Services Group, the University's strategic planning consultant, indicated a total value of this encumbered fee position at slightly in excess of $210 million. For the Fiscal Years ended June 30, 1998 and 1999, the University's return on this investment, including both income and capital appreciation components, is calculated at 17.1% and 13.65%, respectively.

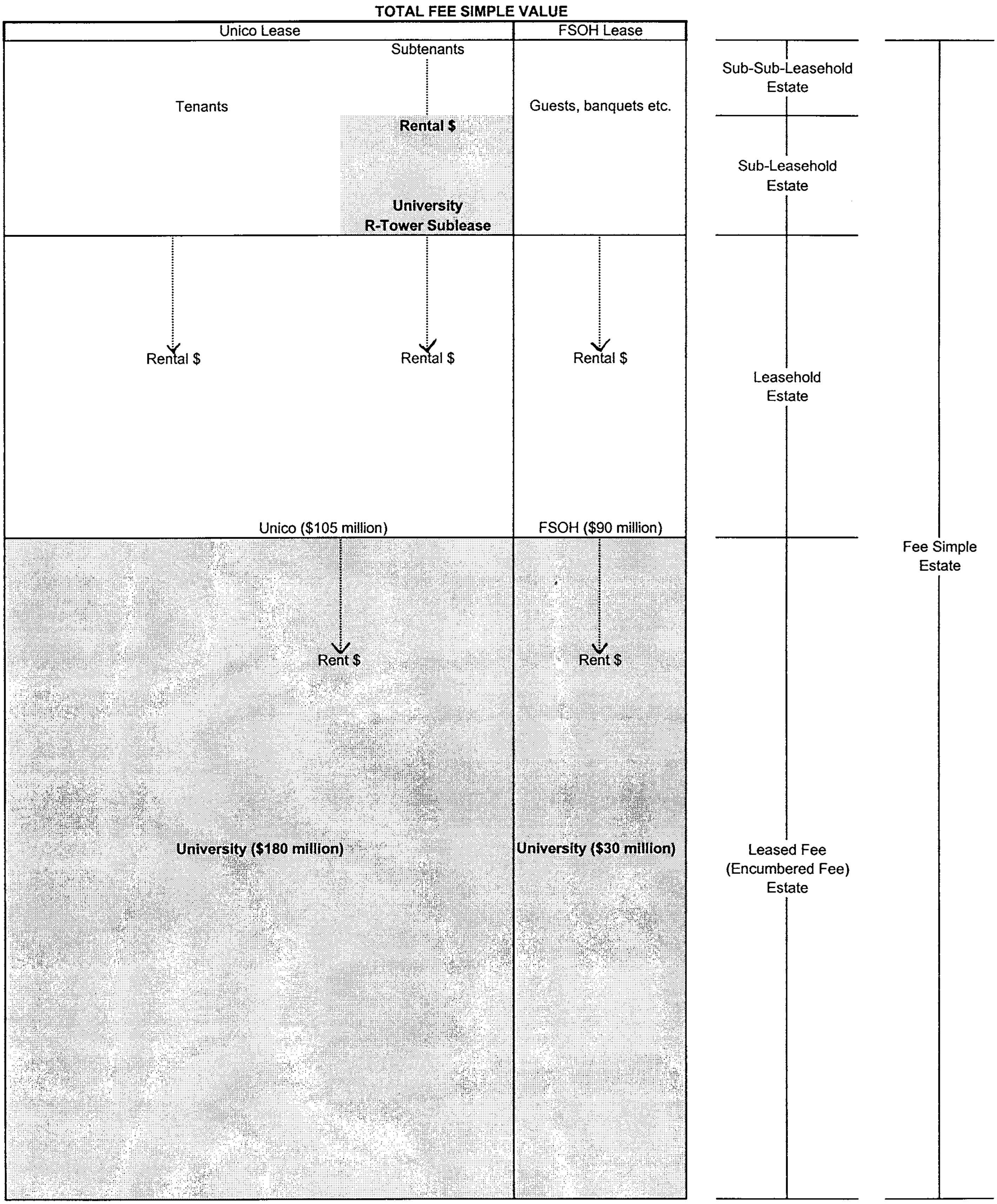
   As to comparison of return on investment to similar properties with long-term leases managed by other firms, it is difficult to provide actual data with "apples to apples" accuracy. Return on investment information from all but a few public agencies is private and not readily disclosed. More importantly the Metropolitan Tract investment is made up of a unique blend of older Class B and C buildings, Class A office space and retail. There a few, if any, holdings that match this particular size and mix of property. Accordingly, to reach some comparable statistics, one must take information from like buildings and then create a hypothetical "Metropolitan Tract" example, which would arrive at a blended return that could be compared to the performance of the University's Metropolitan tract. Similar properties would include mature buildings with stabilized income, matching the Metropolitan Tract.

