



Date: January 13, 2022

To: Jay Goldstone, Chief Operating Officer
City of San Diego

From: David Brodsky and Nedko Nedev
KNN Public Finance

Re: **Analysis of the Costs of Terminating and Refinancing the Leases for the 101 Ash Street and Civic Center Plaza Buildings**

We have been asked to review the leases the City entered into on two properties: 101 Ash Street and the Civic Center Plaza and adjacent buildings. Both leases are structured as lease-purchase agreements whereby at the end of the lease term the City would own the buildings. Both leases have similar provisions allowing the City to acquire the buildings prior to the end of the lease by making a prepayment that is calculated in a manner designed to make the lessor whole (a “make-whole” payment), as further described below.

A make-whole payment is a common feature of bonds issued at taxable interest rates (the payments for these two leases are based on taxable interest rates), and typically results in a prepayment cost that is greater than the outstanding principal of a financing; under current market conditions, that would be the case with these two leases. We have been informed that the City has negotiated terms with the lessor that would allow the City to acquire the buildings at a lower price, based instead on a calculation of the outstanding principal amount of the loan embedded within each of the lease agreements.

The purpose of this memo is to confirm the facts described above (that the result of the negotiations reduces the cost of acquiring the buildings and terminating the respective leases) and to describe the analysis behind that conclusion. In addition, we have calculated the cost of financing the termination payments through the City’s issuance of tax-exempt general fund lease revenue bonds; because such a financing would be at tax-exempt interest rates (while the current leases reflect taxable interest rates), there are additional savings that can be achieved.

The economics of the renegotiated acquisition costs and their refinancing at tax-exempt interest rates, under current market conditions and other assumptions described below, can be summarized as follows:

	101 Ash Street	CCP Buildings
Acquisition cost under current lease terms (make-whole)	\$81,860,452	\$51,379,676
Renegotiated acquisition cost (outstanding principal)	74,372,216	47,161,062
Savings	<u>7,488,236</u>	<u>4,218,614</u>
Additional present value savings (over current leases) from tax-exempt financing	<u>1,899,973</u>	<u>1,473,304</u>
Total savings	\$9,388,209	\$5,691,918

The Current Leases

Both buildings are currently being occupied/acquired under financing leases, so that at the end of the term of the leases ownership automatically transfers to the City. While the leases themselves only set forth the amount of monthly rental payments, we have been provided information regarding the value of the buildings at the onset of the lease and the embedded interest rates used to impute the amount of principal amortization embedded in each rental payment. In turn, we can then develop a schedule of the amount of “principal” that would be outstanding after each monthly payment.

Both leases contain provisions for the City to exercise an optional purchase of the building, at a cost determined by a formula that incorporates the remaining lease payments discounted by a factor based on the then-current interest rate on federal treasury securities at the time of the calculation. This kind of formula is common in the taxable bond market for both corporate and taxable municipal bonds and is designed such that an investor is “made whole” on its investment (hence its common name: a “make-whole” payment). If the prepayment occurs at a time when prevailing interest rates are lower than at the time of the original investment, the investor gets compensated for the fact that they would need to reinvest the prepaid funds at a lower interest rate. This premium over the amount of outstanding principal compensates the investor for future lost earnings and explains the difference between the make-whole acquisition cost under the lease and the amount of outstanding principal in the preceding table.

Calculating the “Make-Whole” Acquisition Cost

To understand the make-whole calculation requires an understanding of “present value.” The notion of a present value is that an amount of money today is worth more than the same amount in the future. Over time, the value of one dollar diminishes due to inflation. Put differently, money received in the future is not worth as much as an equal amount received today. To create an “apples-to-apples” calculation of the value of money over time, future cashflows (such as a rental schedule) are discounted by an interest rate to a single *present* value. The appropriate interest rate used in this discounting will be determined by the purpose for which the analysis is used. Often future dollars will be discounted by an assumed rate of inflation; in other cases they will be discounted by what is an assumed investment rate for money today. The latter is the method used to calculate the make-whole payments under the leases.

