

A Bad Deal

An Analysis of the Pending California State Office Building Sale / Leaseback Program

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Executive Summary

California Governor Arnold Schwarzenegger has proposed selling off 11 state-owned office properties for the purpose of helping balance the state's huge budget deficit. The plan is to lease back the sold properties from the buyers using a relatively stringent long-term lease. The Governor's proposed budget estimates that the sale will net roughly \$1.97 billion in revenues. Many of the properties have outstanding debt on them that will need to be paid off in the event of a sale. Approximately \$1.31 billion in payments will need to be made to close these bonds and pay interest penalties. As such, the plan's proponents estimate the net proceeds to be \$660 million.

The properties are slated for sale in the belief that, like similar transactions undertaken by corporations in the private sector, the state can almost immediately employ potential cash that's currently locked up in the value of these buildings. Implicitly, it is also based on the idea that buildings managed by the private sector will be cheaper to maintain because of lower employment costs. Notably, this new policy is a direct repudiation of a tradition enacted over 30 years ago to lower the state's cost for courts, employees, and agencies by developing state-owned office buildings.

Our analysis of this transaction suggests that the initial estimate of the net proceeds from the sale of the buildings (\$660 million) may be slightly high given current market conditions – but are well within the realm of possibility. Nevertheless, we strongly recommend against selling the properties for three reasons:

1. While the transaction may net the state a profit in the short run, ultimately the long-run costs of renting will be far greater than the cost of owning the properties directly. Even if we assume that the cost of maintaining the properties is higher under state ownership, rental prices will cost \$4.2 billion more than the direct expenses over a 30-year period, \$1.5 billion in current value. This expense is considerably larger than the \$600 million the state hopes to raise. The reason for this gap is that the cost of capital for the state is lower than for the private sector.
2. Even if the sale of the properties was net neutral (that is to say the funds raised in the short-run fully offset the expenses of renting the properties back in the long-run) such a transaction violates the spirit of the Prop-58 ban against using long-run debt to fund current state spending, as it imposes a cost burden on the future in order to cover current state expenditures.
3. Lastly, using one-time revenues to try and solve a structural budget gap is always bad policy, as it simply moves the need to make tough decisions ahead in time. In this case the overall amount of cash raised is so small relative to the current budget gap that it accomplishes little in solving the state's short-run problem.

Critics of government often cite the numerous ways that public budgets obscure what is happening from the eyes of the electorate. This is a classic case of such a transgression. The fact that this sale increases the cost to the state over the long run is not included in the budget proposal. This is possible because the public sector is allowed to account strictly on a cash basis, unlike the private sector where an accrual basis is the law for such large transactions. If the state government used standard accounting principles, this transaction would actually end up expanding the budget gap substantially, rather than reducing it.

The following report details how we arrived at these results. The next section discusses the properties and the nature of the state's leaseback agreement. The third section lays out the empirical analysis, and how we arrived at

our net present values for the two scenarios, sell and lease, or own. The final section concludes with a discussion of the violation of the spirit of the law.

Sale and Leaseback of California State Office Buildings

In December of 2009, the California Department of General Services (DGS) awarded a contract to CB Richard Ellis Group, Inc. (CBRE) to broker the sale of 11 state-owned office properties comprised of 24 separate buildings including a total of 7.3 million square feet. The previous June, Governor Schwarzenegger had directed the sale of these properties in an attempt to raise a then-estimated \$660 million to offset looming deficits in the state budget.

There has been little public discussion about these plans, and even less independent fiscal analysis of the long run costs to the state. On April 6th, 2010, the *Los Angeles Times*¹ published an editorial by real estate developer Jerry B. Epstein, who was – until recently – the president of the Los Angeles State Building Authority, the three-person governing body which oversees the construction and maintenance of state-owned buildings in the downtown area. According to Epstein, not only had the state’s Department of General Services refused to provide an objective market study comparing the net proceeds from the sale versus the rental and other costs associated with its leaseback, but reacted to his inquiry by firing him and reappointing someone else in his place.

