



REPORT

DATE ISSUED: July 18, 2003

ITEM 100

REPORT NO: HCR03-053
For the Agenda of July 23, 2003

SUBJECT: Approval of Purchase and Sale Agreement for the Housing Commission's Proposed Office Development (District 2)

SUMMARY

Issue No. 1: Should the San Diego Housing Commission recommend that the Housing Authority authorize the Chief Executive Officer (CEO) to proceed with the purchase of the Housing Commission's proposed office development to be located at Smart Corner at 12th Avenue and "C" Street in Downtown San Diego, conditioned upon approval of the Development and Disposition Agreement (DDA) concerning this project by the Redevelopment Agency of the City of San Diego?

Recommendation 1a: That the Housing Commission rescind its approval of the initial draft of the Purchase and Sale Agreement (PSA) for Smart Corner, voted on June 28, 2002, and referenced in Housing Commission Report No. HCR 02-063 in conjunction with the Housing Commission's proposed new office facility.

Recommendation 1b: That the Housing Commission recommend Housing Authority approval of a new PSA (Attachments 1 and 2a and 2b) with Lankford & Associates, Inc., or a Limited Liability Company of which Lankford & Associates, Inc. is the managing member owning not less than 51% of the company, provided that the composition of the Limited Liability Company is approved by the Housing Commission's CEO, or designee and General Counsel, and authorize the CEO to execute a PSA as approved by General Counsel to effectuate the purchase for an acquisition cost not to exceed \$23,846,160.

Recommendation 1c: That the Housing Commission recommend the Housing Authority approve a total development budget of \$26,532,510, authorize the CEO to expend up to this amount, and delegate the resolution of all cardinal issues related to the acquisition of



the proposed new office facility to the Board of the Housing Commission, so long as initial annual principle and interest costs do not exceed \$1,754,000.

Recommendation 1d: That the Housing Commission form a new office facility advisory ad-hoc committee to be comprised of Commissioners Salas, Yip and Adams-Brooks to provide Housing Commission staff direction and resolve non-cardinal issues related to the acquisition of the proposed new office facility. “Non-cardinal” are those issues not involving changes to the essential elements of the transaction, but including all other types and kinds of issues related to the transaction. Upon the advice of the new office facility advisory ad hoc committee and General Counsel, the authority to make decisions concerning non-cardinal issues shall be vested in the CEO of the Housing Commission.

Fiscal Impact No. 1: Approval of the acquisition of Smart Corner would result in a total projected cost of up to \$26,532,510 (Budget is shown in Attachment 3). Sources of funding would include:

Loan Proceeds	\$20,441,260
SDHC Equity	\$ 1,500,000
SDG&E Credit	\$ 150,000
Value of Existing Headquarters	\$ 4,441,250
Total Sources of Funds	\$26,532,510

Ongoing operating expenses would be approved each year in the Housing Commission’s annual budget.

Issue No. 2: If it is decided to pursue purchase of a new office facility at the Smart Corner, how should the Housing Commission finance acquisition of the property?

Recommendation 2a: That the Housing Commission reject financing term sheets provided by Buchanan Street Partners, L.P. in conjunction with their contract as Financial Advisors to the Housing Commission. A summary of proposed terms is included in Attachment 4.

Recommendation 2b: That the Housing Commission recommend Housing Authority accept the Financing Term Sheet provided by US Bank directly to the Housing Commission (Attachment 5), and authorize the CEO, with advice and concurrence of General Counsel and the Commissioners’ new office facility advisory ad hoc committee, to seek a firm financing commitment consistent with that term sheet, and authorize execution of all required documents to secure a 2-year forward commitment for financing and 5-year permanent financing in an amount not to exceed \$21 million at a fixed interest rate of no greater than 7 percent.

Fiscal Impact No. 2: This action will result in expenditures of fees and costs of up to \$271,350 to US Bank and in the creation of a non-recourse fixed rate mortgage obligation to the Housing Commission of up to \$21 million to be secured by the new office facility.