Metropolitan Tract Cash Flow



	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Net Cash Increase	($590,000)	$230,000	$760,000	$1,700,000	$600,000	$400,000	$2,300,000	$4,900,000	$8,600,000	($2,200,000)	$3,900,000	$1,600,000	($850,000)
Cash to UW	2,200,000	1,900,000	2,007,000	1,541,229	2,458,771	2,400,000	3,400,000	4,000,000	9,000,000	9,000,000	6,000,000	8,000,000	8,000,000
Cash Invested in Tract	6,200,000	6,600,000	6,800,000	7,100,000	7,300,000	7,900,000	5,500,000	2,000,000	2,600,000	1,400,000	3,500,000	3,500,000	3,500,000
Cash for Operations	2,200,000	2,000,000	2,100,000	2,100,000	2,100,000	2,100,000	2,100,000	1,900,000	1,900,000	2,100,000	2,500,000	2,700,000	3,500,000
Total Cash Held	122,000	348,000	1,107,000	2,846,000	3,432,000	4,084,000	6,353,000	11,293,000	19,622,000	18,121,000	22,122,000	24,355,000	23,680,000

METROPOLITAN TRACT
Breakdown of Property Interest



For fiscal year ended June 30, 1998, return on investments for a similar set of properties such as the Metropolitan Tract would be approximately 11% to 12.5%. For fiscal year ended June 30, 1999, the rate of return for similar property would have increased to a range of 11% to 15%, with the vast majority of comparables falling within the 12.5% to 13.5% range. Both years 1998 and 1999 have seen strong increases in the rate of return of property, with fiscal year 1999 showing somewhat greater returns as the actual rent increases negotiated in 1997 and 1998 have begun to provide higher cash flow.

In comparing the Metropolitan Tract to this analysis of a similar set of hypothetical properties, one needs to take into account that the percentage returns are usually stated as the average through five years, whereas the University's investment return is for a specific year. Sometimes a return on investment might be particularly low or high in one year due to certain expenses, capital improvements, or re-leasing costs.

3. *Describe clearly the rate of return on investment generated by the Metropolitan Tract, and discuss the University's strategies, in the short, medium and long terms, for maximizing this rate of return on real estate investment in the central business district of downtown Seattle. Compare the rate of return on the Metropolitan Tract to rates of return for commercial real estate as contained in appropriate indices of such rates.*

As alluded to in the response to the previous question, returns on real estate are comprised of two components:

-<u>Income Return</u>: The annual net cash flows generated from property operations, and
-<u>Appreciation Return</u>: The annual change in value of the property resulting from changes in market value based on those returns, net of capital expenditures.

The following "Components of Real Estate Return" chart illustrates the conceptual bases for these return elements.