The core of our analysis comes from data provided to us by CBRE as well as secondary information from the Office of the Treasurer, the Legislative Analysts Office, and the Department of General Services. Table 1 summarizes the names and locations of each property as well as the bond retirement year, amount of deferred maintenance (if any), estimated market value as of June 2009 and the estimated proceeds to the state once the bonds have been defeased.

Table 1: Estimated Market Value of State Properties for Sale

Building	Location	Bond Retirement	Est. Mkt. Value (\$)	Deferred Maint. (\$)	Est. Proceeds (\$)
Attorney General Building	Sacramento	2015	132,205,457	—	109,180,184
California EMA	Sacramento	N/A	33,599,256	—	31,919,293
Capitol Area East End Complex	Sacramento	2027	463,886,784	3,604,000	33,322,444
Elihu M. Harris Building	Oakland	2014	166,652,439	2,541,000	20,139,871
Franchise Tax Board Complex	Sacramento	2011 - 2030	396,746,064	2,124,000	126,848,761
Earl Warren/Hiram Johnson (Civic Center)	San Francisco	2021	357,553,555	2,792,000	69,515,878
Junipero Serra State Building	Los Angeles	2019	76,426,606	4,300,000	30,835,276
Justice Building (4949 Broadway)	Sacramento	N/A	34,097,410	2,096,000	32,392,540
Public Utilities Commission Building	San Francisco	2013	124,863,480	6,424,000	96,855,306
Judge Joseph A. Rattigan Building	Santa Rosa	N/A	7,784,012	1,872,000	7,394,811
Ronald Reagan State Building	Los Angeles	2011	181,933,179	5,026,000	103,456,520
Totals			1,975,748,242	30,779,000	661,860,884

Each sale comes with a specific lease arrangement for the state. A summary of these cash flow summaries is included below. Note that the rental prices are below equivalent market rates. This is not a benefit to the state, since this will reduce the value of the properties to a prospective buyer.

¹“State should keep ownership of its buildings” *Los Angeles Times* Op-Ed By Jerry B. Epstein April 6, 2010.

Table 2: Current Rental Values of State Properties

Building	Rentable Sq. Ft.	Existing Scenario		Leaseback Scenario - FY 2011		Annual Rent Difference
		Rent/SF (\$)	Annual Rent (\$)	Rent/SF (\$)	Annual Rent (\$)	
Attorney General Building	307,396	1.93	7,119,291	2.84	10,476,056	3,356,764
California EMA	107,004	0.65	834,631	2.55	3,274,322	2,439,691
Capitol Area East End Complex	1,111,167	3.44	45,868,974	2.80	37,335,211	-8,533,763
Elihu M. Harris Building	544,625	2.79	18,234,045	2.58	16,861,590	-1,372,455
Franchise Tax Board Complex	1,525,152	1.84	33,675,356	2.31	42,277,213	8,601,857
Earl Warren/Hiram Johnson (Civic Center)	676,097	4.39	35,616,790	3.26	26,448,915	-9,167,875
Junipero Serra State Building	324,312	2.56	9,962,865	2.19	8,522,919	-1,439,945
Justice Building (4949 Broadway)	276,112	1.80	5,964,019	2.00	6,626,688	662,669
Public Utilities Commission Building	210,453	2.39	6,035,792	2.99	7,551,054	1,515,262
Judge Joseph A. Rattigan Building	61,114	1.80	1,320,062	1.95	1,430,068	110,005
Ronald Reagan State Building	515,390	1.80	11,132,424	2.19	13,544,449	2,412,025
Totals	5,658,822	2.31	175,764,250	2.51	174,348,485	-1,415,765

The leases are structured as follows:

