

EVALUATION PURPOSE

The purpose of this evaluation is to respond to the California State Auditor (CSA) Report 2014-108, “State Board of Equalization Building, *Despite Ongoing Health and Safety Concerns, the State Has Not Thoroughly Analyzed the Costs and Benefits of Relocating Employees*” (Audit Report), published in September 2014.

The Audit Report recommended that the Department of General Services (DGS) proactively evaluate whether continued State ownership of the building is a sound financial decision. This document will respond to the DGS portions of the Audit Report’s recommendations by providing:

- An evaluation based upon sound financial considerations for the State’s continued ownership of the BOE Headquarters property located at 450 N Street, Sacramento.
- An analysis of independently provided real property appraisal and facility condition assessment reports for the BOE Headquarters property.
- A merger, into the overall analysis, of independent estimates of immediate repair costs pertaining to the capital outlay project authorized by the Department of Finance in 2014 for DGS and BOE.
- A general discussion of potential productive uses of the property if BOE is authorized to move to a new facility at a future date.

Appraisal Conclusions



Maintaining ownership and repairing the BOE Building is a sound financial decision

- *Overall market conditions are not optimal for selling real estate at this time as building values are likely to rise in the future.*
- *The cost to construct a new office building to state standards is significantly greater than the costs of immediate repairs or full renovation of the property.*
- *The 450 N Street building occupies roughly 25% of the site; the remainder of the property could potentially serve as an ideal site for a future State building.*
- *The completion of immediate repairs identified would provide for a greater than 1:1 return on capital outlay funds invested.*
- *The proposed improvements add substantial value to the property; appreciably greater than the value of the site alone plus demolition costs.*

BACKGROUND

BUILDING INFORMATION

Description – The BOE Headquarters Building is located at 450 N Street in Sacramento and is owned and managed by DGS on behalf of the State of California. The California Public Employees Retirement System developed the project in the early 1990’s as an investment for its real estate portfolio. Construction was completed in 1992; BOE occupied the building in February 1993 and continues to be the sole state tenant. Small secondary tenants include childcare and cafeteria vendors. DGS purchased the property for \$81 million as agent for the state in 2007.

The BOE Headquarters Building is an 868,131 gross square foot (GSF) facility, including a 25-story office tower (644,293 GSF) and a 4-story parking garage (223,838 GSF, 711 spaces, built in 1964) situated on a 108,900 square foot site. The office tower is located on the most northeast corner of the parcel and includes 478,746 net usable square feet (NUSF). The general footprint of the office structure is 25,000 GSF (including exterior access/landscaped areas), with the exception of the first floor which is approximately 82,000 GSF.

Immediate Building Repairs Project – After a variety of system maintenance issues over the years, the Department of Finance (DOF) agreed in early 2014 that major building repairs were necessary and instructed DGS to proceed.

With funding now budgeted and approved, design is currently underway for a project to repair, replace and/or upgrade various building systems. The scope of this work is based on items identified in a 2009 infrastructure study, with costs for the immediate repair needs derived from the Clarke Project Solutions, Inc. report prepared September 11, 2015, which is also a source for the “sell or retain” analysis included in the property appraisal to be discussed in a subsequent section.

The current assumption is that the building will be occupied during construction and the work will be completed in phases, with four floors to be temporarily vacated during each phase to allow for construction sequencing. Repairs to the cafeteria and day care areas of the building are not included in the current project; additionally, leased swing space will be required, but activities and costs for this aspect of the project are not included in the current analysis.

The following building systems are included in the improvement project:

- Exterior skin, including replacing spandrel glass with metal panels or laminated glazing
- Heating, Ventilation and Air Conditioning (HVAC), including cleaning ductwork and terminal boxes and sealing ductwork
- Plumbing, including replacing break room fixtures and piping, and replacing sanitary piping, fixtures and venting
- Fire life safety (FLS)/low voltage electrical systems, including new telecommunication and data wiring and new fire alarm system

- Mold remediation, for impacted portions of the repairs and including removing and replacing necessary finishes
- American Disabilities Act upgrades including handrails, guardrails, casework, paving, and doorways in garage and office areas

Conceptual project costs for the items listed above is \$31.1 million, as provided by Clarke Project Solutions, Inc. (September 11, 2015).

