

# Economic Analysis Summary

SALE // LEASEBACK State Office Building Portfolio



## SUMMARY OF THE ECONOMIC ANALYSIS

The Department of General Services (DGS) has compared the costs under the California First, LLC sale-leaseback (Sale-Leaseback) proposal versus the continued state ownership of the properties (Status Quo).

To compare the relative costs of the Sale-Leaseback to the Status Quo, the State must first estimate the cash flows under each scenario in nominal dollars and then adjust them to account for differences in timing. Nominal dollars are those that have not been adjusted to remove the effect of changes in the purchasing power of the dollar but rather reflect buying power in

the year in which it is expended. This includes developing revenue and expense projections, estimating capital expenditures, quantifying transfers of risk, making assumptions regarding growth rates, estimating terminal capitalization rates and applying a discount rate to convert them into present values (PVs). The present value concept is the idea that a dollar now is worth more today than an identical amount in the future. To calculate present value, the future sum of money is discounted at an appropriate discount (interest) rate to reflect the time value of money and other factors such as investment



Elihu M. Harris Building, Oakland

risk. The net present value (NPV) of a series of cash flows over time, both incoming and outgoing, is defined as the sum of the present values (PVs) of the individual cash flows. NPV is widely used throughout economics, finance, real estate and accounting as a decision making tool that measures cash flows, in present value terms.

It is important to point out that the uncertainty with cash flow projections increases and the accuracy diminishes as you forecast out further in time. In addition, capital expenditure projections in this analysis are based upon an unconstrained budget. In the public and private sector, budgetary constraints and alternatively surpluses can accelerate or decelerate the timing of capital expenditures. Additionally, changes to the discount rate or growth rate assumptions can result in significantly different outcomes.

At the request of the Legislature, the projected costs shown in the following tables assume that the State renews its lease continually through the end of 50 years at the terms set forth in the leases. However, the proposed lease term is 20 years with six five-year non-obligatory options to renew. At the end of the 20-year lease term, the State would have three options that include renewing the lease at the terms set forth in the lease, renegotiating the terms of the lease or not renewing the lease. Therefore, the amounts shown beyond the initial 20-year lease term are not relevant.

The net present value displayed in Table B indicates for Years 1 through 20 a savings of \$2 million for the California First, LLC proposal compared with the Status Quo.

| A | Comparison of Cost in Nominal Dollars | <i>(in millions)</i> |                  |                  |                  |
|---|---------------------------------------|----------------------|------------------|------------------|------------------|
|   |                                       | Years 1 to 20        | Years 1 to 30    | Years 1 to 40    | Years 1 to 50    |
|   | Status Quo                            | \$4,385              | \$7,936          | \$12,709         | \$16,285         |
|   | Sale-Leaseback                        | 6,172                | 10,750           | 16,672           | 24,291           |
|   | <b>Savings/(Net Costs)</b>            | <b>(\$1,787)</b>     | <b>(\$2,814)</b> | <b>(\$3,963)</b> | <b>(\$8,006)</b> |

| B | NPV Comparison of Cost*    | <i>(in millions)</i> |                 |                 |                 |
|---|----------------------------|----------------------|-----------------|-----------------|-----------------|
|   |                            | Years 1 to 20        | Years 1 to 30** | Years 1 to 40** | Years 1 to 50** |
|   | NPV Status Quo             | \$2,202              | \$2,817         | \$ 3,297        | \$3,480         |
|   | NPV Sale-Leaseback         | 2,200                | 3,070           | 3,656           | 4,049           |
|   | <b>Savings/(Net Costs)</b> | <b>\$2</b>           | <b>(\$253)</b>  | <b>(\$359)</b>  | <b>(\$569)</b>  |