- An original lease term of 20 years beginning at the close of escrow;
- Lease rates are locked for Years 1-5 with escalations of 10% in the Base Rent on the fifth anniversary of the commencement date and on each fifth anniversary thereafter;
- On the first anniversary date of the lease and each twelve months thereafter, the rent will increase or decrease by 1/12th of an amount that will be determined by multiplying the base amount by the percent that the applicable CPI index rose or fell for the previous 12 months and assuming a base period of June 2010;
- On the first anniversary date and every twelve months thereafter, the monthly rent will increase by 1/12th of the amount determined by multiplying the annual property tax expense for the preceding 12 months by the actual percent increase capped at 2%. The initial property tax expense will be based on the original purchase price, but will not reflect any future changes in value due to subsequent sales;
- Lessee has the option to extend the term of each lease for six additional terms of five years each on the same terms and conditions of the original lease and set on the same 10% increases every five years (i.e., Base Rent in Year 1 of the lease extension would be 110% of the Base Rent of the final five-year term of the original lease) as well as the Operating Expense CPI Escalator;
- The state is responsible for paying all charges for gas and electricity in addition to rent;
- Charges for parking spaces vary by building from free to \$250 per month and are included in the Total Gross Revenue projections provided by CBRE;
- Lessor will provide the full range of services, utilities and supplies such as sewer, trash disposal, water, elevator service, janitorial services and property management similar to those provided by office buildings of comparable quality in the same market area;
- Lessor shall maintain all leased premises, and the building and property of which they are a part, in good repair and tenantable condition during the entire lease term; and

- CBRE has estimated the CPI at 3%, a 3% increase in the operating expense growth rate, and a 2% property tax growth rate per year through the life of each lease.

All of the figures included in CBRE’s cash flow summaries – including rates for insurance coverage, janitorial service, utilities other than gas and electricity, and ongoing maintenance and repairs – assume that the new owners will retain CBRE Asset Services and base their cash flow assumptions on these numbers, some of which were based on economies of scale that CBRE enjoys due to its national purchasing power. However, the new owner(s) are under no contractual or legal obligation to do so, and may either self-manage the properties or choose alternate property management firms.

Estimate of Net Sales Proceeds and Long Run Costs

The state needs office space so its agencies can accomplish their work. The own versus rent discussion necessarily revolves around which is the least expensive option to provide the needed space. In the ‘own’ scenario, the costs to the state would include upkeep and bond payments. Under the rent scenario, the cost is the rental payments minus the net funds that could be raised from the sale of the structures. For both scenarios we need to control for the discount rate to bring future values into present value terms. The estimates generated are rough—the numbers included are the best we could find from the variety that are generated by the sources we used. However the final conclusions are fairly robust and wide enough for even substantial changes in these estimates.

In the sales documentation, CBRE has laid out the expected path of rental prices according to the lease terms and given some basic assumptions regarding inflation in their sales documentation. They also estimated the ongoing expenses for running the building.

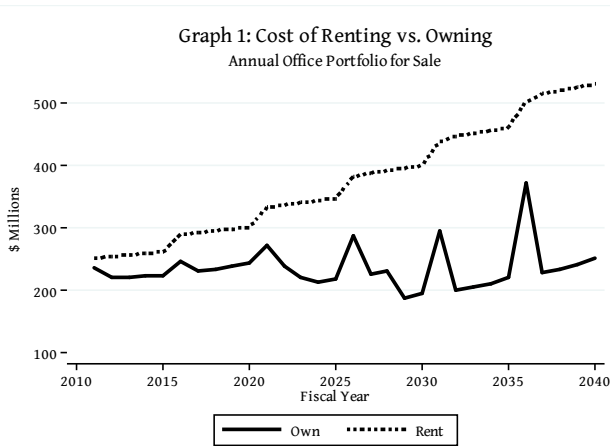
Table 3: Office Rental Price Changes (%)

	Actual 1994-09	Forecasts 2010-14
East Bay	6.1	0.7
Los Angeles	1.5	1.2
Sacramento	1.0	0.7
San Francisco	4.0	2.6
Weighted Avg.	2.2	1.2

Source: Portfolio and Property Research

One of the standard arguments regarding outsourcing of public services to private agencies is that higher productivity and lower benefit costs will reduce the overall expense. To deal with this we assume a 50% higher labor cost. Approximately half the ongoing expenses of running the buildings, such as maintenance and operations is labor related (the balance is utilities, real estate taxes, materials, insurance, and other non-labor costs), so we assume that the annual cost of operating the facilities under the State is 25% more expensive in total than if a private sector enterprise was managing the buildings. There is one exception: management fees that are linked to having a third party run the building. Presumably, if the state is running these buildings directly it implies that this expense would not occur. We did not make the same distinction with administrative costs.

