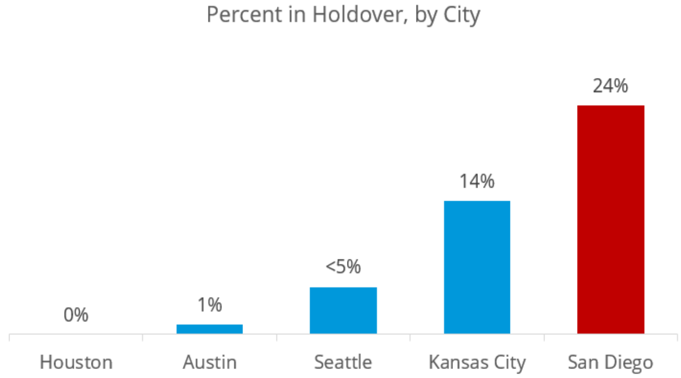
Performance Audit of the City's Lease Management and Renewal Process

Why OCA did this study

The Department of Real Estate and Airport Management (DREAM)—formerly known as the Real Estate Assets Department (READ)—manages the City of San Diego's (City) real estate portfolio for City departments, including the administration of more than 800 properties owned by the City that are leased to third parties. These properties generate more than $80 million in income for the City per year and provide opportunities for the City to leverage properties and lease them to tenants who provide cultural and community-based services. Therefore, effectively managing the leasing out of City-owned property is essential to maximize the City's revenues and ensure the best use of the City's assets.

Exhibit 3

The City of San Diego Has a Much Larger Percentage of Active Lease Agreements in Holdover Than Cities We Benchmarked Against



Note: Jurisdictions may have different portfolio sizes and staffing levels, and may not calculate holdover percentage with the same methodology; figures were compiled using auditors' best professional judgment and shown for the purpose of providing material comparison and context regarding the percentage of San Diego's leases in holdover.

Source: OCA generated based on interviews with real estate department's in cities identified for benchmarking.

What OCA found

Finding 1: The City allows a much higher share of leases to remain in holdover than other jurisdictions, which may be leading to foregone revenue for the City and potential or perceived favoritism.

Best practices generally discourage lease holdovers. By allowing leases to fall into and remain in holdover, the City may be losing out on potential revenue that could be generated from appraising a property and renewing or entering into a new lease with the current tenant at current market value, or by entering into new tenancies using a competitive bidding process. Additionally, the City may potentially be conferring an unfair benefit to the current tenant, creating unnecessary uncertainty for both the City and lessees, and limiting the City's ability to enact and enforce updated contract provisions.

We found the City has made little progress on addressing the prevalence of lease holdovers since a Grand Jury report from 2017. Relevant Council Policies have not been updated, and the proportion of holdovers appears to be little changed—101 of 421 (24 percent) of active leases as of July 15, 2021 were in holdover, including many for over a decade.

In FY2016, DREAM established a key performance indicator (KPI) with a target of keeping holdovers under 20 percent of total lease agreements. In the FY2022 Adopted Budget, the target was increased to 25 percent.

Many of the real estate department managers from the cities we benchmarked against believe that in most cases, it is best to avoid leases falling into holdover. As shown in Exhibit 3 above, these cities' proportions of leases in holdover appear to be significantly below 20–25 percent.

We found several factors that are contributing to a high percentage of City leases falling into holdover, including:

- DREAM does not have a formal process for selecting which leases will be prioritized for renewal;
- DREAM is not proactively using its lease management system to initiate the lease renewal process far enough in advance;
- DREAM is not exercising or consistently including in contracts rent-based financial disincentives for holdover, reducing the incentive lessees have to renegotiate leases that are expiring; and
- DREAM appears to be significantly understaffed, limiting its ability to effectively oversee lease management and renewal.

DREAM did not have an estimate of how much revenue the City is foregoing by having so many holdovers. However, with more than 100 properties in holdover and DREAM's property portfolio collecting approximately $80 million in lease revenue annually, even a small percentage of undercharging due to holdover could result in potentially millions of dollars in foregone revenue for the City each year.