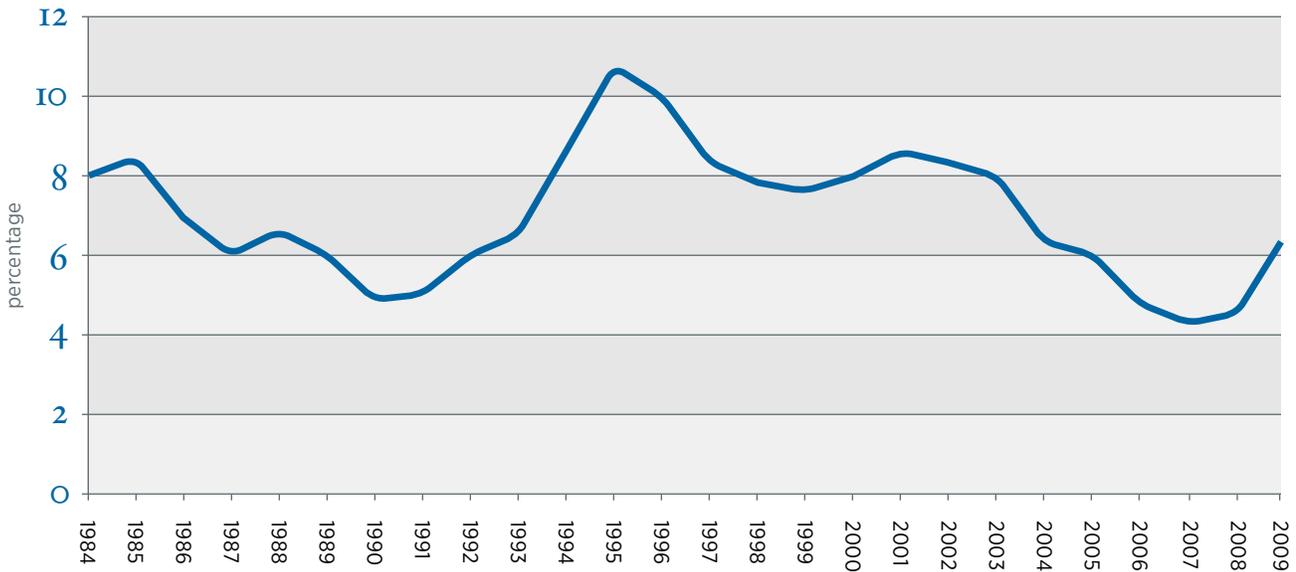
\* NPV was calculated using a discount rate of 5.75% for years 1 through 20 and 6.75% for years 21 through 50 reflecting a 1% yield premium to account for normal yield curves on longer term debt.

\*\* The costs outlined beyond 20 years are highly speculative. At the end of the 20-year lease term, the State has the option to vacate buildings, renegotiate leases, or renew leases. Future State office needs will be impacted by economic factors, State policies and initiatives, and emerging technologies.