Environmental Review: The actions being recommended herein are approval of an agreement to purchase and sell an office building and a parking garage. No obligation of the Housing Commission to purchase the office building and parking garage exist under the PSA unless and until all environmental clearances have been obtained. Approval of a purchase and sale of real property by the Housing Commission is categorically exempt under the provisions of California Environmental Quality Act (CEQA) as discussed herein. Further, CCDC has reviewed environmental reports for the full block development, and any approval of the DDA would require certification of all environmental documents. For a more thorough discussion of the environmental review, please see Attachment 6.

Previous Related Actions: On September 21, 2001, and November 27, 2001, the Housing Commission and Housing Authority, respectively, authorized the CEO to execute an Exclusive Negotiating Agreement (ENA) with Lankford & Associates, Inc. for potential development of the Housing Commission Headquarters facility at Smart Corner at 12th Avenue and "C" Street in San Diego (Report HCR01-105 and HCR01-105 Supplemental).

On June 7, 2002, the Housing Commission authorized the CEO to execute up to two (2) 30-day extensions to the ENA with Lankford & Associates, Inc. (Report HCR02-053).

On June 28, 2002, the Housing Commission voted to recommend approval of a PSA with Lankford & Associates, Inc. to the Housing Authority (Report HCR02-063). This document was never brought forward to the Housing Authority for approval and was never executed.

Future Related Actions: Approval of the recommendations contained in this report will be sought at a joint meeting of the Housing Authority and the Redevelopment Agency scheduled for July 29, 2003. If recommendations in this report are adopted at the joint meeting, purchase offers will be entertained and Housing Commission staff will return to the Housing Commission and the Housing Authority at a future date for specific approval to sell the Housing Commission's office at 1625 Newton Avenue.

BACKGROUND

The San Diego Housing Commission historically has utilized its own revenues (no City General Funds are involved) to provide for all of its administrative needs, including office space. It moved into its current main offices at 1625 Newton Avenue in 1984, when its staff consisted of fewer than half the current number of employees and it assisted thousands fewer

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families than now (with a budget of \$21.5 million compared to today's \$163 million). The Housing Commission owns this retrofitted warehouse facility outright.

Over the past 19 years, renovations have been made to the site, and warehouse space has been built out in increments to accommodate the need for more employees. Rather than continue to invest more funds to cobble out additional office space at Newton, several years ago the Housing Commission decided to lease two other office facilities off site. The result is a scattered workforce, overcrowding in the main office site, inefficient visitors' waiting and interview areas, as well as deteriorating building systems.

The Agency has in recent years been reluctant to spend the millions of dollars necessary to make the needed major renovations because of concerns about return on investment and because renovations would not improve the site's access to public transportation and its shortage of parking spaces. The building is in an industrial area, and continuing to upgrade an office facility would overprice it for the warehouse-dominated neighborhood.

However, the building's deteriorating floors, inefficient heating and ventilation system, electrical re-wiring needs, and other problems can no longer be ignored. For the past few years, the Agency has set aside funds toward major renovation or other options, and in July of 2000, it established an ad hoc subcommittee of the Board to work with staff and Keyser Marston & Associates (KMA) to investigate options. KMA was directed to conduct a financial analysis for each potential choice, including: renovation, lease new offices, or buy a new facility. (The current situation, the "do nothing" base case, was quickly eliminated as an option due to the inadequate conditions cited above.) KMA's analysis eliminated leasing as an option because of its expense and no equity appreciation, verified that renovation would yield a poor return on investment and leave the Agency with transportation issues, and suggested a further investigation into purchase opportunities. Criteria established by the Board in the search for a new office facility included: provide appropriate physical space (size, functionality, parking, etc.), contribute to a neighborhood revitalization effort, be financially advantageous, and, if possible, provide housing along with office space.

In the meantime, CCDC, which had purchased a city block at 12th Avenue and "C" Street, sought a developer for a transit-oriented, mixed-use development—with retail, office space, and homes—on the site to help meet its redevelopment plan goals. It issued a Request for Proposals for same, and the Housing Commission issued a Request for Qualifications for developers interested in developing an office facility for the Agency.

Lankford & Associates, Inc., successfully responded to both solicitations, and on November 27, 2001, the Housing Authority authorized the Housing Commission to enter into an Exclusive Negotiating Agreement (ENA) with Lankford & Associates. Since that time, the Commission staff and General Counsel have been involved in negotiations with Lankford &

Associates, Inc. The proposed PSA attached hereto is the result of those efforts. Summary and full text of the proposed PSA are found in Attachments 1 and 2.

