State of Washington DSHS Centers

Alternatives Analysis

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HEARTLAND

INTRODUCTION

Heartland has prepared the following report at the request of the State of Washington (the "State"). The State engaged Heartland to undertake an analysis of the five Department of Social and Health Service's ("DSHS") residential habilitation centers to identify potential surplus real estate parcels at each center, to evaluate opportunities and constraints with such parcels from a real estate perspective, and to recommend a strategy to optimize and capture value from such real estate.

This report follows several other reports, which addressed many of the existing conditions and issues at each of these centers. Specifically, we considered:

- The July 2002 *Complete Appraisal of Real Property* by Cushman & Wakefield (the "Appraisal");
- The December 2002 *Capital Study of the DDD Residential Habilitation Centers Report 02-12* from the Joint Legislative Audit and Review Committee (the "JLARC Report"); and
- The April 2003 *Report on the Potential Excess Property of the Department of Social and Health Services Division of Developmental Disabilities Residential Habilitation Centers* from the Department of General Administration (the "GA Report").

In order to provide the State with the most efficient and time sensitive evaluation, we did not attempt to recreate all of the previous analysis. In many cases, we leveraged off of these previous studies for base information, which we then confirmed and expanded as often as possible through direct contact with the appropriate people. Therefore, throughout the report, there are references to each of these previous reports. In particular, we have relied on the Appraisal for determining the value of the property on an "AS IS" basis. In this "AS IS" scenario, although we agreed that the indicated values determined by the Appraisal were reasonable, in most cases we felt the marketing and absorption timeframes for these properties would be longer than the Appraisal indicated and our analysis factors this extended period through the discounting of these future values over the period indicated in each alternative.

This report is divided into a section for each of the five centers and the analysis of each property stands on its own. At the same time, there are several properties that are very similar in circumstances and similar strategies are recommended. For each property, we have started with three questions: (i) what land, if any, is surplus regardless of the operations on the site; (ii) is the land under the buildings on the site more valuable than the site as currently developed; and (iii) is the land under the buildings essential for optimum value to be realized from surplus parcels? Per the specifics of our engagement, we have made no assessment as to whether the facilities should continue to operate as DSHS centers. We have focused exclusively on the alternatives for obtaining value from the sites and, in our opinion, which of the potential alternatives provides the best strategy for optimizing value from a real estate market perspective. In the case of Fircrest, as directed in the budget proviso that authorized this study, we have restricted our recommended alternative to a ground lease-only scenario, although we advise the State to seriously consider the sale alternatives we discuss below.

There are various issues which we believe the State should consider in their overall analysis of how to proceed with the five Department of Social and Health Service's ("DSHS") residential habilitation centers which we have not addressed. One such issue is the question of whether consolidation of any or all of the facilities is desirable and, if consolidation occurs, where it should occur. Given Fircrest's potential real estate value, in our opinion, this is the least favorable potential consolidation site from a real estate perspective. The community and political reaction to the potential loss of these centers as an employment base and part of the community should also be addressed. With alternatives that recommend a sale of all or a part of a site, additional attention and focus needs to be spent on the legal process for surplusing the property and what if any requirements there are with regard to offering the sites to other governmental entities prior to open market sales. In addition, any investment/reinvestment policies and financial resource issues, as well as potential legal constraints on the eventual sale structures need further consideration. Finally, we have not focused on the mechanics of transactions which the State should consider to maximize value from a sale such as joint ventures, sales over time and financing mechanisms.

Our analysis culminates in a financial analysis that determines the net present value and net cash flow from each alternative. This report provides the State with an analysis and recommendations that consider not only the highest present value, but also the greatest cash flow. As mentioned above, rather than recreate what was already completed, for the "AS IS" analysis, we relied on the accuracy of the recent Appraisals, which we discounted to account for our opinion, that marketing timeframes would be longer than the Appraisal indicated. For the other analyses (alternatives assuming changes of uses, value after demolition, etc.), we completed a residual land value model, which calculates the net present value and net cash flow based on a discounted cash flow. This model considers the market rate for developed land, the costs to develop the land, the time to entitle, develop and sell the land, and the appropriate discount rate to reflect the risk and return for such a project.