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Graph 1 shows annual costs to the state of using the facilities as state owned or privately held. In general, renting is more expensive on an ongoing basis. However, this would be offset by the funds raised in the initial sale of the properties. The gaps grows over time, in small part because of the increases in rental prices that are not reflective of rising costs, but also because the bonds used to purchase or build the office space will all eventually be paid off, reducing expenditures to just ongoing maintenance. Note that the spikes in the owned cost line are due to periodic maintenance, including painting and new carpets.

The next step is to estimate the potential selling price of the properties. This is clearly not a standard transaction, inasmuch as terms of the lease make it an unusual purchase. Traditional market comp studies simply won't work. For a prospective buyer, the purchase of the properties has some distinct benefits over a normal purchase. For one thing, the buildings are more or less full, and the state is committing to a 20-year lease – often in markets in which office vacancies have approached or well exceeded 20%. This is a long-run cash machine.

As for the rental rate increases, the lease requirement that the Base Rent rises by 10% every five years is separate from any changes in operating expenses that are linked to the CPI. Given an assumption of a 3% inflation rate, overall there is a 2.6% annual average increase. This is actually competitive. A review of the long-run weighted averages of asking office rents in the markets in which the various properties are located, shows that between 1994 and 2009, the average annual rental price increase was only about 2.2%. The forecast for the next five years puts this at 1.2% due to the current turmoil in the market. The use of one blanket lease agreement does lead to some strange regional discrepancies. The properties in the San Francisco Bay Area have seen stronger rental growth than the lease agreement, while in Los Angeles and Sacramento, the long-run averages are lower than the lease agreement.

However, the terms do not all favor the buyers. One large risk is inflation. Two-thirds of the rental price increases are fixed. If inflation does kick in, the owners of the properties would find themselves in a financially losing position quickly. Given the length of the lease – 20 years with an additional 30 years of automatic extensions – this is a long-run issue.

Lastly, the Department of General Services noted that the leases could be subject to an appropriations clause, which means that in the event the State fails to budget dollars for these leases, the leases are voided and the State cannot be held liable. In short, the State can simply walk away from their obligations if the State's legislative bodies find it useful to do so.²

Still, the risk of either of these outcomes is, at present, low. The bond markets remain calm, and long-run rates are at normal levels. One of the greatest price risks—energy—is actually not even borne by the buyer, since the State agrees to pay gas and electricity for the buildings as part of the lease. Similarly, abandoning one or more

²<http://www.documents.dgs.ca.gov/dgs/dgs/LeasebackBuildings.pdf>.

leases would incur large fixed costs on the State, and frankly it is unclear where entire state departments could be moved without new construction in these markets.

To create an estimate of the potential market value of these properties, we pursue two techniques. The first is to look at current cap rates (net annual income divided by the price of the property) in the markets, and apply these to the current net cash flow generated by the properties. The second way is to use a traditional net present value methodology for the expected cash flows over the next thirty years.

For the cap rate methodology, data from Portfolio and Property Research currently pegs the cap rate for sales in the region at 8 to 9. These rates include a risk premium that would not be needed for the purchase of the state properties. However, they are based on current low net incomes due to the high vacancy rates seen in many markets as a result of the weak economy. In other words, the long-run cap rate currently being priced into the market is even higher. In order to cover the potential spread, we will use a low cap rate of 7.5 and a high one of 9.5 to reflect the potential range of prices the State may receive.