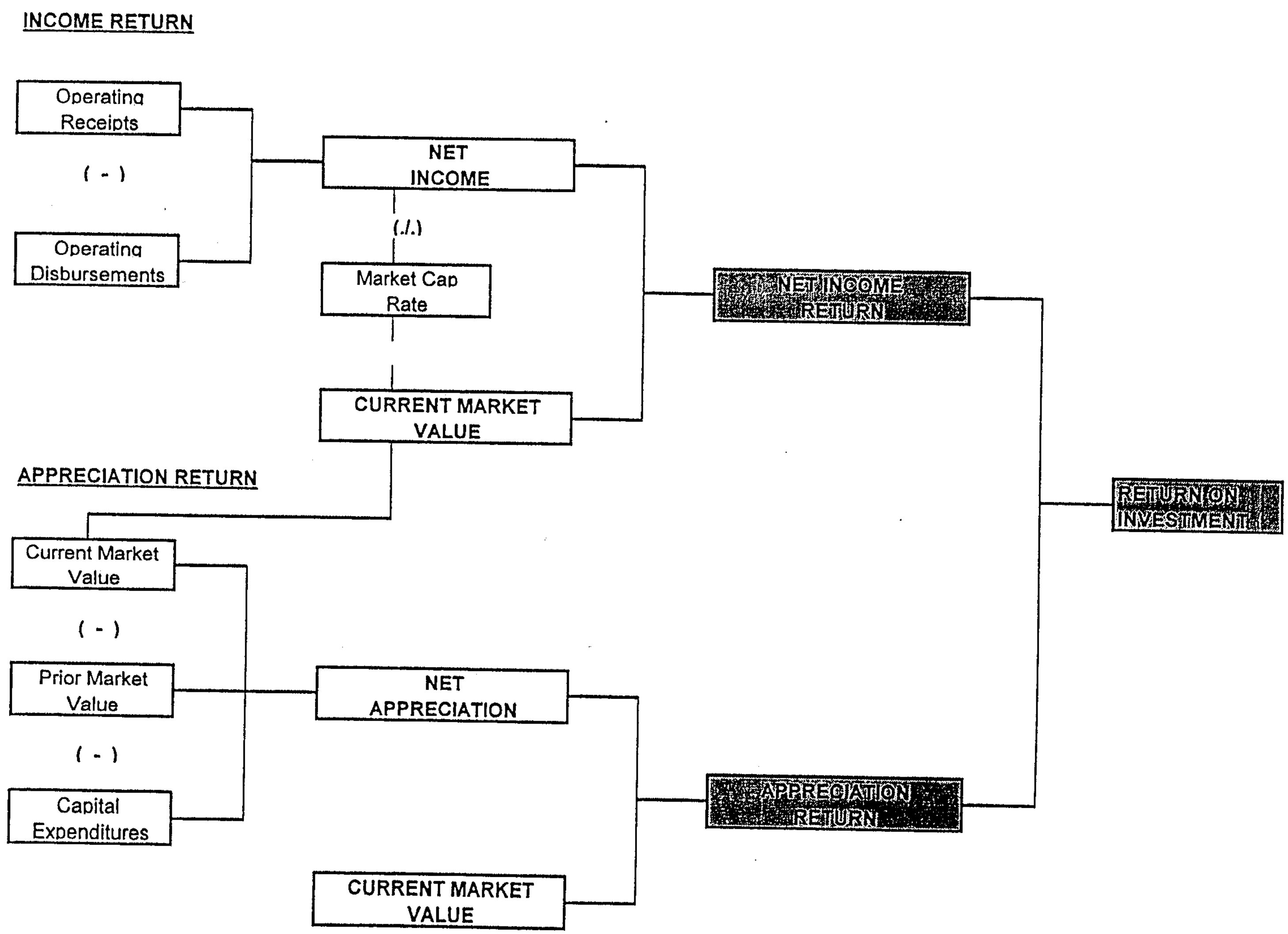
Financial return data for privately-held commercial real estate properties are generally both subjective and confidential. Therefore, in its strategic policy activity, the University has made extensive use of data provided by the National Council of Real Estate Investment Fiduciaries (NCREIF), a nation-wide organization of not-for-profit owners of commercial real estate properties, for comparison with the returns from the Metropolitan Tract. Ten-year comparisons of Metropolitan Tract Returns with rates reported by this organization are illustrated on the attached "Total Returns: Metro Tract vs NCREIF" chart. Additional detail on both UW and NCREIF returns are shown on the subsequent "Data on Financial Returns to UW" table.

Recognizing that the University's range of strategies for maximizing its investment is limited by the master leases under which the Metropolitan Tract is operated, its status as a public agency of the State of Washington, and the delegations of authority to it under State law, a number of strategic actions and guidelines are under consideration or have been actively employed.

-<u>Short Term</u>: These strategies include vigorous controls and objective application of investment criteria by the University to the capital reimbursements which are its responsibility under the UNICO Lease. These include innovative methods for improving returns on reimbursement of tenant improvements under that Lease, and aggressive and innovative leasing of its sublease space within the Rainier Tower.