DISCUSSION

Development Concept

The proposed PSA would have Lankford (the “Developer”) build a five-story office facility consisting of one floor—the ground floor—for lease to retail establishments, one floor for office space to be leased to other organizations, and three floors for the Housing Commission’s offices. Under the building, the Developer would construct a parking garage. These facilities (collectively the “Project”) would be constructed for a fixed fee guaranteed maximum price of \$23,846,160.

Across from the Project, on the same site, the developer proposes to build a separate 19-story building to contain ground floor retail space and private residential condominium units (the “Developer Portion”). The Housing Commission has no direct involvement with the residential building.

The site would also contain an easement for a realigned MTDB trolley track with a new station; the site also accommodates several bus lines. The trolley station and its related components would be financed and developed by MTDB.

The entire Smart Corner site, including the Project, the Developer Portion, and the MTDB trolley station, sit within “air-rights” parcels atop the underground parking garage.

CCDC, owner of the Smart Corner site, proposes to enter into a DDA with Lankford & Associates, Inc., to develop it. On July 16, 2003, CCDC voted to recommend Redevelopment Agency approval of the DDA.

Ownership Structure

Ownership During Construction:

The Developer shall own the Project, as well as other components of the Development, until the completion of the Project, whereupon the Housing Commission would use its financing to purchase the completed improvements comprising the Project.

Permanent Ownership:

The final ownership of the components of the development would be as follows:

SDHC – 5-story office building, to be owned by the Housing Commission consisting of ground floor retail, 3-stories of Housing Commission office space, one floor of rental space for other office users

Lankford & Associates – 299-unit condominium building to be owned by residential users and ground floor retail

MTDB – An easement diagonally through the site for MTDB, on which a new Trolley station would operate

SDHC Garage – 634-space subterranean garage, to be owned by the Housing Commission, of which 367 spaces are set aside for residential users and 267 spaces are for the Housing Commission's Project

Financing

The \$26.5 million development budget includes all costs associated with the acquisition and occupancy of the Smart Corner facility by the Housing Commission (Attachment 3). In addition to the purchase price (which includes tenant improvement allowances), the project budget contains amounts for fixtures, lease up commissions, financing costs and moving expenses. The acquisition would be funded from a variety of sources, enumerated in the Fiscal Impact section, and includes a conventional bank loan.

One of the challenges of this proposed acquisition was how the Housing Commission could effectively lock-in fixed interest rate permanent financing for acquisition of a building that will not be completed for approximately two years. In order to assist Housing Commission staff with that effort, on February 28, 2003, the Housing Commission authorized a 120-day Brokerage Services Agreement with Buchanan Street Partners, L.P. (BSP). The primary stated purpose of the contract was to assist the Housing Commission in obtaining a 2-year forward commitment for permanent financing for approximately \$20 million at the lowest possible rate.

Although BSP was unable to produce the term sheet meeting the criteria for the desired financing, they were able to secure three term sheets for construction/short term take-out financing (Attachment 4). This alternate concept would have the Developer utilize the available money during the construction phase and then have the Housing Commission utilize the funds for acquisition at the completion of construction. Unfortunately, each of the three term sheets is lacking in key respects, and Housing Commission staff recommends the rejection of all the term sheets provided by BSP under the terms of their contract. Shortcomings include amount, terms, organizational structure and pricing, among other issues.

US Bank currently provides banking services to the Housing Commission. In order to provide the highest level of service, they have worked diligently with Housing Commission staff to provide an advantageous term sheet (Attachment 5). Their proposed variable rate of LIBOR plus 2.25% is lower than any of those provided by BSP, and their proposed loan amount of up to \$21 million adequately meets the needs of the project, exceeding those provided by BSP.