FACILITY CONDITION ASSESSMENT (FCA)

The Governor's 2014-15 budget provided DGS the authority and funding to complete a long range planning study of all state owned office buildings in the Sacramento region. DGS contracted with Hellmuth, Obata & Kassabaum (HOK) to conduct the study. The Long-Range Planning Study included Infrastructure and Facility Evaluation findings, which used a Facility Condition Index (FCI) and risk analysis scoring criteria to rank the 29 Sacramento region State-owned office buildings based on need for renovation, repair, or replacement. The BOE Headquarters Building was ranked 16th out of 29 buildings using both "condition" and "risk" scoring criteria and 12th for condition-only score, with rank 1 being the building with the most need of repair or replacement.

The HOK study found the BOE building subject to wear and soiling; however, still in a serviceable and functioning condition. This supports the appraisal findings that maintaining ownership of the building is a sound financial decision.

Further detail of methodology and calculation of costs/values is available within the FCA document for the BOE Headquarters Building (link provided): www.documents.dgs.ca.gov/dgs/pio/building/2015-06-08%20Board%20of%20Equalization%20Report%20rev.pdf

METHODOLOGY & ASSUMPTIONS

Methodology – The following methodology was used by Integra Realty Resources to produce this appraisal:

- Define necessary scope of response
- Interview and engage subject matter experts
- Gather information (historical and current data)
- Evaluate real property appraisal valuation report
- Develop summary information
- Evaluate potential productive uses for property
- Prepare final report

Assumptions – The following assumptions exist for this Assessment Report and Real Property Appraisal Valuation Report, and were provided primarily from the Integra Realty, Inc.:

- Values provided in the appraisal report are based on a number of extraordinary assumptions and hypothetical conditions as identified in that report, including:
 - Building size derived from the Statewide Property Inventory as of July 1, 2015.
 - Any mold or other hazards found while performing the facility improvement will be remediated within the costs identified.
 - Improvement Project costs estimates provided by the Clarke Project Solutions, Inc. September 11, 2015 report are accurate.
 - Costs to provide expanded cabling requirements of BOE within the core area are not factored into the real property appraisal valuation report since they are specific to the tenant.
 - Various hypothetical conditions related to individual value scenarios are identified within the real property appraisal valuation report. The hypothetical conditions are limited to certain valuation assumptions relative to occupancy assumptions and those valuation scenarios that consider or disregard the occupancy conditions as set forth in the 2011 Series E Bonds.
- The appraiser’s recommendations regarding potential productive uses of the 450 N Street property are general concepts only; comprehensive project-specific plans will be developed as needed.

APPRAISAL SUMMARY

Intended Use of the Appraisal – DGS hired Integra Realty Resources to complete an appraisal of the BOE Headquarters Building and property located at 450 N Street in Sacramento. The appraisal, which provides value estimates as of September 15, 2015, considers various valuation scenarios with and without the immediate repairs completed.

The appraisal is intended to help DGS determine if continued state ownership of the building is a sound financial decision; if completing the immediate repairs is in the best interest of the state; and if BOE moves to a new facility, what the potential productive uses of the property are. The appraisal provides a market derived opinion of the fair market value of the site. While the appraisal is not the sole determinate in deriving these conclusions, it provides additional support for the recommendations made in this assessment report.

The appraisal does not take into account other external factors that cannot be account for via available data.

Appraisal Valuation Approach – The appraisal considered the three traditional approaches to value:

1. *Cost Approach*, which assesses the value of the property by estimating the value of the land to which the depreciated value of the improvements is added.
2. *Sales Comparison Approach*, which estimates market value by comparing the property appraised to similar properties that have sold or are currently listed for sale.
3. *Income Capitalization Approach*, which derives a value indication for the subject property by converting anticipated income and reversionary benefits into a real property value.

