California's Asset Enhancement Approach to Land Sales

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In 1998, the National Association of Directors of Administration and General Services awarded the California Department of General Services' Asset Enhancement Program (AEP) an Award of Distinction for the innovative sale of some key pieces of the State's surplus real property. Outgoing Governor Pete Wilson summarized the results of three major sales from the program by stating: "When combined, the three sales have earned taxpayers some $334 million, created more than 16,000 jobs, generated over $1 billion in new construction, and returned more than 360 acres of valuable property to the local tax roles." The sales conducted by the AEP also provided for substantial affordable housing, a new subsidized day care center, new facilities at an existing State developmental center, additional transportation infrastructure, historic preservation, numerous public amenities, and wildlife habitat while still producing these remarkable financial returns.

Program Overview

The AEP is administered by a small team of department staff and consultants that first targets the parcels that would likely generate the most revenue to the State if sold properly. That means modifying the natural instinct of most public agencies to avoid any market or entitlement risk by selling property "as-is." This former practice invariably required deep discounts to convince buyers to take such risks.

The new program combines market research, pre-solicitation planning and preliminary entitlement processing to reduce risks to both the buyer and the State. Together, these activities form the basis of an informative solicitation package while substantially reducing much of the market and entitlement risks.

Once the State selects a buyer, the parties negotiate a purchase agreement. The most significant condition of the agreement is that the local jurisdiction approve the buyer's plans to develop the property prior to closing escrow. This one provision, as complex as it may become, is the source of AEP's substantially higher returns to the State on the sale of real properties. In agreeing to it, the State relies on the analysis that is referenced above (and illustrated below) in determining whether the shared risk is worth the enhanced price. AEP requires a substantial deposit from the buyer that further helps

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to protect the State's interests. Upon executing the agreement, the State and buyer jointly proceed to complete the planning and entitlement process.

This paper uses the sale of two large pieces of infill properties to illustrate different aspects of the AEP's value enhancement process. The first property, East Agnews in the city of San Jose, is 136 acres of mostly vacant land adjacent to a state institution for the developmentally disabled. The second property, West Agnews in the city of Santa Clara, is nearly 300 acres of a former state developmental hospital, which included a number of historic but obsolete buildings along with over 170 acres of vacant land.

Reduction of Risk = Increase in Price

The approach taken by the AEP team has worked to attract property users and developers who contribute their time, money and reputations in a final entitlement effort. In contrast to the former practice, these parties pay full price because the risks associated with obtaining local land use approvals have been alleviated prior to the close of escrow. Such risks include outright disapproval by the local government entity, as well as approvals that include conditions that are so costly as to render them meaningless.

Securing local approvals that include the least costly conditions, then, becomes the focus of the AEP's and the buyer's efforts to enhance the value of the property. Although the State's pre-solicitation work substantially reduces the risks, the State continues to share the remaining risks in order to realize the highest feasible land value. This also results in the State, which typically has a lower cost of funds than the buyer, avoiding time discounting because the buyer is able to delay putting up the bulk of the purchase price until just before construction is ready to start. Finally, this procedure permits the price to include an after-escrow participation for the State when it is appropriate.

Land Use Approval Process

The value enhancement process that the AEP employs prior to sale has been successful partly because of the legal, political and economic characteristics of California real estate development. Most of these features apply to other states, although the California local entitlement process is certainly as tough as any other state's procedure. The fact that the State is the seller of land offers no shield against the local land use approval process that often restricts and/or increases the costs of development.

The first word one learns when entering the world of real estate development and value in California is entitlements. That term warrants brief discussion because it is what poses the most significant opportunity and potentially costly risks in the value enhancement process.

Property that has all the necessary approvals to develop for a particular use is considered entitled. The California Environmental Quality Act (CEQA) establishes the legal framework to zone and approve the development of real estate in California.

CEQA requires an extensive environmental analysis to prepare an Environmental Impact Report (EIR). The lead agency, often the local city council, decides whether to certify the EIR as complete or adequate. The council determines whether the EIR identifies all the impacts, feasible alternatives, and possible mitigations of a proposed development. They do this after public hearings that can be contentious, to say the least.

Those impacts that are identified as having no feasible mitigation will either kill a project or require the lead agency to approve a Statement of Overriding Consideration. This decision is pivotal and often turns on economic, political, or social reasons as much as legal ones.

Decisions to approve an EIR, a development project, and the required mitigation measures are extremely subjective. They are full of risk on the part of the applicant. Because they are political decisions, they often turn as much on who is proposing it as the project being proposed.

These decisions are often the subject of legal and ballot opposition by interests opposed to a project. These challenges are based on a variety of problems — both real and perceived — that many areas of the country face: increasingly congested roads, loss of farmland and/or open space, NIMBYs, overcrowded schools, etc. On the other hand, the property owner may litigate in the case of a project that has been denied or has onerous mitigation requirements imposed on it.

Theoretically, the most significant legal constraint on local decision makers is the requirement that mitigation measures must have a reasonable nexus to environmental impacts identified in the EIR. But suing a city that must ultimately process and approve a development application — even after successful litigation — may not be a politically astute strategy.