As was stated above, it is the Housing Commission's desire to obtain fixed rate financing in order to lock in operating cost. Interest rate risk is most effectively managed by the execution of a SWAP, a separate and distinct financial instrument that effectively converts a variable rate to a fixed rate. The cost of a SWAP is based on a published percentage rate and is additive to the variable rate. If the Housing Commission had been able to lock into a fixed rate on the date of their initial proposal, the "all in" rate (LIBOR plus 2.25% margin plus SWAP) would have been approximately 5.96%, and is currently hovering around 6.5 %. However, because we are unable to lock the rate until all the public body approvals have been received, final bank commitment issued, and documents executed, we have included in our pro-forma analyses for both 6% and 7%. It is expected that the actual rate will fall between those two rates. The draft PSA includes a provision that allows the Housing Commission to exit the deal if the interest rate exceeds 7% at the time of execution of the forward commitment.

Budget Analysis

Occupancy costs for the new facility have been estimated by KMA. The costs will be a function of the loan payment amount plus the operating expenses (utilities, janitorial, etc.) minus any revenue earned from the leased retail, offices and parking. Based on conservative income and expense projections, the occupancy cost for the proposed new office facility is shown in Attachment 7, as a range. Even at the higher price these costs are reasonable for the type of structure envisioned. However, it is also appropriate to analyze the budget implications to the Housing Commission of a new office facility.

In the first year of ownership of the new facility, the Housing Commission would be faced with the challenge of having to spend as much as between \$378,000 - \$533,000 more than it currently budgets for office space. Because KMA projects that Smart Corner rental income will rise faster than hard costs for occupancy, this differential over current expenditures would decline over time (Attachment 8). By the fifth year of occupancy, even the high estimate for Smart Corner would cost less than the renovation option. In the long term, annual expenditures for the new facility would actually become less expensive than the "as is" scenario, but the need to address the short-term gap cannot be ignored. For perspective, this first year cost differential represents approximately 2% of the administrative portion of the FY04 Budget.

A year ago, during the deliberations concerning the Housing Commission's FY03 Budget, Housing Commission staff also produced estimates of 5-year budget projections. This Smart Corner proposal is within the projected budget increase for office expenses.

Over two years ago, the Housing Commission embarked on a re-engineering effort. It was this effort that enabled it to become one of the most successful in the U.S. in terms of its ability to use all available vouchers. This successful business redesign provided greater housing benefit to clients and also enabled the Agency to earn additional annual administration fees from HUD.

The Housing Commission will be able to meet the challenge it will face in FY 2005 because of similar re-engineering undertakings. These have already begun and have included a reduction of management staff, and a shifting other positions from administrative areas to direct service. Strategic process redesigns in other areas will continue, and several revenue-generating programs included in the adopted Business Plan are being pursued. These changes will not reduce service in the Agency's core programs.

It is noteworthy that the Housing Commission would face a similar financial challenge even were it to choose the alternative of renovating its site. In fact, the first year cost difference between renovating and purchasing at the upper end 7% interest rate is only \$80,000.

Of course, this challenge would not be necessary in the "do nothing" scenario, but not renovating Newton Avenue is not a viable option, as safety and deferred maintenance issues are of increasing concern.

By meeting the Agency's space needs with an investment that will yield the greatest return, the Housing Commission will in time have substantially more equity in a downtown building. It might choose to borrow against this equity, or the building could be sold in the future with the appreciated value applied toward a new facility to house all City departments.

Risks and Mitigation

1. Rental Income. There is some risk involved with realizing the rental income included in the pro forma. To mitigate this risk, rental income from the following sources was estimated conservatively:

- One floor of the office space will be available for lease to other organizations. Although it is not possible to obtain firm commitments from potential lessees so far in advance, several non-profit organizations have expressed interest in leasing the available space, and its location near San Diego City College offers additional opportunities.

- The ground floor in the proposed office facility will be available for lease to retail establishments; the site is adjacent to one of the busiest trolley stops in the City, making the retail space very desirable for businesses.
- The rental income derived from the parking garage is an important part of making the proposal affordable to the Housing Commission. KMA has concluded that there is currently a shortage of parking in the area, which will be exacerbated by planned development that would eliminate several surface parking lots, thereby increasing the likelihood of full utilization of the parking garage.

2. Sale of Newton. There is also risk involved in selling the Newton Avenue property with appropriate pricing and timing. However, brokers indicate that downtown development is creating a market for displaced businesses nearby, and that the market for similar properties is strong. The Housing Commission does have short-term contingency plans if the property is not sold within two years; but, naturally, these would add to the cost.

