OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Review of Proposed Civic Center Plaza/King Chavez High School Building Lease-to-Own Proposal

OVERVIEW

On January 26, 2015, the City Council is scheduled to consider a proposal to enter into a 20-year lease-to-own agreement for Civic Center Plaza and the King Chavez High School building with CCP 1200, LLC, a Delaware limited liability company (CCL, LLC). This report provides a brief history of the City's efforts to acquire the Civic Center Plaza and King Chavez High School properties, an overview of the proposed lease-to-own agreement, a discussion of additional capital costs associated with the proposed agreement, and a discussion of concerns related to procedural issues associated with Council's consideration of this item.

While entering into this agreement may result in long-term financial and strategic benefits to the City, it is difficult to quantify those savings with any specificity, as they ultimately rely on an assumption of the rental rate the City might negotiate outside of the proposed agreement. It is also important that the City understand the costs and responsibilities it will assume by entering into the proposed agreement. Should the City enter into the proposed lease-to-own agreement, it should be prepared to consider making $21.4 million of capital improvements to CCP over the next five years, plus costs for furnishings needed to maximize space efficiencies.

FISCAL/POLICY DISCUSSION

History

Civic Center Plaza (CCP) is a 295,000 square foot office building built in 1973. It has been occupied by City employees since 1991, when the City assumed the remaining term of a 40-year lease agreement between the building's current owners and their previous tenant.

In 2013, in anticipation of the expiration of the existing lease in July 2014, the City and CCP's owner entered into discussions of either selling the property to the City or entering into a new lease agreement. In April 2014, the City entered into a non-binding Letter of Intent to purchase the CCP and King Chavez properties with an agreed upon price of $44 million, and a hold-over rental rate of $1.15 per square foot per month to cover the months between expiration of the existing lease and purchase of the building.[1]

In September 2014, CCP's owners demanded that the City enter into a binding contract by the end of October 31, 2014, with escrow to close by December 31, 2014. At that time City staff anticipated using lease-revenue bonds to pay for acquisition of the properties. However, it was determined that lease-revenue bonds were not an appropriate source of funding to purchase CCP, and the City entered into discussions with the real estate development company Cisterra Development (Cisterra) to develop an agreement by which Cisterra would purchase the CCP and King Chavez properties, and then enter into a lease-to-own agreement with the City.

Cisterra has since formed CCP, LLC, which has entered into an agreement with the properties' current owner to purchase the CCP and King Chavez sites at the previously established $44 million price. CCP, LLC is currently escrow with the properties' owner; escrow was originally set to close on January 30, 2015, but the closing date has since been extended to March 15, 2015. Staff indicates that January 26th is the last possible date for Council to approve the proposed lease-to-own agreement so that it can be signed by the Mayor before the March 15th close of escrow.

In December, the City contracted with outside entities to conduct an assessment and appraisal of the CCP building. The assessment was completed on December 8, 2014, and is discussed later in this report. The appraisal was completed on January 14, 2015, and is discussed below.

Appraisal

The City contracted with D.F. Davis Real Estate, Inc. to complete an market appraisal of the CCP and King Chavez sites. The appraisal examined the value of CCP and the King Chavez building through two approaches: a value based on comparable sales, and a value based on the income an owner could expect to realize. Based on comparable sales, the appraisal estimated the value of the CCP and King Chavez building as $45.2 million; based on expected income, the properties' value was estimated at $40.1 million

The appraisal notes that generally the estimated value of the two approaches is similar, and that when differences in valuation occur, typically the valuation based on *income* is strongly emphasized, as it is based on the income potential of the property and reflects the actions of buyers and sellers in the market. However, the appraisal conducted for CCP and the King Chavez building *de-emphasized* the income based valuation and emphasized the comparable

[1] Rent being paid under the previously existing lease totaled $1.85 per square foot per month; the $1.15 per square foot per month rate represented a significant decrease from that amount.

sales valuation, citing strong investment demand and owner-user demand at higher per-square-foot prices.

The appraisal concluded that the estimated stabilized market value of the property was $45.2 million, which represents the valuation based on comparable sales.

Proposed Lease-to-Own Agreement

Staff is proposing that the City enter into a 20 year lease-to-own agreement with CCP, LLC, at the conclusion of which ownership of CCP and the King Chavez High School building would be transferred to the City. Under the agreement, the City would pay CCP, LLC $0.91 per square foot per month,[2] and would assume responsibility for all capital improvements, operations, and building management.

Staff estimates that operating expenses for the building will total $10.23 per square foot per year. To partially offset these expenses, the City would receive revenue from paid parking under CCP and from the King Chavez High School; these combined revenues are estimated to generate $1.1 million annually. The net annual cost to the City under the proposed agreement is expected to start at $5.2 million. At present, $4.0 million is budgeted for rental of CCP in FY 15, though this amount is based on the below-market $1.15 per square foot per month rate the City is currently paying.

Should the City enter into the proposed agreement, it would need to identify $1.2 million in funding for CCP operating expenses in FY 2015 above what is currently budgeted. An additional $21.4 million in capital expenditures, discussed below, is anticipated to be required in the next five years should the City enter into the proposed agreement.