Based on our analysis focusing on the three primary questions indicated above, we believe the centers fall into three categories:

- **Fircrest**, which has significant redevelopment potential and where the redevelopment potential provides an opportunity which exceeds, in our opinion, the achievable net present value of a sale of the existing site "AS IS" if the site is sold and less if it is ground leased;

- **Lakeland Village in Medical Lake and Rainier School in Buckley**, which have significant excess land that is not necessary for the centers and any potential expansion area. In both cases, we believe it would be prudent to take advantage of this excess land regardless of whether DSHS is operating on the site. There is little current driving force to remove the campus given the large quantity of excess land, and likely slow absorption. In addition, the underlying land value does not exceed the "AS IS" value of the land and buildings and therefore redevelopment of the areas under the center is not justified at this time. If DSHS stops operating at the site, the campus area should be marketed as a campus with buildings; and

- **Francis Haddon Morgan Center ("FHMC") in Bremerton and Yakima Valley School in Selah**, which do not have significant excess land and where the underlying land value does not exceed the "AS IS" value of the land and buildings and therefore redevelopment of the areas under the center is not justified at this time. If DSHS stops operating at the site, the campus area should be marketed as a campus with buildings.

Per the budget proviso authorizing this study, we have analyzed and recommended a ground lease scenario. We have also included our analysis of a sale scenario, which, in our opinion, would be the preferred alternative from solely a real estate perspective. Within a non-sale scenario, our conclusion for Fircrest is that the best alternative is to master plan and ground lease the site for redevelopment. We are aware of discussions around ground leasing this property versus selling it, which we believe is based on two issues: (i) partial ownership in the CEP&RI Trust ("Trust"); and (ii) concern over selling a property that will rise in value. As to the first issue, it has been indicated that a few different strategies could be employed to address this concern. The essential conclusion is that a sale of Trust property is acceptable as long as the value is replaced in the Trust. One potential may be replacing the value with excess property at Lakeland Village and Rainier School. As to the ground lease issue, we believe that this will significantly and negatively affect the potential of the property. Under a ground lease scenario, the potential for "for sale" housing would be virtually eliminated, which in turn substantially increases the number of residential rental units and extends the absorption period. As to other potential commercial uses (including multi-family rental housing), a ground lease would have to be for a significantly long period of time, typically 50 to 99 years plus renewal options, which essentially changes the ownership. In addition, since most ground leases will not subordinate to construction financing, the potential pool of developers for the site is greatly diminished.

For Lakeland Village and Rainier School, our recommendation is to leave the existing buildings intact with additional land for potential expansion for DSHS or a future user. We then recommend selling the excess land at each center. In the case of Rainier School, this should occur following the harvesting of the timber. At such time as the campuses are no longer used by DSHS, they should be sold as developed property. While it may take an extended marketing period to achieve such a sale, the underlying land value does not justify demolition of the existing buildings at this time and will not in the relatively near term.

For Yakima Valley School and FHMC, the small amount of excess land should be sold, if possible, and then, at such time as the campuses are no longer used by DSHS, they should be sold as developed property. While it may take an extended marketing period to achieve such a sale, the underlying land value does not justify demolition of the existing buildings.

We look forward to working with the State to appropriately position and implement the strategies outlined in this report.

Recommended Strategy Summary

	Low	High	Probable
Fircrest			
Net Present Value	$2,100,000	$5,500,000	$4,000,000
Stabalized Annual Rent (Yr. 12)	$1,650,000	$1,650,000	$1,650,000
Francis Haddon Morgan Center			
Net Present Value	$1,000,000	$1,200,000	$1,510,000
Net Cash Flow	$3,000,000	$3,000,000	$3,000,000
Yakima Valley School			
Net Present Value	$400,000	$500,000	$700,000
Net Cash Flow	$1,700,000	$1,700,000	$1,700,000
Rainier School			
Net Present Value	$6,500,000	$7,100,000	$6,800,000
Net Cash Flow	$9,200,000	$9,200,000	$9,200,000
Lakeland Village			
Net Present Value	$2,000,000	$2,300,000	$2,800,000
Net Cash Flow	$5,400,000	$5,400,000	$5,400,000
TOTAL NET PRESENT VALUE	**$12,000,000**	**$16,600,000**	**$15,810,000**
TOTAL NET CASH FLOW W/O FIRCREST	**$19,300,000**	**$19,300,000**	**$19,300,000**
FIRCREST STABALIZED ANNUAL RENT (YR. 12)	**$1,650,000**	**$1,650,000**	**$1,650,000**