



THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Item Number: 340

City Lease of 1010 Second Avenue Office Space

OVERVIEW

The City leases various facilities, such as office space and warehouses, from private parties to house some City employees and support the daily operations of the City. On October 30, 2013, the Real Estate Assets Department (READ) presented an informational report to the Budget and Finance Committee regarding three office space leases set to expire in calendar year 2014. Among the leases discussed were those for 1010 Second Avenue, set to expire on March 31, 2014. The 1010 Second Avenue leases are comprised of two leases for a total of 141,889 square feet of office space.

Over the past several months, the City and Jason Hughes, who was appointed as the Mayor's volunteer Special Assistant for Real Estate Services on April 10, 2013, have been working through the process of re-negotiating the 1010 Second Avenue leases. To support these efforts, Mr. Hughes evaluated other lease sites and requested lease proposals from several private parties to accommodate the City's needs. From June 2013 through September 2013, the City received four proposals in response to Mr. Hughes inquiries including a proposal from the landlord of the 1010 Second Avenue building. The three additional responses were for alternate locations at: 600 B Street; 525 B Street; and 777 Front Street. The monthly rental rates, terms, and features of the proposed leases varied amongst the responses.

On December 10, 2013, the City Council will be presented with the recommendations from READ. This report provides a brief summary of the proposals received, notes the benefits and concerns of each proposal and presents preliminary estimates of the potential savings.

FISCAL/POLICY DISCUSSION

Existing 1010 Second Ave Leases

The existing leases for the 1010 Second Avenue location total 141,889 square feet of space that currently accommodates approximately 420 city employees from several City departments. These departments include but are not limited to the City Auditor, Fire Rescue, Transportation and Storm water, and Public Works. Each department pays a pro-rata share of the lease based upon the amount of square footage the department occupies. The departments can be categorized into four specific funds that will be responsible for the lease payments: the General Fund, the IT Enterprise Fund, the Facilities Financing Fund, and the Local Enforcement Agency Fund. The pro-rata shares of the lease payments for these specific funds are as follows: eighty five percent (85%) for the General Fund, seven percent (7%) to the IT Enterprise Fund, six percent (6%) to the Facilities Financing Fund, and two percent (2%) to the Local Enforcement Agency Fund.

The original lease for the 1010 Second Avenue location was entered into in 1999 for up to 136,321 square feet of space and has been amended on five occasions. A second lease was entered into in June 2011 for an additional 5,567 square feet of space. The current rental rate for the original lease is \$1.65 per month per square foot of lease space and \$1.74 per month per square foot of lease space for the second lease. Both leases are set to expire on March 31, 2014. The current total annual lease payment amount for the two leases is approximately \$2.8 million.

SYNOPSIS OF PROPOSALS RECIEVED

Re-negotiated 1010 Second Avenue lease

The re-negotiated 1010 Second Avenue lease would encompass the total space (141,888 square feet of space) covered by the two current leases. The proposed terms of the re-negotiated lease would become the sixth amendment to the original lease. Key components of the proposal include:

- Term of the lease is 72 months (6 years) with the ability to terminate the agreement after three years, with six months prior notice to the Landlord.
- The proposal includes a contraction provision which would allow the City to reduce the amount of space leased after December 31, 2013, with three months prior notice to the Landlord. The contraction right would be for the ability to reduce the total lease space by approximately 11,000 square feet.
- The monthly rental rate per square foot starting in Year 1 of the lease is \$1.17 per square foot and increases by three percent (3%) annually thereafter. The monthly rental rate is proposed to be retroactively set to July 1, 2013 with any payment received to-date over that scheduled amount to be used to offset future monthly payments.
- The facility is a full-service lease with the Landlord paying for all costs of ownership, management, security and any other costs associated with operating the facility, unless specifically excluded in the agreement.

- The Landlord has agreed to repaint all the suites, repair and/or replace the building Heating Ventilation and Cooling System (HVAC) as needed, reseal doorways to ensure the doors will safely close, and schedule regular pest control measures at the sole expense of the Landlord.
- Additionally, the Landlord will make available \$10.00 per square foot in Tenant Improvement Allowance (TIA) to address any additional improvements the City deems necessary (such as new carpet). The usage of any TIA would be amortized over the term of the lease and added as additional monthly rent. The usage and cost of the TIA would be weighed against the benefit of the improvements upon entering the lease. No usage of TIA is assumed for this analysis for this facility at this point in time.