Initial Screening

Prior to applying the AEP treatment to a property, the AEP team conducts a Preliminary Strategic Assessment to select properties that are potentially most valuable. This evaluation estimates the likely range of obtainable price for the land and considers the potential for other benefits or problems, as well as other factors. Such other benefits may include opportunities for economic development and other State objectives. The research and analysis conducted in these assessments is in much less depth than in the AEP process, but still sufficient to identify the market, planning, economic, entitlement and legal issues that will be part of the value enhancement process.

Economic Analysis

Once a site passes the test of the Preliminary Strategic Assessment and is identified as a viable site for the AEP process, the team gets to work. It pursues the in depth marketing, valuation, political and legal analysis that will most likely affect the approval of a particular property for alternative uses. This analysis balances the enhanced value of the property against the costs and risks associated with the entitlement process. The price or rent and absorption the market research estimates as obtainable for each practically possible land use option or building envelope is estimated. The costs of prototypical envelopes for each option are then synthesized with cost estimates for the development options to estimate the land residual value that each potential use can support. The political and legal analysis is then focused on each of these potential uses in order to select those uses or combinations of uses estimated as capable of supporting the highest land values.

The East Agnews property illustrates why it is so important to consider different variations of each pre-disposition analysis: economic, marketing, planning and political/legal. The land residual analysis found that the highest value for the land, $103 million, could be realized if it could be used to build housing, particularly single family units between 12-14 per acre. The land value for multi-user, light industrial use was estimated to be worth $63 million. A single user corporate campus was roughly $75 million. These values contrasted to an appraised value of between $18-30 million for the sale of the site in its "as is" condition. At the time the land was declared surplus, it was being used for dry farming by a tenant who paid for the use of the land by cutting the weeds on the property.

Planning Process

The AEP team uses knowledge of the local voters and interest groups, as well as of the elected officials, to begin the planning and impact analysis needed to change the existing zoning from public use.

In the case of both East and West Agnews, the State completed the planning, traffic, engineering, fiscal and environmental studies needed to apply for a change to the respective city's general plan. After hearings before local commissions, planning boards, and the city councils, the general plan amendments and environmental approvals received significantly reduced the risk that final planning approvals would be delayed, include burdensome conditions or uneconomic densities.

In the case of East Agnews, extensive discussions with city officials, as well as with political leaders in the community, made it clear that the likelihood of obtaining approval for housing on the site was between low and nil.

In the case of West Agnews, certain market factors, on-site infrastructure conditions and planning issues suggested that the property be planned, sold, and entitled as a master planned community divided into three phases. Phase One would be approximately 80 acres for R&D use because issues relating to access, visibility, and sound contours from the local airport precluded its use for housing or commercial space. Phase Two would be 160 acres of mostly vacant land that the City hoped to zone for a community shopping center, approximately 1,650 units of housing, school and public amenities. Phase Three would be the remaining 16 acres on a relatively discrete portion of the property. The team introduced a concept plan for Phase Two concurrently with the application for the project approvals of Phase One. This reassured the City of the ultimate use of the site and further increased the buyer's confidence in the uses and densities likely to be granted final approval.

Marketing Analysis

One of the primary objective of the market studies of alternative uses is to obtain reliable estimates of potential absorption and price or rent per use for inclusion in the residual land value analysis. However, these studies do serve other ends, as well.

Of necessity, the market research includes significant contacts with members of the local real estate community and likely users to gain the insights of apposite experts. This process helps identify the user niches that are likely to benefit most, and therefore produce the most motivated buyers. This part of the research also lets the real estate and local business community know that the State had started planning for the re-use of the site and would be coming out with a solicitation for a buyer.

Solicitation Strategy

AEP's research and analysis is pulled together into a final marketing and disposition strategy that directs the key features of the State's solicitation and buyer selection process. For example, the strategic parameters provided by the East Agnews studies included the following:

- Ideally, entitling the site for housing would maximize the State's return. But political, social, and local fiscal pressures made such entitlement unlikely.

- Therefore, the objective should be to seek entitlements for the next highest land value supporting uses, office/R&D.

- Due primarily to traffic congestion, the City would probably have to approve an unpopular Statement of Overriding Consideration. The City Council would be less likely to do that for a speculative developer, who might just sit on the valuable site, than for a user who would contribute near term economic benefits to the city. The selection criteria should be in favor of a single corporate campus user, preferably with local support.

The breadth and scope of the actual advertising campaign is equal to or exceeds most comparable private sector efforts. The broad advertising that AEP generally uses includes:

- Signage

- Advertisements in local and national newspapers and journals

- Brochure that describes the area, property, and disposition process

- Supplemental Information Package containing much of the AEP analysis

- Web site and E-mail address

- One-on-one contacts with interested buyers

In addition to the broad marketing of the solicitation package, a member of the team telephoned all major R&D employers located within a 3 mile radius of East Agnews to notify them of the availability of the property.