Specific BOE Headquarters Building Valuation – The following definition of Fair Market Value is utilized:

- (a) The fair market value of the property taken is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so doing, nor obliged to sell, and a buyer, being readily, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available.
- (b) The fair market value of property taken for which there is no relevant, comparable market is its value on the date of valuation as determined by any method of valuation that is just and equitable.

(Source: California Code of Civil Procedure, Section 1263.320)

Based on the criteria set forth above the appraisal examines a number scenarios under which the valuation of the property may be measured. Please see full report for greater details on these scenarios.

Other Valuation Considerations: Excess Land Element – The appraisal also considers the excess land element of the property and the current and potential uses for this component. The site contains 108,900 square feet of total land area, of which the office tower and exterior access and landscaped areas occupy approximately 30,000 square feet or ± 25 percent of the site. The remainder of the property is improved with a four-story 50 year old parking garage and building area separate from the office tower portion of the structure which encumbers 78,900 square feet. This excess land area has the potential for the development of a second high-rise building and necessary parking adequate to support both buildings. The appraiser methodically establishes the foundation for the economic fundamentals that are required for new office development to occur. The following considerations assume the property is free and clear of any debt, bonds or other encumbrances and include:

- Temporary loss of parking for the tenants of the existing building

Prepared by the Department of General Services

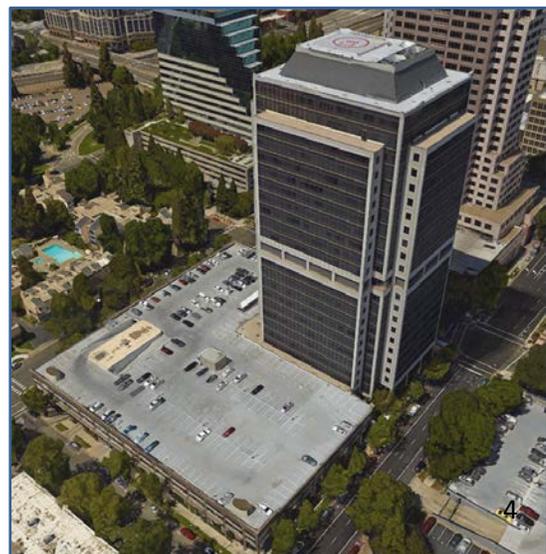


Figure 1 - Aerial View of BOE Building and Excess Land
(Source: Google Maps)

- Potential for interim parking at nearby locations
- Rents required to adequately support new construction
- Office demand required to support new construction
- Discussions with local developers and real estate brokers regarding the potential for excess land and potential uses.

Market and Economic Analysis – The appraisal provides an in-depth office market analysis that captures current vacancy rates, office rents, and office demand from several sources including various commercial real estate brokerage companies, PricewaterhouseCoopers Real Estate (PwC) Investors Surveys, Real Capital Analytics, CBRE, Integra Realty Resources, Inc., Real Estate Information Systems (REIS), CoStar, and Colliers International. The vacancy and net absorption rates, provided in the Integra Realty Resources Appraisal Report, reflect the trends in these factors since 2004, showing the gradual drop in vacancy and related improvement in net absorption from the peak in 2012 to the current rates as of Fall 2015.

Highest and Best Use – While the downtown office market is in a recovery mode, the basic economic fundamentals have not recovered to the point where new speculative high-rise office development is supported. As quality supply becomes more scarce and limited, most observers anticipate demand will drive rents to levels that support new construction, within the next several years. Generally, the appraisal determines that while there is a state-driven demand for new construction more indicative of a build-to-suit development, current market rents do not support new speculative construction.

Ultimately, the appraisal concludes that new office development would be economically justified when annual market rents of approximately \$42.87 per rentable square foot or \$50.59 per usable square foot on a full service basis are obtainable. The appraisal indicates current market rents for the two newest high rises Class A office buildings located in the Central Business District (CBD), the Bank of the West Tower and U.S Bank Tower, to be between \$34.80 and \$39.17 per rentable square foot.

