THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

Date Issued: October 12, 2016 **IBA Report Number:** 16-34

City Council Docket Date: October 17, 2016

Item Number: TBD

Review of 101 Ash Street Lease-to-Own Proposal

OVERVIEW

On September 21st, 2016, the Smart Growth and Land Use Committee heard and recommended approval of a report from City staff that recommended the City enter into a 20-year lease-to-own agreement for the former Sempra Building at 101 Ash Street with 101 West Ash, LLC, a subsidiary of Cisterra Development LLC (Cisterra). That item is now pending Council consideration on October 17th, 2016. This report provides a brief history of the City's efforts to acquire the property at 101 Ash Street, an overview of the proposed lease-to-own agreement, and a discussion of the overall impact to the City associated with entering into this agreement.

Should Council approve this item, Real Estate Assets Department (READ) staff contemplate relocating Development Services Department (DSD) staff, as well as City staff in other downtown locations, to 101 Ash Street. Entering into this 20-year lease-to-own agreement will insulate the City from the risks of rising rental costs for leased office space. It should be noted that projected savings associated with the agreement – estimated by READ at $44.4 million over the 20-year term – rely on an estimated market rate for renting similar office space downtown. Additionally, we note that the lease-to-own agreement will result in less savings than purchasing the building outright would, though staff indicates that language in Cisterra's agreement to purchase the building from its current owner precludes the City from purchasing the building outright.

FISCAL/POLICY DISCUSSION

History

The former Sempra Building at 101 Ash Street is a 314,545 square foot office building built in 1968. It was occupied by San Diego Gas & Electric from 1968 through 1998, and by Sempra Energy from 1998 through 2015. After Sempra vacated the building in 2015, the building's owners approached the City offering to sell the building to the City at a price of $100 million. An appraisal conducted for the building estimates its value at $67.1 million. Given the $100 million sale price offered to the City, the City did not pursue negotiations to purchase the building directly from its current owner.

Concurrently, Cisterra began negotiations to purchase the building, and eventually entered into a purchase and sale agreement (PSA) to purchase the building for $72.5 million. During Cisterra's negotiations to purchase the building, the City and Cisterra entered into a non-binding agreement that would allow the City to either:

- Purchase the building outright from its current owner by having Cisterra assign the PSA in its entirety to the City, allowing the City to issue bonds to finance building acquisition (with total estimated financing costs of $110.6 million over 20 years); or
- Enter into a lease-to-own agreement with Cisterra that would transfer ownership of the building to the City after 20 years (with total rental costs of $127.8 million over 20 years).

City staff initially recommended that the City pursue the option to purchase the building outright through assignment of Cisterra's PSA. However, upon examining the actual PSA between Cisterra and the building's current owner, City staff indicated that certain language included in the PSA could result in a legal challenge should Cisterra assign the PSA to the City. City staff therefore now recommend that the City enter into the proposed lease-to-own agreement.

Office Space Need and Alternatives

READ has worked towards the City's goals of relocating DSD staff from the City Operations Building (COB) and expanding floor space for permit activity, and finding office space to accommodate employees that are current spread out among multiple different downtown office buildings. COB consists of 143,000 square feet of office space. The City additionally leases approximately 142,000 square feet of office space at the Executive Complex.

The City's lease at the Executive Complex currently costs $1.28 per square foot per month, and expires on June 30th, 2019. READ indicates that the market rate of Executive Complex office space could increase to $2.81 per square foot per month upon expiration of the existing lease in 2019. READ has investigated entering into a lease for 165,000 square feet of office space at 110 Plaza, and estimates that lease costs would total $2.25 per square foot, and increase annually. READ estimates that total costs to continue renting office space at the Executive Complex and to lease new office space at 110 Plaza would total $251.5 million over the next 20 years.[1]

[1] This estimate assumes that the current market rate for office-space rentals is $2.50 per square foot per month. As a point of comparison, the City's current lease for office space at 525 B Street is $1.70 per square foot, though READ notes that this lease is due to expire in 2020, and the rate under a new lease may increase up to $2.40 per square foot. If the City were able to negotiate rental rates below $2.50 per square foot for space at Executive Complex and 110 Plaza, total costs here would decrease.

The proposed lease-to-own agreement for the 101 Ash Street building would provide sufficient space to replace the space at COB and the space that would potentially be leased at 110 Plaza. READ estimates total rent and operating costs under the lease-to-own agreement over its 20-year term total $207.1 million, as is detailed below.

Proposed Lease-to-Own Agreement

Staff is proposing that the City enter into a 20-year lease-to-own agreement with a subsidiary of Cisterra, at the conclusion of which ownership of the 101 Ash St building would be transferred to the City. Under the agreement, the City would pay Cisterra $6.4 million annually,[2] and would assume responsibility for all capital improvements, operations, and building management. Cisterra would also provide $5.0 million to the City to make tenant improvements to the building. Total rental costs over the 20-year term would be $127.8 million, which represents the equivalent of paying a 5.5% interest rate.

