

Mercer Island project tops list of biggest deals in 2008

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To local developer Michael Christ's great benefit, his Island Square luxury mixed-use project in Mercer Island's revitalizing hub became the proverbial match-made-in-heaven for national apartment operator UDR Inc.

UDR's appetite for high-end new apartment developments in top-tier locations prompted its winning offer of just over \$112 million to Christ, principal of Seco Development in Renton.

That logged the deal as the Puget Sound region's largest real estate transaction of 2008.

While the five-story redevelopment venture was still in its initial lease-up stage, real estate investment trust UDR was looking to quickly buy about \$1 billion worth of apartment communities in order to defer capital gains tax liabilities from a \$1.7 billion portfolio sale.

Seco's Island Square development was pretty much what the publicly traded REIT's brain trust had in mind.

In upgrading its portfolio in the wake of the big sale early last year, Highlands Ranch, Colo.-based UDR (formerly United Dominion Realty) wanted to own some sizable, newly completed upscale developments boasting superior locations within preferred markets such as Seattle. And Island Square's "A-plus location and A-plus quality" clearly fit the bill, said Matt Akin, the REIT's senior vice president overseeing acquisitions and dispositions.

The project features 235 high-end studio, one- and two-bedroom apartments and approximately 39,000 square feet of office and street-level retail space. Studios start at about \$1,100, some of the one-bedroom apartments rent for more than \$2,000 a month, and the most expensive two-bedroom units range to well over \$3,000.

While those rents rank among the highest in the region, they're a lot more affordable than houses on Mercer Island, where the median price is still about \$1 million. Two-bedroom, two-bathroom apartments on the island command an average rent of about \$2,300, compared to the region-wide average of less than \$1,200, according to apartment research firm Dupre + Scott in Seattle.

The island's geography has a lot to do with those rents and values. Island Square's location just off Interstate 90 is smack dab between the region's biggest employment hubs: the Seattle and Bellevue central business districts. Apartment broker Kenny Dudunakis at Hendricks & Partners in Seattle, who helped negotiate the sale between Seco and UDR, says it's a three-mile commute to either downtown.

After years of debates over a new development plan for Mercer Island's sole commercial district, Island Square is one of several mostly mixed-use developments now transforming the area from sleepy strip malls into what Dudunakis anticipates will be a 24-hour urban environment with plenty of eateries and nightlife.

Christ's team built Island Square on the site of the 1950s-vintage Island Market Square shopping center. And once residents and businesses absorb the district's current construction wave, additional new competition for Island Square will be minimal for the foreseeable future, as developers have exhausted pretty much all of the apartment units entitled under Mercer's zoning, Dudunakis said.

"The constraints on new development are very much in our favor long-term," said UDR's Akin, "as long as we don't see a lot more rezoning."

Hence the nosebleed price tag and fervent bidding for Island Square last spring despite the deteriorating national economy and dysfunctional real estate capital markets. Indeed no fewer than 30 would-be buyers toured the property, and Seco received more than a dozen serious offers, Dudunakis said.

The broker calculates UDR's price for Island Square's apartment component at about \$377,000 per unit, with the commercial element accounting for the balance. Only a handful of local multifamily properties have sold at higher per-unit prices even as values hit new highs over the past three years or so, said Dupre + Scott co-principal Mike Scott.

Predictably nearly all of them are in the area's most expensive neighborhoods: central Seattle, Bellevue and Kirkland. The property fetching the highest per-apartment price: a small eight-unit waterfront property in West Seattle at \$418,750 per unit.

And as Akin explained, UDR had additional motivations to outbid the competition for Island Square. As the final bid deadline approached last spring, few assets of the development's stature were available in the REIT's target markets, further motivating UDR to step up its bidding, Akin said.

Likewise Island Square would mesh well with UDR's already substantial local portfolio, boosting operational scale efficiencies, added Akin.

But given the worsening economy, UDR decision-makers were skeptical about the near-term prospects of the commercial space in a location undergoing such a radical transformation, Akin added. Hence, to help close the UDR deal, Seco essentially agreed to assume risks associated with the office and retail components for five years, offering UDR pre-set monthly payments under a "master lease" arrangement.

Nevertheless, the office and retail components are performing about as well as could be expected in the current environment, with 97 percent occupancy at an average annual lease rate of \$28.55 per square foot, Akin said. In fact, Island Square's retail space leased quickly to banks, real estate companies and other small businesses, and was nearly all committed by the time the property traded hands, Dudunakis said.

As for Island Square's apartments, Akin acknowledged that softening renter demand is an unavoidable factor. The occupancy rate had hit the 90 percent mark, but dipped back slightly early this year.