The benefits of this proposal include the low monthly rental rate for office space, retroactively setting the effective date of the lease to July 1, 2013 which would provide immediate rental savings, the flexibility to reduce the amount of leased space by approximately 11,000 square feet, and the ability to terminate the lease after three years. This provides for a short-term, low cost option should the City consider a long-term plan, such as building or purchasing other facilities, to address housing City staff. Additionally, the Landlord has provided several improvements to be addressed at the Landlord's expense. Though the Landlord will make \$10.00 in TIA available for other improvements, usage of this funding mechanism would add to the monthly rental rate and effectively reduce the saving from this proposal.

600 B Street

The proposal for the 600 B Street office space covers 103,315 square feet of office space and would also be located in a building familiar to the City. The City recently relocated approximately 400 City employees from the 600 B Street location to an alternative site at 525 B Street. The key components of the 600 B Street proposal are as follows:

- Term of the lease is 78 months (6 ½ years) with one renewal option to extend the term five (5) years.
- The monthly rental rate per square foot starting in Year 1 of the lease is \$1.55 per square foot and increases by four percent (4%) annually thereafter. The proposal includes a rent abatement provision which would not charge rent from October 1, 2013 to June 30, 2014. As the proposal anticipated an earlier start date for the lease, the actual abatement period would need to be re-evaluated to ensure capturing an originally proposed nine month period.
- The facility is a full-service lease.
- The Landlord does not propose to provide any improvements to the facilities at the Landlord's expense. The proposal states the property will be occupied by the City in an As-Is condition.
- The Landlord will make \$25.00 per square foot in TIA available for the City to address any improvements the City determines to be necessary and beneficial. Any used TIA would be amortized over the lease term and added to the monthly rent payment. Based on an assessment by Jason Hughes, it is anticipated that \$15.00 in

TIA would be needed to be used for the preparation and development of this location for the City needs. The usage of \$15.00 in TIA would increase the monthly rental rate by \$0.23 per square foot.

The benefit of this proposal is the rent abatement for a portion of the first year of operation. Though the abatement period would need to be confirmed, calculating a nine month abatement period would yield savings of approximately \$1.4 million in lease payments in the first year of operation. Accepting the location in an as-is condition is a concern as Mr. Hughes has estimated the need to utilize a portion of the funding made available from the Landlord. Usage of this funding source would increase the monthly rental rate and increase the overall cost of the lease. An additional potential expense related to this proposal would be the moving expense. For the recently completed relocation of employees from 600 B Street to 525 B Street, approximately \$600,000 was expended in moving costs for a similar number of employees (approximately 400 employees).

525 B Street proposal

The proposal for the 525 B Street office space covers 98,858 square feet of office space and would be located in a building that currently houses City employees. The key components of the 600 B Street proposal include:

- The term of this lease is 84 months (7 years).
- The monthly rental rate per square foot starting in Year 1 of the lease is a weighted average of \$1.81 per square foot and increases by three and one-half percent (3.5%) annually thereafter. The monthly rental rates per square foot range from \$1.25 per square foot to \$2.00 per square foot based upon the location of the office space within the building.
- The facility is a full-service lease.
- The Landlord, as part of the cost factors built into the monthly rental rate, will provide \$18.67 (weighted average as the amounts provided vary per location within the facility) per square foot in TIA for the City to address any necessary improvements. As these costs are built into the monthly rental rate, usage of these funds will not impact the monthly rental rate. However, based on an estimate from Mr. Hughes, it is anticipated that \$20.00 per square foot in improvements would be necessary for this location. As this exceeds the amount offered by the Landlord, the City would need to address these additional costs out of pocket. The out of pocket expenses are anticipated to be approximately \$130,000 in one-time costs.

The benefit of this proposal is the amount of the TIA provided by the Landlord. Though a preliminary estimate of \$20.00 per square foot of TIA for needed improvements was provided by Mr. Hughes, the actual amount of TIA required could potentially be less. The recent move by City staff to the 525 B Street location required approximately \$16.00 in TIA to develop and prepare the agreed upon space. Moving expenses would apply to this proposal as well. The concern related to this proposal is the uncertainty of the needed improvement costs.