The make-whole calculation in the leases is made by discounting the remaining rental payments to determine a present value based on a discount rate that incorporates current treasury yields, a common benchmark for the investment market. Specifically, the discount factor is based on the current yield for a treasury security of the same term as the average life of the remaining lease payments (in practice, interpolated between the two closest commonly traded treasury terms – e.g. for a six-year remaining average life, the relevant yield would be the midpoint between the five-year and seven-year treasury yields), plus a spread of 50 basis points (or half of one percent). This additional spread or margin is intended to reflect the fact that investing in a lease as a lessor bears more risk than investing in a federal treasury security.

If the stream of rental payments were discounted by the interest rate embedded in the lease itself, then the present value would be the same as the outstanding principal. If the discount rate is lower than the rate of the lease, as is the case in the current market, the present value would be greater. In other

words, since the make-whole discount rate is lower than the interest rate used to calculate rental payments in the leases, the calculated cost to prepay the lease is greater than the outstanding principal, as illustrated below using our calculation of the make-whole rate as of January 5, 2022:

	101 Ash Street	CCP Buildings
Rate on lease	3.503%	3.400%
Outstanding principal	\$74,372,216	\$47,161,062
Discount rate to calculate prepayment	2.125%	2.112%
Make-whole prepayment	\$81,860,452	\$51,379,676

The amount that would be due if the optional prepayment for the buildings were exercised under the terms of the original lease will change over time, as treasury yields fluctuate. If interest rates go up, the make-whole prepayment cost would go down. If interest rates go down, the cost would go up.

The difference between the make-whole prepayment cost and the amount of principal outstanding under the lease represents the benefit to the City of renegotiating the terms of the leases to allow the purchase of the properties at a price of just the outstanding principal.

Refinancing the Leases with Tax-Exempt Lease Revenue Bonds

The most likely mechanism for the City to finance the purchase option payment is through another lease financing instrument. In this case, rather than relying on a real estate broker to arrange financing, the City would arrange the financing. Given the size of the funding requirement, the lowest cost financing would come from selling tax-exempt lease revenue bonds. These bonds have been issued by the City many times in the past for such purposes as the convention center and its deferred maintenance capital projects.

While the underlying obligation would be a lease agreement similar to the current leases, by funding the lease with lease revenues bonds the City would attract a range of investors who would buy the bonds based on the City's credit. This will lower the cost. In addition, the current leases are not structured so that investors can deduct the interest component of the payments from income taxes; the City's bonds would be tax-exempt, resulting in even lower interest rates.

The table below shows the difference in interest rates between the current leases and what the City could borrow at in the current market. The bond rates differ slightly, depending on the remaining life and structure of each lease.

	101 Ash Street	CCP Buildings
Taxable interest rate on lease	3.503%	3.400%
Tax-exempt City bond interest rate	1.683%	1.560%

Note: The analysis of tax-exempt financing is illustrative, based on interest rates as of January 5, 2022, and assuming a bond closing of May 2, 2022. The terms of the bond issues are co-terminus with the existing leases, with the Ash Street component maturing in 2037 and the CCP component maturing in 2035.

As suggested in the introduction to this memo, the refinancing of the leases with City with tax-exempt lease revenue bonds would produce additional savings beyond those obtained by renegotiating the

purchase option price. Taken together, the refinancing savings would well exceed the minimum threshold called for by the City’s debt policy: 3% present value savings.

	101 Ash Street	CCP Buildings
Savings generated by renegotiating purchase price	\$7,488,236	\$4,218,614
Additional savings from tax-exempt financing	<u>1,899,973</u>	<u>1,473,304</u>
Total present value savings	\$9,388,209	\$5,691,918
Present value savings as % of current leases	12.8%	12.2%

About KNN Public Finance

KNN has served in the role of a municipal financial advisor since 1985, including working with the City of San Diego in various capacities for over 20 years. Since 2016, the firm has been employee-owned. We are one of the most active advisors in the California public finance market, ranking among the top three municipal advisory firms in terms of par amount and number of transactions in California in most years (The Bond Buyer Far West Midyear Review dated August 27, 2021). While nearly all of KNN’s clients are California issuers, we are a nationally recognized municipal advisory firm. For the calendar year 2021, KNN was ranked 6th nationally (United States Municipals Review Full Year 2021 dated January 3, 2022) based on par amount financed.

KNN is currently under contract with the City as a general municipal advisor and has performed this analysis in that capacity.