TRANSBAY JOINT POWERS AUTHORITY

Memorandum

To: Cost Review Committee (CRC)

From: Sara DeBord, Chief Financial Officer, TJPA
Martha Velez, Facility Manager, TJPA

Date: For the Committee Meeting of November 17, 2017

Re: Agenda Item 7, Funding Source for Tenant Improvements

As shown in the staff memo for Agenda Item 8, Expenditures and Commitments of the City Financing, current commitments total $141 million, representing a nearly $21 million decrease since the previous CRC meeting, made possible through partial de-obligation of previously appropriated amounts upon financial close of the City's first sale of Community Facilities District (CFD) bonds. Anticipated additional commitments do not currently exceed $7.1 million, which would bring the total City Financing amount for Phase 1 to $148 million. At its November Board meeting, the TJPA Board directed TJPA Executive Director Mark Zabaneh to request approval from the CRC to utilize additional City Financing to fund base building and tenant improvements that are necessary for retail/commercial leasing.

The Phase 1 CM/GC is contracted to deliver the retail and commercial spaces in shell condition, excluding the improvements needed in order to create the spaces to be leased. It was not possible to include these improvements in the CM/GC contract because it is not known what the configuration of these spaces will be, in that the market and tenant activity will dictate the buildout of these spaces. In addition, TJPA's contracting and operating strategy was based upon a "master lease" concept. Under a master lessee model, a public owner provides a long-term leasehold of the full facility to a private sector entity charged with performing most, if not all, operations and maintenance work and responsible for certain costs associated with operations and maintenance and capital improvements (including tenant improvements). The TJPA released a Request for Proposals (RFP) that assumed a master lessee structure. But to ensure a strong market response and guided by the market's inquiries around potential alternative structures, the RFP allowed respondents flexibility in proposing alternative deal structures and economic terms to the master lessee structure.

The TJPA received proposals from three respondents. Two of the teams (Cushman & Wakefield and Lincoln Property Company) proposed asset management structures, where a public owner hires a private sector entity to execute building maintenance and operations work, as well as lease and manage retail spaces and run programming throughout the facility, without making a capital investment. One team (Young Woo & Associates) proposed a hybrid master lessee structure. As described in detail in the March 2017 report to the TJPA Board, under the master lessee structure, Young Woo & Associates would have borne the cost of the base building improvements and the landlord's share of tenant improvements. But in exchange, the master lessee would have retained a substantial amount of the revenues (more than 80%) generated by the facility through the first ten years of operations. Thus, the net annual income to the TJPA was far superior under the asset management structure versus the master lessee structure.

The base building improvements will generally include the following: demising walls that create the individual spaces; topping slab that provides a level surface at each built out space in order to install floors and thresholds; mechanical, electrical and plumbing points of connection; electrical and, if needed, gas meters; air conditioning units; and scrubbers and venting shafts for the food spaces. This work will be accomplished under the direction of TJPA's asset manager, Lincoln, by a general contractor selected through an RFP process. The estimated base building improvement cost is summarized below.

It is also necessary for a retail/commercial tenant to make tenant improvements to any space it leases. Tenant improvements vary widely based on the particular requirements of a tenant, but may include things such as partition walls, shelving, counters, installed equipment, lighting and carpeting. The cost of tenant improvements likewise varies widely depending on the size of the leased space and the tenant use, typically from less than $100 per square foot to more than $300 per square foot, and from the low tens of thousands of dollars in total cost of improvements to the low millions of dollars in total cost. This work will be either performed by the tenant, or accomplished under the direction of Lincoln by its general contractor.

Colliers, the leasing agent on the Lincoln team, advises that it is typical in the San Francisco market for landlords and tenants to negotiate a tenant improvement allowance in lease agreements. Colliers advises that the market contribution from landlords is an allowance of approximately one-half of the total cost of tenant improvements, with the tenant bearing the remainder of the cost. Earlier this summer, the TJPA Board approved a Merchandising Plan for the transit center, and this plan makes certain assumptions about the TJPA's ability to provide certain tenant improvement allowances to certain tenants on a particular schedule in order to achieve the overall schedule for retail/commercial occupancy and full activation of the facility, and to meet the leasing goals of the Merchandising Plan.