METROPOLITAN TRACT

Components of Real Estate Return on Investment



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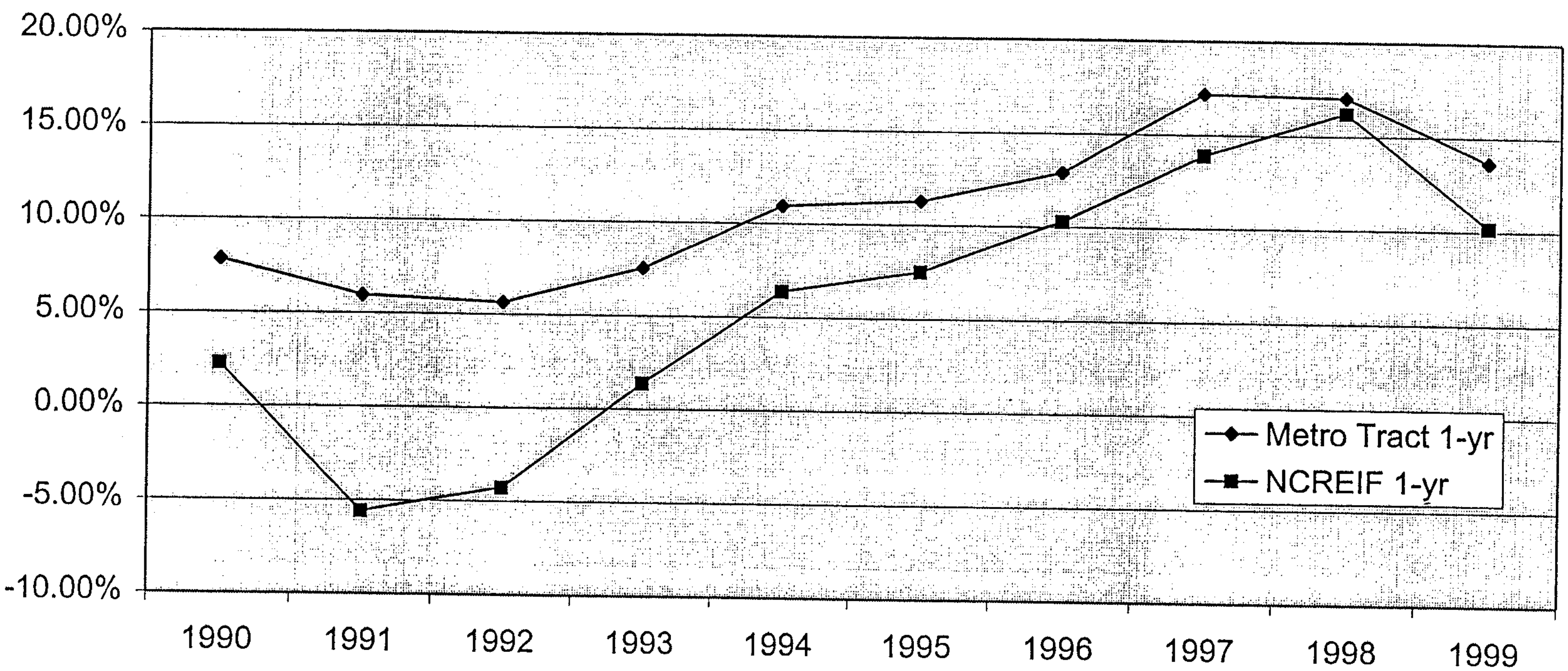
Total Returns: Metro Tract vs. NCREIF
1990 - 1999



	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Metro Tract	7.87%	5.95%	5.65%	7.55%	10.95%	11.29%	12.92%	17.22%	17.07%	13.65%
NCREIF	2.29%	-5.59%	-4.26%	1.39%	6.38%	7.53%	10.30%	13.92%	16.23%	10.18%

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METROPOLITAN TRACT

Data on Financial Returns to UW - Fiscal Years 1990 thru 1999
($ in 000's)

	Fiscal Years Ended June 30									
	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
UW Value - Encumbered Fee (1)	$ 126,414	$ 130,434	$ 134,583	$ 138,866	$ 145,554	$ 152,556	$ 162,415	$ 179,604	$ 198,763	$ 211,743
UW Net Cash Flow from Operations	$ 10,563	$ 10,488	$ 10,713	$ 10,942	$ 10,897	$ 11,020	$ 9,931	$ 14,440	$ 13,404	$ 13,169
Reinvestment - UW	$ (6,659)	$ (6,871)	$ (7,381)	$ (4,897)	$ (2,202)	$ 6,554	$ (2,515)	$ (4,077)	$ (3,419)	$ (5,217)
Transfers to UW Campus	$ 1,541	$ 2,459	$ 2,400	$ 3,354	$ 4,000	$ 9,000	$ 9,000	$ 5,950	$ 8,000	$ 8,000
Return on Investment:										
UW Income Return	8.55%	8.17%	8.08%	8.00%	7.79%	7.97%	7.36%	8.70%	7.93%	7.77%
UW Appreciation Return	-0.69%	-2.22%	-2.44%	-0.45%	3.15%	3.33%	5.56%	8.52%	9.14%	5.88%
NCREIF Income Return	6.65%	6.77%	7.57%	8.21%	8.75%	9.13%	8.88%	9.08%	8.77%	8.28%
NCREIF Appreciation Return	-4.10%	-11.77%	-11.19%	-6.43%	-2.22%	-1.49%	1.34%	4.54%	7.01%	1.86%

Note:
(1) Based on capitalized actual and projected cash flows.