The upper end of the indicated rental range has been obtained in only a few instances, and has not stabilized above the \$42.87 per rentable square foot threshold required for new development.

Thus, the appraisal concludes the current use of the site is the highest and best use of the property, and the parking garage to be an interim use until market conditions warrant, and market rents support, new office development with parking adequate to support both the existing building and new development.

GENERAL POTENTIAL PRODUCTIVE USES FOR BOE HEADQUARTERS BUILDING

The appraisal report prepared by Integra Realty Resources provides value estimates for the 450 N Street property predicated on various scenarios. All the estimates support expending the capital necessary for the immediate repair needs and maintaining state ownership of the building as cost-effective. Since continued ownership of the building is considered financially prudent, the potential productive uses of

the property with continued occupancy are considered, consisting of use categories in various combinations which consider:

- Completing immediate repairs
- Utilizing the excess land surrounding the existing building
- Expanding the existing floor plates for lower floors
- Renovating existing building, either partial or complete

Various delivery options are possible within this framework and can be more fully explored.

The general potential productive uses are described in the following chart.

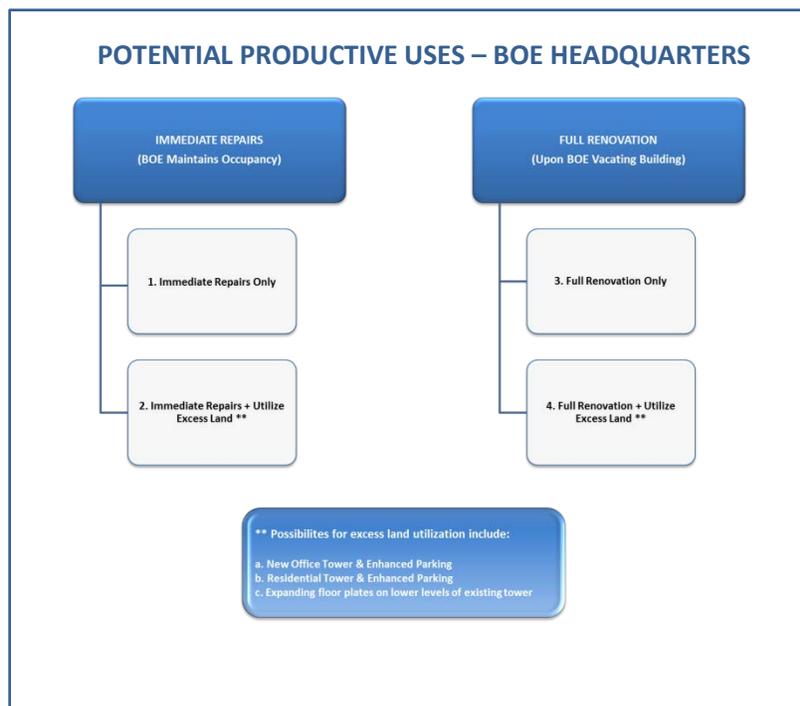


Figure 2 - Potential Productive Uses

CONCLUSION

The appraisal results for the BOE Headquarters Building, located at 450 N Street in Sacramento, demonstrate that continued state ownership and occupancy, including completing the immediate repairs, is a sound financial decision. Further, the appraiser's economic analysis reveals that based on existing market rent levels, the highest and best use of the site is its current use as an office building; with the parking garage recommended to remain as an interim use until market conditions support additional development on the site's excess land. The state, at its own discretion, may utilize the site's excess land for the construction of additional building space prior to full market recovery.

While a general discussion of potential productive uses was considered for this assessment, a thorough analysis of real estate pricing, project and related costs, utilization of the excess land, and transaction timing, among other factors, is necessary to determine the appropriate use of the 450 N Street property.

DGS is committed to fully exploring next steps in conjunction with the BOE business delivery study and in partnership with the Administration's state office infrastructure priorities.