As for the net present value formula, we apply a cost of capital to the net returns for 30 years of net income on the properties. Finding an appropriate cost of capital is difficult—these numbers simply aren’t estimated. They reflect both the cost of debt as well as the cost of capital. An informal survey of a number of commercial real estate experts provided us with an 8.5% to 10.5% range. We subtract the \$30 million in deferred maintenance from the totals. The range of prices is from \$1.6 billion to slightly over \$2 billion. The initial estimate from the state (\$1.97 billion) fits within this range, but at the higher end. Still, it is not outside the realm of possibility.

Table 4: Estimated Sales Value of State Properties

Millions of Dollars

Method	Cap. Rate	Sales Value	Net Proceeds
1	9.5	1,638.8	316.8
2	7.5	2,084.0	759.8
Cost of Capital			
3	8.5	2,047.5	723.4
4	10.5	1,672.2	350.0
Average		1,876.0	552,808,274

The net proceeds from the sale is the final price, minus the commission (we estimate at .8%) and the bond payoffs, which total \$1.31 billion. This puts the range of potential one-time gains for the State at \$316 to \$760 million. Again, this value is within the initial State estimate of \$660 million but only at the upper range. We estimate the average potential gain for the State at \$550 million.

There may be skepticism about the ability of the State to sell these properties easily based on the

conventional wisdom that problems in the commercial markets are severe enough to lower the value of properties even further than the original estimates – or delay the sale for a year or more. Yet, like so much conventional wisdom, we believe that this is false. Many have characterized problems in commercial real estate as stemming from a lack of credit—in short, only a few available buyers. This is not true. There is plenty of cash waiting on the sidelines to buy commercial real estate, as many savvy investors have pulled together war chests to take advantage of what was predicted to be a wave of commercial real estate foreclosures. The lack of transaction volume is due more to a lack of sellers, which in turn is due to a change in accounting rules that occurred at the start of last year allowing many creditors to simply avoid foreclosing on underwater borrowers and having to acknowledge losses to their portfolios. As such, few foreclosures have occurred.

While it is true that for normal properties there is considerable risk due to rising vacancies, the State properties are guaranteed cash flow in another tough market. In fact, the lack of supply and low risk for these properties may in fact benefit the State. In some circumstances when a property sale has occurred, frustrated investors have actually engaged in bidding wars, and consequently some transactions have seen cap rates dip to the 6 to 7 range. In short, the net proceeds may be even larger than what we have modeled. Of course much of this depends on the market's perception of the risks of doing business with the State and the overall potential for inflation.

Nevertheless, we still feel that the sale would be a bad deal for the State. To consider why, we need to calculate a net present value of the cash flows under the buy versus rent scenarios. As we saw in Graph 1, the long-run cash costs of owning the building are lower for the State than renting the units. Yet this is offset by the potential sales value up front. We need to compare the present value of this cost difference to our expected sales prices in order to find out which is the best long-run financial option for the State.³ To estimate the present value of future expenditure differences, we use an annual discount rate of 5.5%. This is higher than the current 20-year Treasury Bond rate, and thereby includes the risk premium for state borrowing.

Table 5: Net Present Value of Own vs. Rent Options

Present Value Cost of Ownership	\$3,399.2
Present Value Cost of Lease	\$4,897.0
Present Value of Cost Differential Between Leasing and Owning	\$1,497.7

Figures in millions of dollars. Present values are based on the estimated 30 years of operational costs association with the building as shown in Graph 1. Present values are calculated by using a discount rate of 5.5%.

Table 5 details the final analysis of the long-run value of selling compared to maintaining ownership. The present value (PV) of the aggregate cost of ownership runs roughly \$3.4 billion over a the 30-year period. The PV for renting for the same period of time runs roughly \$4.9 billion. In other words, the present value to the State of this change in ownership would be roughly \$1.5 billion in *current* terms. This amount is twice our 'best-case' expected proceeds from the sale of the property, and three times the average value.