READ staff indicates that an additional $3.3 million in operating expenses would also be required each year.[3] Annual costs to lease, maintain, and occupy the building are expected to total $9.7 million. Total costs over the 20-year term of the lease are estimated at $207.1 million.

The lease-to-own agreement also includes provisions that allow the City to either (1) purchase the building outright from Cisterra after 5 years, upon making a payment equal to the net-present value of remaining payments using a discount rate no higher than 3.15%, or (2) purchase the building and Cisterra's associated debt for $1. Unless interest rates on municipal bonds drop significantly in the next five years, or the City were to exercise one of these options without issuing debt, it is unlikely that either option would make financial sense for the city.[4]

Using READ's estimates of the cost to lease and occupy an equivalent amount of office space at the Executive Complex and 110 Plaza, this represents $44.4 million in savings.

Cost Difference Between Purchasing Outright and Leasing-to-Own

City staff originally contemplated purchasing the 101 Ash building outright instead of entering into the lease-to-own agreement with Cisterra. Because the City can generally issue bonds at lower interest rates than private entities, purchasing the building outright using bond financing would represent savings over the lease-to-own proposal.

---

[2] This amount is based on rental costs of $1.70 per square foot per month.

[3] Operating expenses are estimated to increase by 2.0% per year over the 20-year term of the lease.

[4] Because the first option requires payment of all remaining rental payments discounted by 3.15% or lower per year, and those rental payments are the equivalent of a 5.5% interest rate, bond interest rates would likely need to decrease to 2% or lower for this to option to generate savings. Potential savings in the second option would depend on the call provisions in Cisterra's bonds, but staff indicates that those provisions will likely preclude any opportunities to generate savings by refunding these bonds with the proceeds of newly issued City bonds.

City staff estimated that the City could purchase the building using 20-year bonds at a 3.25% interest rate. This would represent a total cost of $110.6 million over 20 years, which is $17.2 million lower than the $127.8 million that will be paid under the lease-to-own agreement. The lease-to-own agreement effectively increases the City's financing costs from 3.25% to 5.5%. If the option to purchase the building outright was available, it would represent approximately $61.6 million in total savings over leasing space at Executive Complex and 110 Plaza, as compared to the $44.4 million in savings associated with the lease-to-own agreement.

Staff indicates that the option to purchase the building outright is unavailable due to certain language in the PSA between Cisterra and the building's current owner. Given the $17.2 million difference in costs between purchasing the building outright and entering into the lease-to-own agreement, Council may wish to ask staff, Cisterra, and/or the building's current owner if there are any opportunities to have potentially problematic language in that PSA waived, which would not need to impact the building's sale price.

Short-Term Fiscal Impact of Proposed Measure

Entering into the lease-to-own agreement would allow the City to have access to the building in January, 2017. Rent and operations costs for FY 2017 are expected to total $4.2 million. $2.3 million of this amount is expected to be borne by the City's General Fund, with the remainder coming from non-General Fund sources. This amount was not included in the City's FY 2017 Adopted Budget, and an adjustment to the budget will therefore be necessary.

While READ projects the proposed agreement represents cumulative 20-year savings of $44.4 million over renting other office space, initial annual costs in FYs 2018 through 2020 are higher than the projected cost to rent alternate office space.[5] Total annual costs from FY 2021 on are projected to be lower under the lease-to-own agreement than continuing to rent alternate space.

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. It is important that the City carefully consider major real estate purchases and long-term agreements in order to ensure that the best interests of the City are protected.

Given the condition assessment, appraisal, and downtown office rental market assumptions made by staff, entering into the proposed lease-to-own with Cisterra does represent long-term savings, though the agreement will require additional funding in FY 2017 beyond what was included in the Adopted Budget. While the staff report estimates savings of $44.4 million over the 20-year life of the agreement, we note that the actual amount of those savings is difficult to

[5] Costs in FY 2018 are estimated to be $2.5 million higher than renting alternate space, FY 2019 costs are $2.0 million higher, and FY 2020 costs are $2.1 million higher. Savings in FY 2021 are projected at $505,000, and grow in each fiscal year thereafter.

quantify, given that it relies on an assumed $2.50 per square foot per month market rental rate for alternate office spaces.

Should Council approve the proposed agreement, it should also request staff to identify funding for the additional $4.2 million in rent and operating expenses required in FY 2017, and to identify future year rent, operations and maintenance needs, and funding sources. Council should also request staff to report back after five years in the (unlikely) event that interest rates decrease such that exercising either option in the lease-to-own agreement to take early possession of the building could generate savings.

As the lease-to-own agreement results in $17.2 million less in savings than purchasing the building outright, Council may also wish to request additional clarification as to whether or not Cisterra and the building's current owner would be amenable to waiving the language in their PSA that makes a direct City purchase problematic.

Charles E. Modica, Jr.
Fiscal & Policy Analyst

APPROVED: Andrea Tevlin
Independent Budget Analyst