Staff does indicate that entering into a lease-to-own agreement will result in long-term savings of $24.2 million (with a present value of $9.1 million[3]) over renting space at CCP at market rates. These savings rely on an assumption that the City would enter into a new rental agreement at market rates of $2.00 per square foot per month.[4] It is important to note that actual long-term net savings or costs would be based on the actual rental agreement the City could negotiate at market. If the City were able to negotiate better lease terms, the overall savings associated with purchasing CCP would diminish, whereas if the City were unable to negotiate a $2.00 per square foot rate, savings would increase.[5]

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[2] This amount would grow by 2.5% per year over the life of the agreement.
[3] The present value figures assumes that future year costs and revenues are discounted at a rate of 6.0% annually.
[4] This amount is hypothesized to include $20 per square foot in allowances for tenant improvements; staff estimates that an additional $30 per square foot is also necessary.
[5] For example, the outside appraisal conducted for CCP indicates that market rents for CCP in an as-is condition without any allowance for tenant improvements are $1.68 per square foot per month. Adjusting the assumed market rent down to $1.68 and removing the tenant improvement allowance (thereby assuming that the City would be responsible for the same capital improvements contemplated in the lease-to-own proposal) would decrease expected total savings from $24.2 million (present value $9.1 million) to $11.6 million (with a present value of $6.1 million). Savings decrease further if it is assumed that the building owner will be responsible some portion of capital costs.

Additional Capital Costs

The staff report notes that an additional $15 million in capital costs would be required for CCP to allow for remediation of asbestos, ADA improvements, Title 24 requirements, and to maximize space efficiencies to allow the City to house an additional 245 employees at CCP. It is proposed that this $15 million could be included in future Capital Improvements Program (CIP) budgets. Improvements to allow the housing of additional staff at CCP will require modification of the existing floorplans; it should also be noted that the $15 million in associated identified capital costs do *not* include the cost for furnishing additional workstations, offices, and conference rooms.

Condition assessments of the CCP building determined that $6.4 million in capital improvements are also expected to be required during the first 5 years of operations. While there is some overlap between the $15 million in proposed capital costs for future CIP funding and this $6.4 million in identified needs, the amounts largely represent separate funding requirements. Operating expenses assumed in the proposal do include $300,000 per year towards the $6.4 million in needs, though that is anticipated to provide only $1.5 million over the first five years, leaving a delta of $4.9 million. Staff plans to evaluate CCP's needs regularly and to submit additional CIP funding requests as part of the City's budget process.

To provide additional context, the City currently faces capital needs of over $2.4 billion to provide for street and sidewalk repairs, facility maintenance, stormwater requirements, and other civic functions, as identified in the recently released FY 2016-20 Consolidated Multi-Year Capital Planning Report. Should the City enter into the proposed agreement, it will be important to ensure that CIP funding for CCP needs is provided along with funding for other CIP projects.

Procedural Concerns

Our office has concerns about the manner in which this item was brought forward, especially considering size and long-term nature of the commitment associated with staff's recommended actions.

Council last heard this item at a Closed Session hearing in November 2014. At that time, discussion was limited to the terms the City was willing to consider in directly acquiring the CCP property. The item has not been heard at any subsequent committee or Council meeting. The terms of the proposed deal before Council now are considerably different than those that were contemplated in November. While Real Estate Assets staff has been proactive in briefing Councilmembers and other offices on the status of negotiations, there has not been any opportunity for the City Council to publicly ask questions of staff on this proposal, to direct staff to provide additional information or details, or to suggest amendments to the proposal.

The staff report and associated back-up materials for this item were released on January 22, 2015. The staff report notes that if Council does not act to approve the proposed lease-to-own agreement at its meeting on January 26, 2015, the City faces increased CCP rental rates of 74% to 109% (increasing the current $1.15/sq ft rate to $2.00-$2.40/sq ft). Bringing the item forward in this manner and asking Council to take an immediate action to approve the proposed lease-to-own agreement, while at the same time highlighting the potential for significantly increased costs absent immediate action, does not allow Council sufficient time to fully vet the item, request additional information, or suggest modifications.

In order for Council to provide effective oversight and to fulfill all its legislative roles, it is imperative that Council have adequate time to review and analyze materials presented to it, and be afforded the opportunity to ask questions or request additional information, materials, or modifications.

CONCLUSION

There are several advantages to owning the buildings and facilities in which City employees work. When facilities are owned, the City is not subject to market variations in rental rates or the potential for outside building owners to repurpose their buildings to other uses. Ownership can also allow more accurate forecasts of long-term costs, revenues, and staff capacity. However, it is important that the City carefully consider major real estate purchases, capital improvement commitments, and long-term agreements in order to ensure that the best interests of the City – and ultimately the best interests of the citizens of San Diego – are protected.

We remain concerned that Council has only had a short period to evaluate the proposed lease-to-own agreement for the CCP and King Chavez buildings, and has not had the opportunity to publicly request additional information or suggest potential amendments to the proposed agreement. The stated consequences of Council's not approving this agreement on January 26th – including significantly increased costs and the potential need to relocate hundreds of City staff – may well represent real risks to the City, but adequate time for public review and Council deliberation is essential.

Given the condition assessment, appraisal, and downtown office rental market assumptions made by staff, entering into the proposed lease-to-own agreement with CCP, LLC does represent both short-term and long-term savings. While the staff report estimates savings of $24.2 million over the 20-year life of the agreement, we note that the actual amount of those savings is difficult to quantify, given that it relies on an assumed $2.00 per square foot per month rental rate. Should Council approve the proposed agreement, it should also request staff to identify funding for the additional $1.2 million in FY 2015 operating expenses, and to identify future year operations and capital improvement needs and funding sources.

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