The TJPA does not expect that each tenant would be entitled to a tenant improvement allowance of a particular amount; the TJPA team intends to vigorously negotiate the agency's contribution, if any, toward a tenant improvement allowance, and would expect greater rent as a result of any contribution the TJPA makes to the cost of such improvements. Although the TJPA does not anticipate that it will offer any particular tenant improvement allowance in every case, for budgeting purposes the TJPA thinks it is prudent to assume that the TJPA will offer in the aggregate about one-half of the estimated cost of tenant improvements as an allowance. The TJPA's market-based allowance for the cost of tenant improvements is summarized below.

Summary Cost of Improvements (estimate, $millions)	
Base Building Improvements (Direct Construction Costs)	16.23
Allowance for Tenant Improvements	12.59
Subtotal Improvements	**$ 28.82**
Soft Costs (Architect, etc.)	2.43
Asset Manager Construction Mgmt Fee (3.5%)	1.01
Contingency (10%)	3.23
Total	**$ 35.49**
Total Base Building Improvements	21.16
Total Allowance for Tenant Improvements	14.33
Total	**$ 35.49**

The TJPA assumes that it requires $16.23 million for the direct construction costs of base building improvements and, for budgeting purposes, $12.59 million as an allowance representing about one-half share of the aggregate cost of tenant improvements, plus an estimated $6.7 million for the asset manager's construction management fee, soft costs such as the architect designing the spaces, and contingency. To meet the Merchandising Plan schedule for full lease up and activation of the facility, the TJPA expects to require the funds for these improvements on the following timeframe:

	Annual Cash Flow (est.) ($millions)			
	FY 17/18	FY 18/19	FY 19/20	Total
Base Building Improvements	10.58	10.58	---	21.16
Allowance for Tenant Improvements	5.73	5.73	2.87	14.33
Total	**$ 16.31**	**$ 16.31**	**$ 2.87**	**$ 35.49**

The potential sources of funding for these costs are the City Financing, and the about $10.1 million in early term payments under the Naming Rights Agreement ("Early Naming Rights Fee"). Under the Naming Rights Agreement, salesforce.com agreed to pay an aggregate escalated fee of more than $110 million over the 25-year term of the agreement, made up of: $1,010,000 at the time of execution of the agreement; an upfront, lump sum payment of the fee for the first three years of the term in the amount of $9,112,700 at the time of commencement of regular passenger bus service and the satisfaction of certain other conditions; and an annual fee of $3,278,181 escalated by 3 percent over the term of the agreement starting in year 4 of the term. If the Early Naming Rights Fee is not used for these costs, it will be used to offset transit operator contributions to net operating costs of the transit center.

Under the terms of AC Transit's 2008 Lease of the Transit Center, AC Transit and any other Primary Tenants are expected to pay an Operating Charge, generally calculated as the Primary Tenant's share of the differential between operating costs and operating revenues in a fiscal year. The share is generally calculated based on a Primary Tenant's proportion of the total Exclusive Use Space at the transit center. The Lease contemplates that a Primary Tenant may sublet portions of its Exclusive Use Space to other transit operators to reduce the Primary Tenant's effective financial burden.

The TJPA anticipates that in the near term the two transit operators that will be Primary Tenants of the transit center will be AC Transit and SFMTA. The TJPA anticipates that AC Transit's share of the Operating Charge will be 78.2% based on AC Transit's exclusive use of the Bus Deck Level of the transit center. AC Transit is expected to reduce its effective obligation, however, through subleases with operators on the Bus Deck such as Greyhound, Amtrak, WestCAT Lynx, and SFMTA. The TJPA anticipates that SFMTA's share of the Operating Charge will be 21.8% based on SFMTA's exclusive use of the Bus Plaza of the transit center. SFMTA is also expected to sublease a portion of the Bus Deck Level from AC Transit, which the TJPA anticipates would equal 4.2% (thereby reducing AC Transit's obligation to 74%). Thus, SFMTA's total share of the Operating Charge is expected to be 26%. To the extent retail revenues are less than what is assumed in the budget, the Operating Charge paid by AC Transit and SFMTA would increase.