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-Medium Term: These strategies include exploration of opportunities to participate in arbitrage opportunities under various sub-leases. In particular, the buyout of the then-Seafirst sublease of some 345,000 sq. ft. in the Rainier Tower resulted in an initial cash receipt of $10 million (subsequently reduced by obligations included with that lease) and has resulted in a likely net profit in excess of $4 million, together with an on-going yield spread of some $6 per sq. ft. A later buyout of a portion of that space from a sub-sub lessee is anticipated to yield an internal rate of return in excess of 20% to the University.

-Long Term: In September, 1997, after a competitive selection process, Heitman Real Estate Services Group, (HRES), an international real estate consulting, management and investing firm headquartered in Los Angeles, was engaged by the University to assist in identifying long-range strategies for the Metropolitan Tract. In its March, 1998 report, HRES identified a range of long-range strategic alternatives summarized on the attached "Strategic Alternatives" exhibit. After some consideration, HRES was authorized to assist in exploring the possibility of implementing of Alternatives C and F on that list. A specific offer for monetizing, or capitalizing, the University's position was received and, after careful consideration, was judged inadequate at that time.

Finally, and most importantly, the University has for many years sought to re-vitalize the relatively large but under-performing retail component of Rainier Square, at the same time providing an on-site generator of activity to help improve the performance of the rest of the Metropolitan Tract. This strategy finally appears to be materializing in the redevelopment of the northwest corner of Rainier Square into a major hotel complex. Final agreements for the related ground lease, UNICO Lease modification and development Agreement are currently under review. Details of the transaction are governed by a confidentiality agreement at this time, but should be emerging shortly. This likely transaction was the reason for the request for modification of the Metropolitan Tract legislation.

STRATEGIC ALTERNATIVES

Although not exhaustive, the following section provides a discussion of various alternatives to be considered by the University. The feasibility or success of these alternatives can only be determined by the implementation of negotiations with the various parties. By identifying and explaining the various advantages and concerns related to these alternatives, Heitman hopes to assist the University in determining which alternatives it might be willing to consider implementing.

A. *Overview the University's Position under the Existing Ground Lease(s)*

This alternative is defined as managing the Tract in a manner which best achieves the greatest benefits to the University under the existing ground lease(s).

B. *Initiate Revisions to the Existing Ground Lease(s)*

This alternative is defined as a plan to make revisions to the ground lease(s) under terms mutually agreeable to all parties. The purpose of such revisions would be to further secure the University's long-term goals of maximizing the value and revenue of the Tract.

C. *Facilitated Acquisition of UNICO's Ground Lessee Position*

This alternative is defined as a companion (third party) entity on behalf of the University and under terms and conditions acceptable to the third party acquiring UNICO's ground lessee position in order for the University to obtain a full fee position in the Tract, unencumbered by UNICO.

D. *Dispose of the University's Ground Lessor Position in the UNICO Tract*

This alternative is defined as disposing of the University's ground lessor position in the UNICO Tract as is presently encumbered by the UNICO lease. Prospective acquirers could be any third party buyer as well as UNICO.

E. *This alternative is defined as jointly marketing with UNICO the sale of the UNICO portion of the Tract and the University's position in the Tract to third parties.*

This alternative is defined as jointly marketing with UNICO the sale of the UNICO portion of the Tract and the University's position in the Tract to third parties.

F. *Monetize the University's Position With or Without Revision to the UNICO Ground Lease*

This alternative is defined as the University recapitalizing its position with or without beneficial revisions to the UNICO ground lease (as suggested under Strategic Alternative B). Under Strategic Alternative F, the University could receive funds from third party sources for the University's interest in the UNICO portion of the Tract.

G. *Buy the Ground Lessee Position, Sell the Ground Lessor Position or Revise the Ground Lease with Respect to the Four Seasons Olympic Hotel*

This alternative is defined as a series of negotiations directed towards acquiring the ground lessee position, disposing of the ground lessor position, or revising the ground lease position with respect to the Four Seasons Olympic Hotel. The Hotel lease is currently viewed by the University as a more balanced vehicle as distinguished from the UNICO lease.

4. *Describe those specific strategies the University of Washington and UNICO Properties have under consideration, between now and 2014, to make the Metropolitan Tract properties more attractive to potential and, possibly, different tenants who might generate higher rents and hence higher net proceeds.*

The specific strategies currently under consideration by the University and UNICO are reflected in UNICO's proposed 2000-2004 Capital Investment Plan (CIP). This plan reflects a potential major commitment in such areas as elevator system upgrades, structural improvements and modification of tenant spaces in the Tract's older buildings to continue to increase the Tract's competitiveness in today's market. The plan is currently under review by HRES for presentation and action by the University's Board of Regents in January 2000.