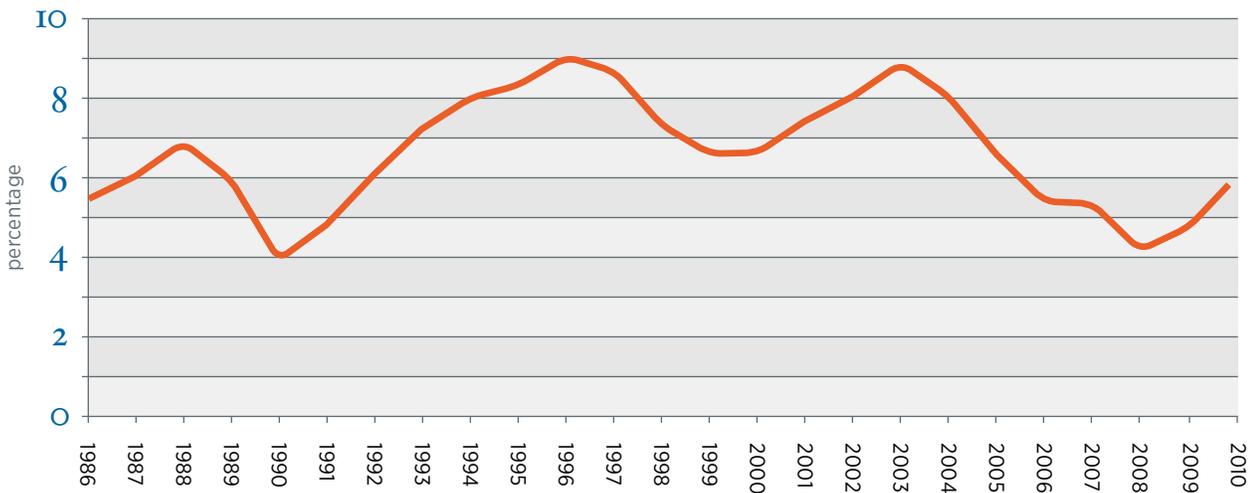
## PRICING

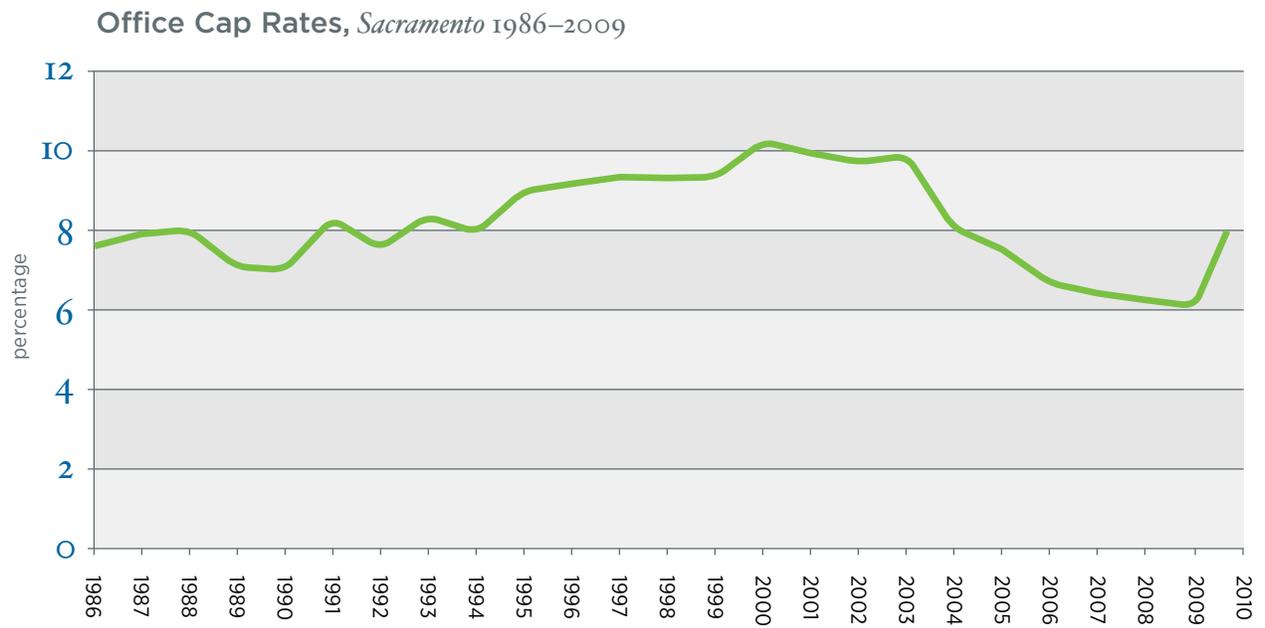
The proposed purchase price of Two Billion Three Hundred Thirty Million Dollars (\$2,330,000,000) represents an overall (“going-in”) capitalization rate of approximately 6.36% based on the estimated net operating income. A lower capitalization rate is indicative of higher pricing given the same income stream. This capitalization rate is below the average transaction capitalization rates for office property sales reported in Los Angeles between 1984 and 2009 and in Sacramento and San Francisco between 1986 and 2009.

Office Cap Rates, Los Angeles 1984–2009



Office Cap Rates, San Francisco 1986–2009





## ASSUMPTIONS

### Growth Rates

*Growth Rates are annual unless otherwise specified.*

| Revenue/Expense Item                    | Growth Rate % | 2010 Cost PSF |
|---|---------------|---------------|
| Sale-Leaseback Rent Increases (5 Years) | 10.00%        |               |
| Parking Rate Increases (5 Years)        | 10.00%        |               |
| California Construction Cost Index      | 3.35%         |               |
| Business Improvement District           | 2.00%         |               |
| Real Estate Taxes (Prop 13)             | 2.00%         |               |
| Insurance                               | 5.00%         |               |
| Operating Expenses                      | 3.00%         |               |
| Utilities                               | 3.00%         |               |
| Capital Repairs/Replacement             | 3.35%         | \$0.25        |
| Discount Rate Years 1-20                | 5.75%         |               |
| Discount Rate Years 21-50               | 6.75%         |               |
| Renovation                              |               | \$250.00      |
| Terminal Cap Rate                       | 8.00%         |               |
| Earthquake Ins. Risk (per \$100)        |               | \$0.40        |

### Infrastructure Studies and Renovations

The portfolio buildings have an average age of over 15 years from the date the buildings were constructed or last renovated. As a normal practice, the DGS conducts infrastructure studies every 20 to 25 years. Beginning with the assumption that office building systems have an estimated serviceable life of 20 to 25 years and buildings have an economic useful life of 50 years, it can be assumed that the State would conduct infrastructure studies and do some level of renovations over the next 50 years if it continued to own the properties in order to extend the economic useful life. The most recent costs of renovation were for OB #8 & #9 (41 years old) at \$254 per square foot (PSF) and Library and Courts (85 years old) at \$352 PSF.