In both of the examples used here, the identified strategy called for a solicitation process that avoided a bid process. The State could use a conventional bid process if no offers included conditions for closing. But since the objective is to maximize the return to the State, it was inevitable that offers would include qualitative conditions to reduce buyer risks relating to such things as financing, zoning, and permits. Therefore, it was necessary to deviate from the traditionally accepted bid process. It is the very subjective aspects of a buyer proposal that render the bid process less effective than the negotiated process that the State has been using in the disposition process described here.

A key subjective factor is, once again, the entitlement process. The AEP recognizes that each city will look at each development and developer differently. Some projects are simply less appealing to the legislative body, which gives the council less reason to find suitable mitigations for identified impacts. Projects and developers that are supported on the council are more likely to enjoy a statement of overriding consideration and/or feasible mitigation requirements than one less supported. As a result, the solicitation needs to facilitate a selection process that is sufficiently flexible for the State to consider a buyer's price <u>and</u> their ability to help secure entitlements for the highest valued development. The solicitation must illicit critical information from offerors other than just price in order to provide a basis for a rational selection.

In the two examples discussed here, the RFP asked interested buyers to describe (1) similar projects that they successfully entitled, (2) how their proposed use(s) were consistent with City objectives, (3) their planned approach to entitling the property being sold, and (4) the conditions they would require for closing escrow.

All contacts, including public officials and the news media, were told that the State would be looking for a buyer who could pay the highest and most certain return. This policy statement underscores the fundamental criteria of the State. On the one hand, the State requires top dollar for the site, which the AEP understood would likely require that the close of escrow be contingent on all land use approvals. On the other hand, the State would not accept a condition relating to approval of a land use that the AEP analysis determines is unrealistic.

To assist interested parties in preparing their proposals, the State team met with any party interested in obtaining additional information.

Evaluation and Selection Process

Upon receiving proposals, the team evaluated each one with particular attention to the following variables:

- The gross price and participation offered
- The time it was likely to take to satisfy all the conditions of closing escrow in order to be able to calculate the present value of the revenue the State would receive
- The likelihood of receiving land use approvals for the proposed use
- The advantages and disadvantages each interested buyer had in helping to secure the entitlements
- The cost of the likely mitigation measures that would be necessary to build each proposed use (since these costs would likely be deducted from the gross price, directly or indirectly).

When the proposals were close in terms of price and other key factors, the State team requested the proposers to provide oral presentation. The State extended such invitations when there were ambiguities or uncertainties in any of the terms that could effect the State's selection. On the other hand, oral presentations were not requested when one proposal was so strong that no answers to any questions by any of the other proposers could likely affect the selection.

After evaluating all proposals for East Agnews, the State selected a corporate user, Cisco Systems. Cisco is the largest computer networking company in the world, its headquarters were four blocks away on the same street as the East Agnews property, and it had been in the community for a number of years growing with San Jose. Their representative on the council was the former chair of the planning commission and protege of the popular mayor. They had given generously to countless worthy causes in the area. They were in desperate need of much more office space immediately. If they did not find it in San Jose, they would not hesitate to expand elsewhere, such as North Carolina where they already owned vacant property. Keeping Cisco's jobs in San Jose was an objective of both the State and the City of San Jose.

The advantages that Cisco had in providing immediate economic benefits to the State and City did not preclude the importance of price as a key factor in the selection of Cisco. However, Cisco's immediate needs undoubtedly increased the State's confidence that the project would proceed and escrow would close in a timely manner. In fact, Cisco prepared plans for the project throughout the negotiation and entitlement periods so that construction started one day after closing. Even more remarkable, Cisco closed escrow upon obtaining its land use approvals for 3.3 million square feet of office space, less than one year after executing the purchase agreement.

Cisco paid roughly $91 million for the property, of which the State is netting approximately $60 million. The difference is primarily to pay for an additional $30 million in new transportation infrastructure benefiting the entire tax-generating region. The State is also projected to receive over $12 million dollars in one-time tax collections, and $20 million in recurring collections each year. In addition, the project will provide space to accommodate 13,000 workers in California while retaining the leading computer networking company in the world at a time that at least two other states were looking very appealing to it.

For similar reasons as Cisco, Sun Microsystems, Inc., made the most favorable offer for Phase One of West Agnews. After the negotiation of a purchase agreement, Sun joined its reputation in the community with the State in securing entitlements for a new one million square foot corporate headquarters. Despite a lawsuit and ballot referendum, which were both defeated, Sun and the State received entitlements in less than a year after executing their purchase agreement.

Phase Two of West Agnews is now being implemented. The State selected a consortium of three major developers who agreed to pay $193 million for 152 acres, a portion of which is expected to be dedicated for a school, park, and other public amenities. The AEP's process that has been described in this paper was responsible for attracting 27 offers at prices that far exceeded most expectations.

Conclusion

The AEP encourages entrepreneurial efforts and a strategy that mimics the approach that a private seller would implement to maximize value.

The process outlined here produced good deals for the State, whether measured in economic terms or other benefits to the State. In both the Cisco and Sun transactions, the local agencies approved the new land uses in less time than most observers had predicted. Much of that credit goes to the pre-solicitation analysis, selection process, and particular buyers described in this paper. These successes required creative leadership on the part of the Department of General Services that empowered its Real Estate Services Division to operate with unusual flexibility and thinking that was "out of the box."

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