The lease-buyout strategies discussed in the prior response are a direct response to dealing with the economic impact of low-rate long-term leases of space in Tract office buildings which, while maintaining relatively high occupancy, have a depressing effect on average rental rates. These arbitrage actions effectively raise those rents, with the University earning the entire difference, rather than merely a percentage of it.

As a measure of the effectiveness of Tract commercial marketing and tenanting strategies employed to date, effective level rents for Class A space in the Tract office buildings have risen by over $6 per sq. ft . in the past three years for new leases and nearly $12 per sq. ft. for renewals. At from $27 to $33 per sq. ft., these rates are becoming competitive with the slightly under $34 per sq. ft. recently reported for new leases in Class A space (most of which is significantly newer than Tract space) in the downtown Seattle Office Market.

Another current strategy being actively pursued by the University at this time is the hotel development described earlier. Under this strategy, a portion of the Rainier Square site would be released by UNICO from its lease and would then be leased to the hotel developer under terms similar in concept to those in the current Four Seasons Olympic Hotel ground lease. Economic gains to the University from this project would be composed of higher rents to the University from the ground lease itself and, indirectly, higher rents from the adjacent retail areas due to increases in activity related to the hotel development.

5. *Describe the terms and the structure of UNICO's property management fees for the Metropolitan Tract and compare these to industry standards.*

Under the terms of the University's agreement with UNICO, UNICO is paid no property management fees as such. UNICO's agreement for the office leasing portion of the Metropolitan Tract is a rather long-term Master Lease, currently expiring (after many extensions to permit leasehold financing of the buildings developed on the Tract with this Lease) in 2014. Under that Lease, UNICO has all active management responsibility, a specific requirement instituted by the Board of Regents, to both achieve insulation from active management issues and to avoid adverse Federal income tax implications of such management. (The financial results to the University summarized on the following table show the performance under the UNICO Lease, Four Seasons Olympic and Rainier Tower Sublease for the most recent fiscal year.)

Under their Lease, UNICO is responsible for leasing, property management and operation, and redevelopment planning and implementation. UNICO receives various percentages of gross lease revenues, currently averaging about 55% annually, from which it pays property operating expenses. The gross revenue sharing was instituted by the Regents in 1953 as a forward-looking approach to inflation protection and growth participation, while avoiding the accounting and tax issues inherent in a net revenue-based approach.

Comparing UNICO's property management fees to industry standards is therefore difficult, if not impossible. This is primarily because UNICO is not being compensated for just property management. UNICO holds the master lease, which by its terms makes them a joint venture partner with the University. Another way to look at it is that UNICO purchased the property for a period of time and has been acting as the owner and developer of the property and is being compensated accordingly.

Industry standard management fees for a portfolio such as the Metropolitan Tract would be 2.5% to 4% of gross rents. UNICO's return must cover all property expenses, its property management and leasing fees, and a return for its "effective ownership" and risk of development of the property over the term of the master lease.

When the UNICO lease terminates, instead of entering into the type of arrangement it currently has with UNICO, the University could hire a property manager and incur related expenses running in the 2.5% to 4% range as discussed above, but would then be responsible for costs of operating, leasing and developing the property.

METROPOLITAN TRACT
Summary - Financial Results
Fiscal Year 1999

RECEIPTS		
UNICO Lease:		
Gross Rentals	$	26,366
Less: Retained by UNICO		(13,961)
Abatements		(1,600)
Payments to UW	$	10,805
Four Seasons Olympic Lease		3,690
Rainier Tower Sublease		1,259
Interest and Other		950
Total Receipts	$	16,704
DISBURSEMENTS		
Leasehold Taxes	$	1,520
UW Operating Expenses		2,015
UNICO Management Fees		0
Total Disbursements	$	3,535
NET INCOME to UW	$	13,169
Reinvestment - UW	$	3,402
Transfers to Campus	$	8,000

Source: Deloitte & Touche Metroplitan Tract audit

sfr 13-Dec-99

6. *Describe any plans under consideration for the private sector to finance building improvements to the Metropolitan Tract properties, rather than continue to have the University finance such improvements from its rental income sources.*

Use of private sector financing for Metropolitan Tract investment is made more complex than for typical private commercial real estate owners by the need to consider the Constitutional prohibition against the using of State credit for private benefit and Federal income tax effects related to active property management by not-for-profit entities. Nonetheless, the University has and will continue to consider and to employ these resources whenever possible and feasible. Past and current such uses include:

-Private sector borrowing to finance the $7.5 million Excess Renovation Expenditure reimbursement required for the Four Seasons Olympic Hotel Lease redevelopment, and

-The establishment of a true ground lease position, under which the lessee is responsible for all capital expenditures for both redevelopment and rehabilitation/modernization. This approach was taken for the Four Seasons Olympic Hotel redevelopment in 1980-82 and will be employed in the proposed new hotel development in Rainier Square.