This may seem like a surprising result, but intuitively it makes sense for two reasons. First, the State has a lower cost of capital than the private sector does, because the debt is safer and of course is tax-free for investors. Moving ownership of the buildings from the State to the private sector makes the capital costs of the property considerably higher. Additionally, the State, unlike the private sector, does not pay taxes on profits it earns. Selling the buildings more or less turns them from a non-profit to a for-profit entity and again, increases the cost of operations.

Sum it up and it's clear that selling these properties is a bad financial decision for the State. While it may add a bit to today's coffers, it does so only at the expense of future years. This basic result would need to be spelled out in any financial documents produced in the private sector where such financial transactions need to be accounted on an accrual basis. It is only because the public sector is unique in being allowed to report transactions on a cash only basis that this result has been hidden. If standard accounting practices were used by the public sector this sale would actually increase the current budget gap.

³We can't directly compare the long run higher costs with today's funds, as future money has to be discounted to turn it into current value terms. To do so we use a standard technique in financial economics known as present value formulas. The basic idea is that if the discount rate is, say, 5%, the \$100 received one year from today would be equal to receiving $\$100 / 1.05$ or \$95.2 today. In the parlance of the industry we would say that the \$100 has a 'present value' of \$95.2. If the \$100 was to be received in two years, it would be worth $\$100 / (1.05)^2$ in present value terms and so on.

State Debt and Spending

Most U.S. states including California have constitutions that ban the use of long-term debt to cover current government expenditures.⁴ While the use of public borrowing can be used to smooth business cycles, unfortunately – more often than not – borrowing by governments is used primarily to avoid making tough decisions in terms of cutting costs or raising taxes to deal with budget gaps. In short, because of a lack of political will, it is used to put the burden of today on future generations of citizens and politicians by ‘kicking the financial can down the road’. Such problems become particularly acute when politicians face term limits on their elected offices. Constitutional bans on such borrowing are in place to prevent this intergenerational robbery.

The current plan to sell off 11 state-owned office buildings flies in the face of this Prop 58 ban—as it more or less does exactly the same thing as using long-run debt to cover current spending. The State can earn some cash in the short run—but only by taxing the future by increasing the cost of state operations. Even if the tradeoff were equal, it would be unfair to put the burden of current budget problems on future administrations. And, in this case the tradeoff is not equal. The long-run losses outweigh the current gains on an order of three—the cash raised today will cost future years of California taxpayers three times as much in current terms. These sales should not occur.

⁴Of course there are some exceptions to the ban on borrowing. Capital investments can be financed through the issuance of debt—because future generations benefit from such investments as much as the current generation does. The State can also use short-run borrowing to smooth out fluctuations in the revenue stream through the course of a year.



About the Author

Christopher Thornberg is a founding principal of Beacon Economics and widely considered to be one of California's leading economic forecasters. An expert in economic forecasting, regional development, real estate dynamics, and labor markets, he was one of the earliest and most adamant predictors of the housing market crash and of the economic recession that has followed. In 2008 he was appointed as chief economist for California State Controller John Chiang as well as chair of the Controller's Council of Economic Advisors. He also serves on the advisory board of Paulson & Co. Inc., one of Wall Street's most successful hedge funds. Dr. Thornberg holds a Ph.D in Business Economics from The Anderson School at UCLA, and a B.S. in Business Administration from the State University of New York at Buffalo.

About Beacon Economics

Beacon Economics is an independent economic research and consulting firm with offices in Northern and Southern California. The firm specializes in quantitative and qualitative macroeconomic research, analysis, and data services. Founded by two PhD economists, Beacon is home to some of California's leading economic forecasters and researchers. The firm currently serves as the chief economic advisor to the California State Controller's Office. Beacon Economics' clients include government agencies, investment funds, non-profit organizations, and private enterprise. The firm's nationally recognized forecast has been called "eerily accurate" and was among the first to predict the collapse of the housing market and foretell the onset and depth of the current economic downturn.

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