On that basis, the economic analysis assumes that an infrastructure study will be conducted at 20 and at 35 years followed by a renovation at year 40. For the purposes of economic analysis, the DGS has assumed future renovations will cost \$250 PSF in current dollars.

Based upon DGS' experience, the costs to complete an infrastructure study are approximately \$0.40 PSF plus \$40,000 in project management fees in current dollars.

### Reserves for Capital Repairs and Replacements

Annual reserves for capital repairs and replacement were modeled at \$0.25 PSF.



Earl Warren / Hiram Johnson Building, San Francisco Civic Center

### Infrastructure Studies, Renovations and Reserves for Capital Repairs and Replacements Growth Rate

The California Construction Cost Index averaged 3.35% between 2000 and 2009 and therefore the DGS has assumed this as the annual growth rate for future capital improvements, infrastructure studies and renovations.

| Year           | California Construction Cost Index |
|----------------|------------------------------------|
| 2009           | -1.10%                             |
| 2008           | 6.80%                              |
| 2007           | 2.10%                              |
| 2006           | 5.40%                              |
| 2005           | 6.00%                              |
| 2004           | 8.30%                              |
| 2003           | 1.00%                              |
| 2002           | 2.10%                              |
| 2001           | -0.10%                             |
| 2000           | 3.00%                              |
| <b>Average</b> | <b>3.35%</b>                       |

### Real Estate Taxes and Assessments Growth Rate

This analysis assumes that the properties will be subject to real estate taxes. A 2% annual growth rate has been assumed for real estate taxes and assessments.

### Insurance Expense/Risk Growth Rate

Currently the State maintains property and liability insurance on the bond funded buildings. When the bonds are paid off, the State will no longer maintain property insurance and liability claims must be processed through the Victim Compensation and Government Claims Board. Upon the sale of the properties, the risk of insured or uninsured property damage is transferred to the buyer and they are required to maintain insurance. In order to quantify the transfer of this risk, the assumptions include insurance on currently uninsured buildings and continual insurance beyond the date the bonds are paid in full. Additionally, assumptions have been made regarding the currently uninsured risks for earthquake. Insurance expenses have been forecasted to grow at an annual rate of 5% due to two factors:

1. Increased cost of construction to construct and repair buildings due to inflation; and
2. Insurance rate increases.

This economic analysis does not include uninsurable risks such as the recent costs for emergency repairs of the Board of Equalization building located at 450 N Street in Sacramento.

### Sale-Leaseback Rent Growth Rate

Assumptions are based on the fixed rental bumps of 10% every five years.

### Parking Revenue/Expenses Growth Rate

Parking revenue in the Status quo has been forecasted to grow at a rate of 10% every five years.

### Operating Expense Growth Rate

Operating expenses have been forecasted to grow at an annual rate of 3%.



### Utilities Expense Growth Rate

Utility Expenses have been forecasted to grow at an annual rate of 3%.

### Variable Discount Rate

At the federal level, in calculating a net present value of leases, the Office of Management and Budget (OMB) requires agencies to use the Treasury borrowing rate on marketable securities of comparable maturity to the period of analysis. For asset sales, OMB requires analysts to do sensitivity analysis that discount the returns from such assets with the rate of interest earned by assets of similar riskiness (risk-adjusted discount rate) in the private sector.

A variable discount rate is a discount rate with higher rates applied to cash flows occurring further along the time horizon to reflect the yield premium for longer term debt or equity investment. Generally, because yield curves are upward sloping (longer term debt and equity

investment commands a higher yield), cash flows to be received over longer periods of time may require an interest rate premium, or discount rate. The discount rate used for years 1-20 is based upon the last sale for lease revenue bonds that occurred on November 16, 2009. The true interest cost (TIC) for different final maturities based on the last tax-exempt sale were:

- 25 year: 6.04%
- 20 year: 5.75%

Additionally, on December 14, 2009, the State Treasurer reported to the Legislature that tax-exempt GO bonds, based on current secondary market trading interest rates were 5.93%. For purposes of this analysis, a discount rate of 5.75% was selected as the most appropriate rate for years 1 to 20 because the risk profile most closely matches that of the lease-revenue bonds sold in November 2009.



