THE CITY OF SAN DIEGO

MEMORANDUM

DATE: September 02, 2009

TO: Andrea Tevlin, Independent Budget Analyst

FROM: James F. Barwick, Director, Real Estate Assets Department

SUBJECT: Civic Center Complex: Analysis of rent assumptions

At the June 10, 2009 meeting of the Council Committee on Rules, Open Government and Intergovernmental Relations, representatives of the Centre City Development Corporation (CCDC) gave a presentation on the SAN DIEGO CIVIC CENTER COMPLEX / CITY DOWNTOWN OCCUPANCY ALTERNATIVES.

Part of the presentation included a financial analysis by Jones Lang LaSalle (JLL) comparing the cost of developing a new Civic Center with the cost of the Hold Steady alternative whereby the City would extend its leases at its current locations for an additional five year term. The JLL analysis included an assumption of the rental rates the City would expect to encounter during the extension period. During the hearing, the text of an e-mail from Irving Hughes Inc. (IHI) was presented disputing the validity of JLL's assumptions for lease rates the City would encounter when renewing its leases when they expire in 2014. Since there was a significant disparity in the rent assumptions presented by JLL and IHI, the Committee requested the City's Director of Real Estate Assets to opine on whose prediction of the City's rent in 2014 was more accurate.

JLL arrived at their estimate of the rent the City would expect to pay for a five year lease extension commencing in 2014 at the buildings it currently occupies by the following method:

- Lease proposals for the extended lease term using a 2014 commencement date were solicited for the three buildings that the City occupies.
- The rental rates contained in the proposals were discounted for the value of the tenant improvements that the City would not require in the Hold Steady alternative.
- The proposals further discounted the quoted rents by five percent to account for negotiating room.
- The rents were combined on a weighted average basis.

The result was a predicted average rent of $2.17 per square foot.

IHI used a completely different method to arrive at their estimate of the City's projected rent. They had obtained a lease proposal with a commencement date of January 2010 from one of the City's current landlords for an 8,000 square foot tenant that they represented. They took the rental rate quoted in the proposal for the fourth year of the lease term (2014) and discounted it by the value of the tenant improvements. Using only this information, they estimated the rent the City could expect to pay for its space at lease renewal would be $1.50 per square foot.

It is very difficult for anyone to predict rents five years into the future. This is particularly the case when the current leasing market and the economy are going through periods of turbulence and uncertainty. Everyone agrees that rental rates have declined over the past twelve months. However, determining when and at what level rents will bottom out and how quickly they will recover is an extremely difficult task. This is the problem faced by anyone (including the City's current landlords) when trying to predict what the rental market will be when the City's leases are up for renewal. Therefore, the most appropriate way to analyze the validity of JLL's and IHI's estimates of 2014 market rents is to evaluate the methodologies they used in making their projections.

The basis for JLL's rent projections on lease proposals was obtained from the owners of all three buildings in which the City would extend its occupancy under the Hold Steady scenario. These proposals contained terms that accurately addressed the City's space requirements. Perhaps most importantly, the commencement date of the leases was 2014. The rents in these proposals were adjusted to account for the savings to the landlord of no tenant improvement allowance and further adjusted for negotiating room. This is a logical and professional approach for producing financial projections using the best data available.

The rent estimate provided by IHI was based entirely on a single lease proposal from the lowest quality building the City occupies and for a tenant whose facility requirements have nothing in common with the City's existing or expected needs. There is an abundance of 8,000 square foot spaces available which required the building owner to compete with virtually every building in the downtown marketplace. More importantly, the commencement date of the lease (January 2010) occurs during a difficult economic time for building owners. The City leases will not commence until 2014, by which time the economy and the leasing market may recover. The use of this lease proposal as a benchmark for the City's projected rents would not pass any reasonable criteria of professional standards. In addition, IHI has provided no evidence of any kind to support an opinion of prospective rental rates for the other two buildings the city occupies.

While it is extremely difficult to predict rent levels five years into the future, it is my opinion that the rent projection methodology used by JLL is professionally sound and provides the more accurate prediction of the city's rent in 2014.

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