Finding 2: DREAM should improve its lease management practices, particularly to protect the City from liability, verify that lessees are utilizing leased property appropriately, and ensure that rent levels align with market conditions.

In addition to reducing holdovers, DREAM should ensure that leases throughout its portfolio are managed effectively. Consistent performance and documentation of key practices may mitigate risk of litigation for the City, reduce expensive problems with properties, reduce the risk of lost revenue, and prevent lost institutional knowledge as the City manages its vast property portfolio. However, as shown in Exhibit 6 below, we found that DREAM has not been consistently performing or documenting several important lease negotiation and management practices.

For example, only 23 percent of leases we reviewed had up-to-date insurance documented, increasing the City's legal liability risk. In addition, while there is no clear-cut standard for the frequency of property inspections, we found that most of the City's lease-outs we reviewed had gone years since their last documented inspection. DREAM should establish and enforce standards for more frequent inspections to help ensure compliance with lease terms and ensure that City properties are being maintained.

Exhibit 6

DREAM Should Improve Its Performance and Documentation of Key Lease Management Practices — See Each Key Lease Management Practice Below for More Information

Testing Metric	# of Leases that Met Testing Metric	Total Leases in Sample	% of Leases Reviewed that Met Testing Metric
Insurance up-to-date in information systems	7	31*	23%
Inspection(s) conducted from January 2019 – July 2021	10	32	31%
Rent adjustments according to terms	19	26**	73%
Appraisal or Statement of Value documented in information systems for leases renewed within past 5 years	11	14***	79%
Key dates entered into REPortfolio	29	32	91%
Any type of job manually entered in REPortfolio	30	32	94%

*One of the leases, a federal agency, is self-insured; thus DREAM does not track their insurance.

**Six of the leases in the judgmental sample are non-revenue leases, bringing the sample size down from 32 to 26.

***We supplemented our original sample by testing an additional 29 recently renewed leases to obtain these results; 14 were eligible for an appraisal under the San Diego Municipal Code.

Source: OCA generated based on information in DREAM's REPortfolio and EDRS information management systems from July 15, 2021. For a list of all results see **Appendix C**.

Finding 3: DREAM should work with the City Attorney's Office to develop a lease template to streamline the lease renewal process and ensure that the appropriate provisions and clauses are included in leases.

We also tested 31 leases from six different categories to identify if several key provisions were included within these contracts. Provisions tested included commencement and termination dates, rental amounts and increases, and others.

Overall, we found that most key provisions were included in all or nearly all of the leases we reviewed. One exception was that financial disincentives for holdover were included in only 61 percent of the leases we reviewed, which we identified as a possible contributing factor to the high number of holdovers discussed in Finding 1.

While DREAM generally includes fundamental contract provisions, not consistently utilizing standard templates creates the risk of other updated clauses being left out or becoming outdated, which may cause legal liability for the City according to the City Attorney's Office. Incorporating the use of lease templates and an up-to-date database of lease clauses can mitigate potential legal liability concerns and save DREAM and the City Attorney's Office time during the renewal process.

What OCA recommends

We make 14 recommendations to address the issues outlined throughout the report.

Key recommendation elements include:

- Documenting and executing a strategy for addressing the number of lease holdovers in the City's portfolio;
- Utilizing financial disincentives or market-rate adjustments where appropriate and including these clauses in new leases;
- Leveraging process improvements, such as automated reminders and increased notice time to tenants that may soon be entering holdover status;
- Re-evaluating staffing levels needed for addressing the high number of holdovers and performing other lease management and renewal functions;
- Establishing, communicating, and enforcing productivity standards or goals for lease management practices such as property inspections, appraisals, and ensuring up-to-date insurance;
- Documenting and publicly-presenting a listing of all City lease outs, their estimated market value, and their actual rent paid to the City; and
- DREAM working with the City Attorney's Office to create a master lease template(s) and lease clause database.

DREAM agreed to all 14 recommendations. For more information, contact Andy Hanau, City Auditor at (619) 533-3165 or CityAuditor@sandiego.gov