7. *Describe any plans that the University of Washington may have under consideration to capitalize existing leases, thus removing itself from direct responsibility for property management in the downtown Seattle business district. If such plans are under consideration, what are some of the timeframes and scenarios for such options?*

The University has no direct responsibility for property management on the Metropolitan Tract. This is a conscious policy long employed by the University for reasons previously discussed. Under the UNICO Lease, UNICO has this responsibility, while the Four Seasons Hotel lessee has not only operating but also capital investment responsibility, as would be the case should the contemplated hotel development in Rainier Square occur.

The capitalization of certain existing sub-leases however, is a strategy that has already been successfully employed by the University to improve the two arbitrage opportunity scenarios described in previous responses and was the strategic direction actively considered relative to the UNICO Lease, with assistance by HRES, in recent months. This is an active strategic area and will be considered whenever market and business conditions permit an acceptable opportunity for implementation.

December 15, 1999

State of Washington
Joint Legislative Audit and Review Committee

LEGISLATIVE AUDITOR
Tom Sykes

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January 6, 2000

TO: Members of the Joint Legislative Audit and Review Committee

FROM: Tom Sykes, Legislative Auditor
Larry Brubaker, Principal Management Auditor

SUBJECT: **University of Washington Report on its Management of the Metropolitan Tract**

OVERVIEW. *The Legislature directed the University of Washington to report to JLARC, every other year, on its management of the Metropolitan Tract in downtown Seattle. Their report is attached. JLARC staff analyzed the financial context of this management, drawing attention to some of the factors associated with the current return on investment picture for the Tract. Staff recommend that the UW report and this additional information be distributed, and that the legislature should direct the University not to renew its leasing arrangements for the Metro Tract under the current terms and conditions.*

Background. In 1860, the Legislative Assembly of the Washington Territory established a university in Seattle, if ten acres were granted from private owners for that purpose. That land, in what is now downtown Seattle, became the original site of the University of Washington (UW). In 1895, the university moved to its present location. The state retained ownership of the original acreage; however, the University's Board of Regents has developed and managed this "Metropolitan Tract" on behalf of the state since then.

ESHB 1991 (C 346 L 99), enacted in the 1999 Legislative Session, authorizes the Board of Regents to lease the Metropolitan Tract for up to 80 years and gives the Board full control to manage, operate, lease, borrow funds, and incur indebtedness as with any other UW property. A new nonappropriated bond retirement account was created, and the net proceeds from leases on the Metropolitan Tract will be deposited in this account. In turn, funds in this account in excess of debt services needs must be transferred to the UW Building Account. The funds in this Account will be subject to legislative appropriation in the biennial capital budget.

JLARC Responsibility. For many years prior to 1996, the University of Washington sent biennial reports on the operations of the Metropolitan Tract to the Legislative Budget Committee—JLARC's predecessor. Under the new legislation enacted in 1999, the UW Board of Regents is directed to report on all leases and transactions of, or any improvements to, the Metropolitan Tract to JLARC during odd-numbered years—the first report due in 1999. In October 1999, JLARC Chair Senator Gardner, in a letter to the University, outlined seven topics to be addressed in their 1999 report to our Committee. The University's responses to those topics comprise their report.

JLARC Staff Review of UW Report. JLARC staff have reviewed the UW's report in response to the Chair's October letter. Our analysis should be looked at in the context of your review of the UW report. Page numbers here refer to those in the UW report.

✓ **Income Generated from the Metropolitan Tract.**

- The amount of income the Metropolitan Tract generates for the UW has varied each biennium since 1987. The amount of income transferred from the Tract to the UW campus has ranged from as low as $2 million per year in 1990-91 to as much as $9 million per year in 1995-96. The Tract provided $8 million per year to UW in 1998-99. *(Page 4)*

- The Tract generates income in addition to the amount transferred to the UW campus. In FY 99, the operations of the Tract generated net operating income of $15.8 million.[1] Of this amount, $8 million was transferred to UW, $3.4 million was reinvested in the Tract, $2 million paid for the UW and Metro Tract property management offices, $1.6 million paid for loan repayments, and $.8 million was added to the Tract fund balance. The amount of the Tract fund balance was $22.9 million at the end of FY 98. *(Pages 16, 4)*