Financial managers often utilize higher discount rates for investments or decisions that are viewed as risky and lower rates when the expected cash flows from a proposed activity are more certain. The higher rate is viewed as a hedge against risk because it puts more emphasis on near-term returns compared to distant future returns.

A yield premium between of 1% was assumed for years 21-50. Therefore, a discount rate of 6.75% was applied to cash flow projections occurring between years 21-50.

### Non-State Tenants

Non-state tenant revenues are not included in the analysis because there would be revenues in both the sale-leaseback and status quo and would be offset equally on a nominal and net present value basis. However, it should be

noted that if the state decision is to proceed with the sale-leaseback, the overall costs to the state would be reduced by an amount of approximately \$575,000 per year.

### Reversionary Valuation

Reversionary Value is the estimated value of a property at the expiration of a certain time period. Under the status quo scenario, there is no reversion per se because there is no leasehold estate, however at the end of the 50 year period of the analysis, the state would still own the property. Therefore, in comparing the status-quo to the sale-leaseback it is necessary to estimate what the value of the properties are at the end of the lease term (reversionary value) and deduct the present value of that reversion from the PV of the Status Quo or add it to the PV of the sale-leaseback. In order to estimate

## Reversionary Value Status Quo *(in millions)*

| Property/Building Name                    | Year 50 Reversion at 8.00% Cap Rate |
|---|-------------------------------------|
| Attorney General Building, Sacramento     | \$323                               |
| Franchise Tax Board, Sacramento           | 1,309                               |
| Capital Area East End Complex, Sacramento | 1,312                               |
| Elihu M. Harris, Oakland                  | 651                                 |
| Earl Warren/Hiram Johnson, San Francisco  | 1,047                               |
| Junipero Serra, Los Angeles               | 346                                 |
| Ronald Reagan, Los Angeles                | 576                                 |
| DOJ, 4949 Broadway, Sacramento            | 298                                 |
| J. A. Rattigan, Santa Rosa                | 69                                  |
| PUC Bldg, San Francisco                   | 283                                 |
| CA EMA, Mather                            | 113                                 |
| <b>Total (Year 50) Reversionary Value</b> | <b>\$6,327</b>                      |
| Discount Factor (6.75% at 50 yrs.)        | 26.21                               |
| <b>PV Reversion</b>                       | <b>\$241</b>                        |

the reversionary value, it was assumed that Year 50 rents represented the market rental rate and that expenses represented 39% of rent resulting in net operating income (NOI) of 61% of rent. A terminal capitalization rate is a rate used to estimate the resale value of a property at the end of the holding period. The expected net operating income (NOI) per year is divided by the terminal cap rate (expressed as a percentage) to get the terminal value. A terminal capitalization rate of 8.00% was used to estimate the value of the properties at the end of 50 years. This rate was used to reflect the risk associated with estimating the terminal value so far out and potential impacts of economic obsolescence.

An alternative method to value the reversion would be to use annual property value growth rates to project reversionary value but it is not more reliable given the 50 year time horizon. An additional alternative would be to assume no renovations and base the reversion on the value of the land only. To determine the present value of reversion, the discount rate for years 21-50 was utilized. Due to the 50 year leasehold estate created under the proposed sale-leaseback, and the concept that there will be value in the leasehold estate separate from the fee interest during the term of the lease, only the PV of the 50 year reversion was considered. The assumptions below do not include deductions for transaction costs at the time of sale.



## ADDITIONAL CONSIDERATIONS

### Opportunity Cost/Income

In the California First, LLC proposed sale-leaseback transaction, the net sale proceeds after bond defeasance are estimated at approximately \$1.2 billion. It is worth noting that because sale-leasebacks create the ability to extract capital at market value which can be redeployed to more productive uses, some analysts would argue that the analysis should include the net cash inflow of the sales proceeds invested at an assumed interest rate compounded over the term of the analysis. Some analysts would argue that in the State's case, this interest rate would be the average return the state would receive on its pension fund investments. Since public pension funds require an average annual return of approximately 8% to meet obligations to retirees, a reinvestment rate of the same rate could be used.

Due to the time preference for the revenue now, these proceeds will not be reinvested but rather will be used to immediately fund programs and services so reinvestment returns were not included in the economic analysis. Over the term of the analysis, this would reduce the costs under the sale-leaseback scenario significantly from what is indicated in this economic analysis. In this instance, because of the time preference for the money now, a more accurate analysis would measure the social benefits of programs funded or social costs of program cut as a result of the revenue realized or not realized based on the decision to sell or not sell.