TJPA staff, in consultation with Lincoln and Colliers, have evaluated several funding options for base building improvements and the tenant improvement allowance, and the result on expected transit operator contributions. The options are summarized in the table below and described in more detail in the narrative that follows, along with a projection of the likely impact of each alternative on retail/commercial revenues and transit operator share of the estimated net operating deficit of the transit center.

Source of Funding	Option 1		Option 2		Option 3		Option 4		Option 5	
	(based on estimated costs; $millions)									
	Base	TI	Base	TI	Base	TI	Base	TI	Base	TI
City Financing	21.16	14.33	21.16	4.23	21.16	0	21.16	0	21.16	0
Naming Rights	0	0	0	10.10	0	10.10	0	5.00	0	0
Retail Tenants	0	14.33	0	14.33	0	18.56	0	23.66	0	28.66
Retail Rent Revenues (est)**	**$57.21**		**$57.21**		**$54.96**		**$25.67**		**$25.16**	
Retail Rent Revenues (est) NPV @ 8%**	$32.62		$32.62		$31.58		$12.74		$12.57	

**Lincoln/Colliers Effective Rent and NPV Rent net of leasing commissions and TI's over a ten-year period escalated annually at 3%

The tables below demonstrate the net effect on Primary Tenant contributions over the next five fiscal years under each of the options. It is important to note that the numbers are estimates, based on current operating projections. These projections are preliminary and still very much subject to change based on, among other things, the outcome of Lincoln's procurement of service providers for the transit center and Colliers' leasing efforts. Unlike the current FY18 operating budget, the projections used for this exercise assume a full 12 months of operations at the Temporary Terminal (versus 9 months) and 3 months of ramp-up costs for the Transit Center (versus 3 months of ramp-up plus 3 months of operations). However, they conceptually give a sense of the impact to rents and operator contributions under each scenario.

Option 1 *($millions)*	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**Total**
Retail Rent Revenues (est.)	-	4.56	6.40	6.59	6.78	**$ 24.33**
AC Transit Contribution	-	-	5.33	3.11	2.74	**$ 11.18**
SFMTA Contribution	-	-	1.87	1.09	0.96	**$ 3.93**

Option 2	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**Total**
Retail Rent Revenues (est.)	-	4.56	6.40	6.59	6.78	**$ 24.33**
AC Transit Contribution	-	6.96	5.33	3.11	2.74	**$ 18.14**
SFMTA Contribution	-	2.44	1.87	1.09	0.96	**$ 6.37**

Option 3	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**Total**
Retail Rent Revenues (est.)	-	4.41	5.77	6.19	6.45	**$ 22.81**
AC Transit Contribution	-	7.07	5.79	3.40	2.99	**$ 19.26**
SFMTA Contribution	-	2.48	2.04	1.20	1.05	**$ 6.77**

Option 4	**FY18**	**FY19**	**FY20**	**FY21**	**FY22**	**Total**
Retail Rent Revenues (est.)	-	0.14	0.26	2.36	3.30	**$ 6.05**
AC Transit Contribution	-	6.52	9.88	6.24	5.32	**$ 27.96**
SFMTA Contribution	-	2.29	3.47	2.19	1.87	**$ 9.82**

Option 5	FY18	FY19	FY20	FY21	FY22	Total
Retail Rent Revenues (est.)	-	-	-	0.15	0.23	**$ 0.38**
AC Transit Contribution	-	3.16	10.07	7.87	7.59	**$ 28.69**
SFMTA Contribution	-	1.11	3.54	2.77	2.67	**$ 10.08**

Option 1 ***(Supported by TJPA Board; Resolution attached)****:*
Under Option 1, the CRC would approve the use of the City Financing for the full cost of base building improvements (est. $21.16 million) and the full cost of the allowance for TJPA's 50% share of the tenant improvements (est. $14.33 million) on the schedule assumed under the Merchandising Plan. The TJPA would then apply the full amount of Early Naming Rights Fee ($10.1 million) to transit center operating expenses, reducing the net differential assumed in the initial operating budget projections. The retail/commercial tenants would also be expected to contribute a 50% share of the cost of tenant improvements (est. $14.33 million).