777 Front Street

The proposal for the 777 Front Street office space covers 100,000 square feet of office space. The key components of the 777 Front Street proposal include:

- Term of the lease is 60 months (5 years).
- The monthly rental rate per square foot starting in Year 1 of the lease is \$1.00 per square foot and remains at this rate for the term of the lease.
- The facility is not a full service facility. The City is responsible for paying the operating costs and utilities for the premises. In order to provide an appropriate comparison with the previously mentioned lease proposals, Mr. Hughes provided an estimate of \$0.75 per square foot per month be added to the base rental rate. This preliminary estimate allocates \$0.25 per square foot per month to utilities and \$0.50 per square foot per month to other facility services such as management and security.
- The Landlord, as part of the cost factors built into the monthly rental rate, will provide \$5.00 per square foot in TIA for the City. As these costs are built into the monthly rental rate, usage of these funds will not impact the monthly rental rate. However, based on an estimate from Mr. Hughes, it is anticipated that approximately \$15.00 per square foot in improvements would be necessary for this location. As this exceeds the amount offered by the Landlord, the City would need to address these additional costs out of pocket. The out of pocket expenses are anticipated to be approximately \$1,000,000 in one-time costs.

The benefit of this proposal is the Landlord providing TIA for any necessary improvements. The concern is a preliminary estimate indicates needed improvements to this location will exceed the provided TIA and result in significant one-time out of pocket expenses. Additionally as noted above the operating costs are not initially included in the base monthly rental rates. Adjusting for this factor increases the monthly rental rate by an estimated \$0.75 per square foot per month. Moving expenses would apply to this proposal as well.

The lease features described for all the lease proposals are provided in a table format in Attachment 1.

SUMMARY

The following table provides a comparison of the first year of operation for the proposed leases. The table incorporates the annual base rent payment and expenses previously identified within our report that would impact the first year of operation costs. The estimated costs do not include standard annual operating expenses, storage expenses, or parking expenses. Additionally, furniture expenses to implement the City's Facilities Strategies Plan are not included as additional analysis would be necessary should the City opt to implement this strategy within the selected office space.

Projected Year 1 costs of the proposed leases

Lease Features	Re-negotiated 1010 Second	600 B Street	525 B Street	777 Front Street
Square Footage	141,888	103,315	98,858	100,000
Base monthly rent rate (per square foot)	\$1.17	\$1.55	\$1.81	\$1.00
Annual rent	\$1,992,108	\$1,921,659	\$2,147,196	\$1,200,000
Value of rent abatement ¹	-	(\$1,441,244)	-	-
Cost of operating expenses ²	-	-	-	\$900,000
Cost of amortization of TIA ³	-	\$285,149	-	-
Out of pocket TIA costs ⁴	-	-	\$131,967	\$1,000,000
Moving Costs	-	\$600,000	\$600,000	\$600,000
YEAR 1 projected cost	\$1,992,108	\$1,365,564	\$2,879,163	\$3,700,000

1. Value of nine months of rent based upon monthly rental rate and square footage to be leased.
2. Estimated cost to cover annual operating costs and utilities.
3. Annual cost of amortizing TIA made available by Landlord.
4. Costs of needed improvements in excess of TIA provided as a part of the monthly rental rate.
5. Moving cost estimated based upon recent relocation of similar number of employees.

The table provides the preliminary estimates for the first year of operation for the respective proposed leases. However, the actual costs will vary based upon several factors such as the actual costs of necessary improvements at the selected facility and moving costs, should those services be required.

FY 2014 Budget

As the negotiations of the 1010 Second Avenue leases were ongoing during the development of the FY 2014 Budget, the Financial Management Department conservatively included the current annual lease payment of approximately \$2.8 million for the 1010 Second Avenue lease in the FY 2014 Budget. Based upon the selected lease agreement, there may be savings in FY 2014 from the budgeted lease payment for the 1010 Second Avenue leases.

