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Brownfields Projects Turn Green in Vastly Improved Redevelopment Climate

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One by one, the obstacles that hampered the clean-up and redevelopment of contaminated properties by private investors are falling away. After years of disuse, a massive industrial parcel in a Cleveland neighborhood has again become a productive part of the community.

Despite vastly improved prospects for the successful redevelopment of environmentally tainted real estate—so-called "brownfields"—a widespread notion persists that such projects are too difficult to finance, impossibly hindered by regulators, and fraught with endless potential liability. This impression is very much out-of-date. Across much of the nation, brownfields are being restored to productive use on economically feasible terms that amply reward investors. Aided by cooperative state and local regulators, improved clean-up technology, and new insurance products to protect sellers, equity investors and lenders, brownfields redevelopment is providing new jobs, boosting tax revenues, eliminating community blight, and reducing the need for costly and potentially environmentally damaging new construction. In the regulatory area, it is worth noting that more than 40 states have now adopted so-called "brownfields initiatives," which provide a variety of economic and legal incentives to encourage redevelopment of tainted property.

Certainly, there is ample opportunity for such redevelopment. According to the U.S. Environmental Protection Agency (EPA), the United States is glutted with an estimated 450,000 brownfields. Many are well-located sites, but require the combined real estate and environmental skills to unlock their potential value.

A good example is a property now known as Nottingham Business Park in Cleveland, one of several major brownfields projects undertaken recently by Brookhill Redevelopment LLC. In all aspects, Nottingham illustrates how the climate for reclaiming contaminated property has changed for the better.

On a fundamental level, brownfields redevelopment faces all the issues and complexities that conventional real estate redevelopment confronts—but at a higher

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order of magnitude because of environmental issues.

Financing brownfields redevelopment is essentially about managing risk, pertaining to both the real estate and the environmental problems. It involves far more than simply seeking a higher yield to compensate for risk—although return is clearly what motivates both developers and lenders. It is imperative to understand the nature and extent of the environmental risk and its relationship to the real estate parameters. These transactions require a combination of real estate redevelopment and environmental expertise, working together to successfully manage such projects.

Nottingham Business Park

In early February 1998, the corporate owner of a 60-acre industrial parcel on Cleveland's east side decided to sell. The then-vacant property, containing three buildings totaling 758,000 sq. ft., had 80 years of industrial history, including use as a torpedo factory during World War II. By the end of March 1998, the property sale was completed. Since the acquisition, a significant amount of remediation and renovation has been completed, one of the three major buildings has been totally leased, and other lease transactions and physical upgrading are well underway for the rest of the project.

Utilizing the community's name, the project was renamed "The Nottingham Business Park." Situated on the south side of St. Clair Avenue, just west of 172nd Street near Cleveland's eastern border, Nottingham Business Park is located within a commercial and residential area approximately nine miles northeast of Cleveland's central business district, with immediate access to major interstate thoroughfares, including I-90 and I-271. The site has rail service and is within one mile of Lake Erie.

The primary structures include a manufacturing and office building with 426,328 sq. ft.; a former manufacturing building, warehouse, and research and development facility containing 170,319 sq. ft.; and a high-bay former specialty metals facility with 162,400 sq. ft. Tenneco's Walker Automotive Division formerly occupied part of the warehouse building. Only the warehouse and a security guard house had been occupied for the last several years prior to the sale.

The Cleveland Graphite Bronze Company, later known as Clevite Corporation, originally developed the property early in the 20th century. Site operations were related to the manufacture of various types of sleeve bearings and bushings for automotive, aircraft, and electric motors industries and other industrial uses, most notably for the manufacture of torpedoes during World War II. In 1988, Pullman Corporation purchased the site, and then Tenneco acquired Pullman in 1996.

The neighborhood, the City of Cleveland, and the Ohio EPA have all been involved with and have supported the remediation and redevelopment of the property. The site is eligible under the Ohio voluntary clean-up program; and the availability of that program and the positive response from regulators are important to the project. A loan application under the city's brownfields program has also been submitted. As part of the redevelopment process, early on support from neighborhood organizations, including the district city council member, was enlisted. These groups were enthusiastic about the property being cleaned up and put back to use. Articles tracking the progress of the project periodically appear in the local press.

Financing for this acquisition and redevelopment came from a major Wall Street investment firm, which provided both conventional senior debt and mezzanine financing. The senior debt has since been securitized through an offering to investors that pooled similar loans.

As of December 1999, two tenants—Soundwich Manufacturing and Beck Manufacturing—lease all of the 170,319 sq. ft. warehouse building. In addition, other large space users are actively negotiating for the lease or purchase of the remaining two industrial buildings.