In addition to the costs noted above, TJPA would need to expend funds to increase the $162 million notional amount of the interest rate cap in place for the City Financing, per TIFIA lender requirements. While projecting the future cost of an interest rate cap is difficult at best, a rough estimate from TJPA's derivative instruments advisor is that it would cost between $200,000 - $300,000 for an increase to the interest rate cap that would be required under any of the options.

Option 1 is expected to result in the most positive impact on operating revenues and the lowest necessary operating contribution from AC Transit and SFMTA. The TJPA's contribution to the tenant improvement allowance would be consistent with the market and allow the TJPA to secure market rents (as described above, estimated $57.21 million over the term, or $32.62 million in NPV), which directly offset operating costs. The full amount of Early Naming Rights Fee would directly offset facility operating costs. By maximizing revenue, the transit operators' obligation to pay the net operating cost of the facility would be minimized (as shown above, net amount estimated $7.2 million in FY20, $4.2 million in FY21, and $3.7 in FY22).

Option 1 is also consistent with the assumptions in the Merchandising Plan, and is expected to be the best approach to realizing the TJPA's goals for small, disadvantaged, and local businesses. Offering a tenant improvement allowance in certain cases at the transit center will enable the TJPA to better attract the tenant mix presented in the Merchandising Plan – small, local, established businesses as well as small, local, emerging businesses (including incubator entrepreneurs). Additionally, the possibility of a tenant improvement allowance takes into consideration and mitigates the fact that the transit center is first generation retail space; that is, there is no track record of successful retail operations at the transit center and thus the prospective tenant is taking a business risk in regard to foot traffic, etc. Finally, the appropriate level of the tenant improvement allowance supports commanding rents that are expected to eventually lead to a stabilized transit center that is self-sustaining.

Option 1 would result in an estimated $183 million use of the City Financing.

Option 2 ***(Preferred by TJPA Board if Option 1 not approved by CRC)****:*
Under Option 2, the CRC would approve the use of the City Financing for the full cost of base building improvements (est. $21.16 million), and $4.23 million of the allowance for TJPA's 50% share of the tenant improvements. The TJPA would apply the full amount of Early Naming Rights Fee ($10.10 million) to the remainder of the TJPA's share of the allowance for tenant improvements. As with Option

1, the retail/commercial tenants would be expected to contribute a 50% share of the cost of tenant improvements (est. $14.33 million).

Option 2 is expected to result in a comparatively positive impact on operating revenues and a comparatively low Operating Contribution from AC Transit and SFMTA. Like Option 1, under this option the TJPA's contribution to tenant improvement allowance would be consistent with the market and allow the TJPA to secure market rents (as described above, estimated $57.21 million over the term, or $32.62 million in NPV), which directly offset operating costs. The transit operator's contribution to operating costs of the facility would be greater than under Option 1, however, based on the application of the Early Naming Rights Fee to capital improvements rather than operating costs (as described above, net amount estimated $9.4 million in FY19, $7.2 million in FY20, $4.2 million in FY21, and $3.7 million in FY22).

Like Option 1, Option 2 is also consistent with the assumptions in the Merchandising Plan, and is expected to be the best approach to realizing the TJPA's goals for small, disadvantaged, and local businesses. Option 2 would result in an estimated $173 million use of the City Financing.

Options 3-5:
Under Options 3-5, the CRC would approve the use of the City Financing for the full cost of base building improvements (est. $21.16 million), resulting in estimated use of City Financing in the amount of $169 million.