✓ **Income Generated Compared to State Investment Board Property.**

- Of the $15.8 million of net operating income generated by Metro Tract operations, $12.1 million was generated by the office properties, which consist of 7 commercial office buildings in downtown Seattle.[2] These properties were recently valued at $285 million. *(Pages 8, 16)*

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[1] The $15.8 million of net income shown here is larger than the $13.2 million net income shown on the Metro Tract financial statement for FY 1999. *(Page 11)* JLARC staff made adjustments in order to make a fair comparison of net income with the State Investment Board's Union Square property in downtown Seattle.

[2] The remaining $3.6 million of income was generated by the Tract's land which is occupied by the Four Seasons Olympic Hotel.

- The State Investment Board (SIB) owns the One and Two Union Square office buildings, which are adjacent to the Metropolitan Tract. Union Square is valued at $336 million, or 118% of the $285 million valuation of the Metro Tract office properties. Union Square generated about $28.8 million in net operating income to the State Investment Board during FY 99. *(Information provided by State Investment Board.)*

- The $12.1 million of net operating income generated by Metro Tract office properties represents a 4.2% return against the $285 million value of the commercial office building properties. The $28.8 million of net operating income generated by Union Square represents an 8.6% return to the SIB against the $335 million value of these properties. Therefore, the Metro Tract is generating about 49% of the amount of operating income (relative to asset value) as the State Investment Board generates on Union Square.

✓ **Reasons for Relatively Low Performance of the Metro Tract Office Properties.**

- The terms of the UW's lease with UNICO, the property manager of the Metro Tract, explains the relative underperformance of earnings from the Metro Tract office properties. The lease allows UNICO to retain more than 50% of the gross rents from these office properties as its management fee. UNICO pays the operating costs of the properties from this amount, but UW pays the capital improvement costs. Typically in the commercial real estate industry, a property manager is paid about 3% of gross rents, and the owner pays both capital and operating costs. In FY 1999, UNICO retained gross rents of $13.9 million, from which they paid the operating costs of the properties. Metro Tract staff stated that they do not know the amount of the operating costs paid by UNICO out of its management fee. *(Pages 15,16)*

- The terms of the UNICO lease essentially makes UNICO a joint venture partner with UW in the ownership of the Metro Tract office properties. UW leases the entire office portion of the Tract to UNICO, which manages the properties. The terms of the lease require UNICO to make certain rental payments to UW. As mentioned above, these payments amount to less than half of the gross rents received by UNICO. The UNICO lease dates back to the 1950s. According to UW staff, the original UNICO lease followed a competitive process.

- The original lease with UNICO was to expire in 1989. The lease was extended in the 1970s and now does not expire until 2014. In return for the extension of UNICO's ownership interest in the Metro Tract, UNICO acted as the banker for several capital improvements to the Metro Tract properties. UNICO paid for improvements to the properties and is being reimbursed (with interest) by UW.

- We did not attempt to assess whether the lease with UNICO allowed for a competitive return on investment to UW when it originated in the 1950s. However, it seems clear that the 25-year lease extensions to UNICO in the 1970s in return for UNICO acting as the banker for capital improvements, has become far more costly to the UW than had the UW simply borrowed money for the improvements from commercial sources. UW is paying interest to UNICO on the capital funding they provided. In addition to interest, the lease extension allows UNICO to continue its ownership interest in the office properties for 25 years following the initial expiration date of the lease. UNICO's ownership interest is currently valued at $105 million, according to an analysis recently conducted for the UW. *(Page 5)* Given that UNICO is 10 years into the 25-year extension, it seems likely that the original value of the lease extension was well in excess of the current $105 million value.

- Had UW simply borrowed the funds to complete the improvements and allowed UNICO's lease to expire in 1989, UW rather than UNICO would be receiving the benefit of UNICO's continuing ownership interest. UNICO retains over 50% of gross rents of the office properties as its management fee. The nature of the leasing arrangement with UNICO would appear to explain why the operating return to UW on the Metro Tract office properties is about 49% of the operating return earned by the SIB on its Union Square commercial buildings.

JLARC Staff Recommendations.

1. The *"Metropolitan Tract: 1999 Supplementary Report to the Joint Legislative Audit and Review Committee,"* together with this cover memo, should be distributed to the Senate Ways and Means and House Capital Budget Committees.

2. The University of Washington should **not** renew its current lease, upon its expiration, under the terms and conditions currently prevailing.