Comparison for the full term of the proposed leases

The following table provides a comparison for the entire term of the respective proposed lease agreements. The figures include the annual base rent payment and additional charges previously identified in our report. The projected costs do not include estimated annual operating expenses, storage expenses, or parking expenses. No new furniture costs are incorporated into the estimates. As the terms of the proposed leases vary, the average annual cost is provided for comparison purposes.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7	Average Annual Cost
Current 1010 Second Avenue¹	\$2,809,382	\$2,843,436	\$2,877,489	\$2,911,542	\$2,945,595	\$2,979,648		\$2,894,515
Re-negotiated 1010 Second Avenue²	\$1,992,108	\$2,060,214	\$2,111,293	\$2,179,400	\$2,247,506	\$2,315,612		\$2,151,022
600 B Street³	\$1,365,564	\$2,281,195	\$2,355,582	\$2,442,367	\$2,529,151	\$2,615,936	\$1,357,559	\$2,264,966
525 B Street	\$2,879,163	\$2,218,374	\$2,301,414	\$2,384,455	\$2,467,496	\$2,550,536	\$2,645,440	\$2,492,411
777 Front Street	\$3,700,000	\$2,100,000	\$2,100,000	\$2,100,000	\$2,100,000			\$2,420,000

1. Monthly rental rate projected to increase \$0.02 annually per the current lease agreement and maintaining current amount of leased space.

2. Based upon maintaining current amount of leased space and not invoking the contractual provision of the proposed lease.

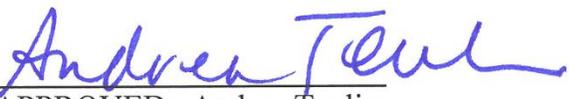
3. Average Annual Cost excludes Year 7 as the amount is only for 6 months.

From the table above, the re-negotiated 1010 Second Avenue lease has the lowest average annual cost when considering the additional charges in Year 1. Compared to the current 1010 Second Avenue lease agreements, the re-negotiated 1010 Second Avenue leases projects savings of approximately \$800,000 (\$650,000 for the General Fund) in Year 1, an average annual savings of approximately \$740,000 (\$629,000 for the General Fund) over the term of the agreement, and a total of approximately \$4.4 million (\$3.7 million for the General Fund) over the term of the agreement. This assumes that the contractual right of the re-negotiated lease is not invoked. Should the City decide to reduce the amount of the space leased during the term of the re-negotiated lease, the savings could be potentially higher.

CONCLUSION

Based upon our review of the information provided by READ, the projected savings from the re-negotiated rates, and the flexibility provided by the terms of the re-negotiated 1010 Second Avenue lease, the IBA supports staff's recommendation to approve the ordinance for the proposed Sixth Amendment to the Lease between Executive Complex, LP and the City.


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 Fiscal & Policy Analyst


 APPROVED: Andrea Tevlin
 Independent Budget Analyst

Lease Proposals

Lease Features	Re-negotiated 1010 Second	600 B Street	525 B Street	777 Front Street
Term	72 months	78 months	84 months	60 months
Square Footage	141,888	103,315	98,858	100,000
Base monthly rent rate ¹ (per square foot)	\$1.17	\$1.55	\$1.81	\$1.00
Annual increase in rental rate	3%	4%	3.50%	-
Free rent/rent abatement	-	9 months	-	-
Value of rent abatement	-	\$1,441,244	-	-
Full Service	Yes	Yes	Yes	No
Cost for Full Service ² (per month per square foot)	-	-	-	\$0.75
Termination Right	Yes, after 3 years	None	None	None
Contraction Right	Yes, after 1/1/14	None	None	None
Improvements borne by Landlord	Paint, Clean carpet, Reseal doorways, and Pest control	None	None	None
TIA built into Monthly Rental Rate ³	-	-	\$18.67	\$5.00
TIA made available by Landlord ⁴	\$10.00	\$25.00	-	-
Estimated TIA to be necessary	\$0.00	\$15.00	\$20.00	\$15.00
Amortization of TIA (per month per square foot)	-	\$0.23	-	-
Out of pocket TIA (cost per square foot)	-	-	\$1.33	\$10.00
Out of pocket TIA costs (\$)	-	-	\$131,967	\$1,000,000
Moving Costs ⁵ (\$)	-	\$600,000	\$600,000	\$600,000
YEAR 1 projected cost	\$1,992,108	\$1,365,564	\$2,879,163	\$3,700,000

1. Monthly rental rate per square foot in Year 1 of lease agreement.

2. Estimated cost to cover monthly operating costs and utilities.

3. As the provided TIA is a cost factor of determining the Monthly Rental Rate, no increase in the rental rate as a result of using the TIA for improvements.

4. TIA made available by the Landlord, however usage would result in amount of funding to be amortized over the lease term and increase the Monthly Rental Rate.

5. Cost estimate based upon recent relocation of similar amount of employees.