3. Interest Rates. Another risk concerns interest rates. Short term, LIBOR and SWAP rates have been somewhat volatile. Rates cannot be fixed until US Bank completes its due diligence (60 – 90 days from Housing Authority approval). To ensure that the purchase price is attainable, the PSA would give the Housing Commission the option of canceling the transaction if interest rates rise above 7%, but with no worthwhile substitute. Without an office facility occupant, construction financing for the entire 12th & “C” block would be jeopardized.

There is an additional long-term interest rate concern. Assuming the Housing Commission completes the acquisition, the US Bank loan is fixed for no more than five years and the Housing Commission must secure longer term financing. Interest rates might be higher then. Among other contingency plans, securing tax exempt financing for a “seasoned” building with tenants in place would be a possibility. Such financing would not impinge on the City’s ability to issue housing bonds or other municipal borrowings (Attachment 9). Also, the Housing Commission could substitute a longer term loan at any time during the five year US Bank loan term without penalty.

CONCLUSION

Approval of this proposed action would improve access for clients while resolving overcrowding and physical condition issues at the Housing Commission’s current facility. It will create greater operating efficiencies, accommodate possible future growth, and allow for long-term capital appreciation. The new building would meet the City’s sustainable building guidelines, be fully accessible, and contribute to meeting redevelopment plan goals. SEIU Local 535 leadership, which represents most of the Housing Commission employees, has been

consulted regarding this matter and is supportive of going forward with this development opportunity.

Housing Commission has analyzed the Housing Commission's options and position with regard to the need to extensively renovate its current facility or relocate. It has been assisted by an ad hoc committee of Commissioners and by KMA. The analysis has included extensive review of the viability of the Smart Corner and other alternatives. The necessary "due diligence" has been performed to ensure reasonable costs, within industry standards, and negotiations have proceeded in good faith with the Developer, pursuant to the Housing Authority approved ENA.

The proposed development plan has some added cost burden in the short term, but it represents the best available option for meeting the Housing Commission's criteria. Importantly, it offers a unique long term business opportunity. The resulting cost of occupancy is below market for a fully serviced similar space. This is achieved by generating rental income at this busy location to offset more and more of the Housing Commission's costs each year.

ALTERNATIVES

Alternative No. 1: Direct Housing Commission staff to proceed with the renovation of the Newton Avenue facility. This alternative is not recommended due to the cost of the rehabilitation and the significant disruption to staff and clients during the construction phase. Return on investment is unfavorable, as this extensive renovation would not substantially increase the value of the property. In addition, this alternative does not address the problems of inadequate parking and access to public transportation, nor is there an opportunity to offset costs with rental income. Leveraging the Newton Avenue building equity for housing in the future is limited, especially compared to the Smart Corner.

Alternative No. 2: Direct staff to pursue new construction or acquisition opportunities outside of the downtown area. This alternative is not recommended, in part, because CCDC's participation has helped make this opportunity feasible and it is unlikely that similar opportunities will become available. Also, it is unlikely that the rental revenue income that would be derived from Smart Corner could be duplicated outside of downtown.

Alternative No. 3: Direct staff to lease other office space. This is not recommended, as it is the most expensive alternative.

Respectfully submitted,

Approved by,

Signature on File with Original Document

Steve Snyder
Asset Manager

Elizabeth C. Morris
Chief Executive Officer

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Information: S Snyder 578-7545

Attachments:

1. Executive Summary of the Purchase and Sale Agreement
- 2a. Purchase and Sale Agreement*
- 2b. Escrow Instructions* (see 2a PSA)
3. Project Budget
4. BSP Term Sheet
5. US Bank Term Sheet Summary
6. Environmental Review
7. Occupancy Cost Comparison
8. Cost Difference Over Time
9. 11/21/01 City of San Diego Memo from Patricia T. Frazier
10. Developer's Statement for Public Disclosure*

*Distribution of this attachment is limited due to its length. Complete copies are on file at the Office of the City Clerk, 202 C Street, 2nd Floor, and at the Office of the San Diego Housing Commission, 1625 Newton Avenue.