Improvements made by Brookhill since acquisition have included: new landscaping; upgrading of security and guard house; extensive lead and asbestos abatement; installation of new window panels; removal of approximately 250,000 sq. ft. of contaminated wood-block flooring; painting, roof, and drainage improvements; upgrades to the utility systems serving the site; and general rehabilitation. The above-ground remediation and building improvements by Brookhill, with appropriate agency oversight, has encouraged and allowed occupancy. The entire appearance, especially the approach to the industrial park, has been dramatically improved.

Security is provided, which has proven important to both tenants and neighbors. Overall response to the improvements, by the neighborhood, the real estate community and all levels of government, has been resoundingly positive. Within the next few months, the high-bay structure will be leased or sold.

The warehouse portion of the largest structure also will be leased, but the multistory office section and a former metal-plating facility are still being remediated and will not be occupied any time soon. Overall, approximately 75 percent of the structures will be utilized, and there remain other redevelopment opportunities on vacant or cleared land on the site. Within the next three years, the turnaround of this vacant brownfield into a vibrant business park should be complete.

Key Aspects of Redevelopment

This example illustrates several key aspects of brownfields redevelopment.

The Acquisition

The real estate axiom that a property has to be acquired at the right price for development to succeed is probably even truer for brownfields. The simple formula is: the current value of the property, if it were clean, minus the cost of remediation equals a fair acquisition price. While fundamentally logical, there are many hidden variables.

In this case, as in many, the corporate owner was most interested in transferring liability and eliminating the costs of continuing to maintain the facility. The owner may have no interest in acting as a real estate developer or may want to put the property into a joint venture transaction to benefit from the future upside. Most environmental acquisitions are done by single-purpose, limited liability corporations. Not only is this increasingly common for all types of real estate, this clearly offers more protection for the buyer. From the seller's perspective, protection against environmental liability reverting back to the seller comes from the insurance policies, a fixed-price clean-up contract, and the monies expended on the purchase price. In some cases the estimated cost of clean up is secured by a bond or other instrument.

Environmental Costs

On the environmental side, the key questions are how much will the remediation cost and when will regulatory closure be received. For a fairly typical leaking underground oil storage tank, both the time and cost should be definable. Nottingham Business Park involved both (1) above-ground issues (e.g., asbestos, lead paint, and contaminated wood blocks), which Brookhill has remediated, and (2) an assortment of in-ground contaminants, including solvents, for which a group of the prior owners retains responsibility.

Remediation cost and the clean-up schedule should be locked in the contract with the environmental consultant, usually in the form of a guaranteed maximum price.

Insurance

The remediation commitment should be backed by environmental "cost cap" insurance (sometimes called "stop-loss" insurance). The insurance company steps in if the cost of remediation exceeds the estimate plus a "buffer," or deductible. Depending on the nature and extent of contamination, protection equaling at least the estimated cleanup often is required by lenders. A second environmental insurance policy, called Pollution Legal Liability, provides protection for unknown contaminants or changes in regulations, usually for a period of 10 years. The one-time premiums of the policies are usually a small fraction of total costs.

Projecting Costs

All of these costs—acquisition, remediation, insurance, plus the legal and technical support to obtain regulatory approvals—must be included in the pro forma. The legal and consulting costs often are substantially beyond conventional real estate transactions. Most of the costs also come early, during and just after acquisition, often before cash flow starts or grows to support the project and therefore must be included in the financing.

Real Estate Factors

The real estate analysis of a brownfields project entails nothing unusual, but should be conservative. Given a property with some level of environmental stigma, it assumes that some extra time and costs will be associated with lease-up, even with an industrial property. In this transaction, it is assumed that the first tenant will not be in place for 12 months after purchase of the property.

Lender Perspective

There are a variety of potential investors for brownfield properties. However, all of them want to be fully protected from environmental liability and meet or exceed their normal real estate underwriting criteria. Lender liability for environmental contamination is a complex and fast-changing area. Current trends in federal and state regulations, after some false starts, will generally provide lender liability protection, unless the lender actively participated in the management and contamination of the property.

Some commercial banks will participate, particularly if the project qualifies for Community Reinvestment Act credit. Although a few pension funds and insurance companies have made investments or at least expressed interest, most are still leery of environmental taint. There are a number of private funds, hedge funds, etc. that have some appetite for projects with greater real estate risk—but not environmental risk. Wall Street firms have invested in brownfield sites, often with the goal of securitizing the assets after remediation, redevelopment, and occupancy have been achieved.

Summary

In the past few years, brownfields redevelopment has evolved from a theoretical but largely impractical concept to an economically viable and socially useful form of real estate investment. Regulators and community development proponents generally support private investment in brownfields, insurance products are now available to help manage the risks associated with brownfields projects, and improved technology facilitates more efficient remediation. As a result, the restoration of contaminated property to clean status and productive use is a reality in many communities across the nation. This activity will accelerate in coming years, as the real estate community becomes more aware of the new viability of brownfields investment. ■