Options 3-5 vary by the amount of Early Naming Rights Fee that TJPA would apply to the allowance for the TJPA's 50% share of the tenant improvements, from the full amount ($10.1 million) to none, requiring that tenants fund the remaining amount. These options would be expected to result in comparatively negative impacts on operating revenues and comparatively greater Operating Contributions required from AC Transit and SFMTA. Based on the shift of all or a portion of the funding of tenant improvements from the TJPA to the tenants, the TJPA would expect a comparative reduction in retail rent revenues as shown in the tables above, due to the periods of free rent that would need to be offered in lieu of tenant improvements. The transit operators' contributions to operating costs of the facility would be greater than under either Option 1 or Option 2, based on the reductions in expected rents.

While retail revenues stabilize over the years, the lease income under Options 3-5 does not catch up to the lease income in Options 1 and 2, even over time. Each option's projected lease income as a percentage of the estimated lease income under Options 1/2, is presented below:

	FY21	FY22	FY23	FY24	FY25	FY26	FY27
Options 1-2	100%	100%	100%	100%	100%	100%	100%
Option 3	94%	95%	95%	95%	95%	95%	95%
Option 4	36%	49%	49%	49%	49%	49%	49%
Option 5	2%	3%	17%	45%	48%	48%	48%

On balance, the TJPA team believes that funding base building improvements and the TJPA's market share of tenant improvements in the near term will be an overall net financial gain to the transit center and reduce the overall net operating cost of the facility, as well as providing significant other benefits to the transit passengers, workers, residents, and visitors to the transit center.

Because Option 1 is expected to result in the most positive impact on operating revenues and the lowest necessary Operating Contribution from AC Transit and SFMTA, and because it would position the TJPA to deliver a fully-activated facility consistent with the Merchandising Plan, TJPA is requesting the CRC's approval to proceed with Option 1.

If the CRC declines to approve Option 1, then TJPA requests that the CRC approve the expenditure of City Financing on the full cost of base building improvements and the net portion of the TJPA's 50% share of tenant improvements after applying the full amount of the Early Naming Rights Fee. The TJPA Board Resolution is attached.

Regardless of whether Interim Financing and/or Early Naming Rights Fees are applied to the cost of Base Building and Tenant Improvements, the use of Program Reserve from the Phase 1 Capital Budget is required. TJPA staff will propose to transfer Program Reserve to a new Base Building/Tenant Improvement budget line in an item presented to the TJPA Board for approval at its December 2017 meeting.

TRANSBAY JOINT POWERS AUTHORITY
BOARD OF DIRECTORS

Resolution No. ____________

WHEREAS, The Transbay Joint Powers Authority (TJPA) is a joint powers agency organized and existing under the laws of the State of California to design, build, and operate the Transbay Transit Center Program ("Transbay Program"); and

WHEREAS, The TJPA elected to pursue an asset management form of agreement for operation, activation, and maintenance of the transit center, which requires the owner to bear certain costs for capital improvements, such as base building improvements and tenant improvements; and

WHEREAS, The TJPA adopted a Merchandising Plan for the transit center, which includes a schedule for retail/commercial leasing that describes the number, type, and location of spaces that are expected to open each quarter and describes efforts to respond to expected market demand for small, disadvantaged, and local retailers; and

WHEREAS, The TJPA anticipates that certain Base Building Improvements and an allowance for the TJPA's market share of Tenant Improvements will be required to activate the transit center consistent with the Merchandising Plan and secure superior rents from commercial/retail tenants; and

WHEREAS, The TJPA concludes that funding Base Building Improvements and the TJPA's market share of Tenant Improvements in the near term will be an overall net financial gain to the transit center and reduce the overall net operating cost of the facility, as well as providing significant other benefits to the transit passengers, workers, residents, and visitors to the transit center; and

WHEREAS, After analyzing various options for funding the cost of Base Building Improvements and the TJPA's market share of Tenant Improvements, the TJPA concludes that utilizing the Interim Financing provided by the City and County of San Francisco (City) and the Metropolitan Transportation Commission (MTC) for these costs would result in the most positive impact on operating revenues and the lowest necessary Operating Contribution from the transit center's Primary Tenants, Alameda-Contra Costa Transit District (AC Transit) and the San Francisco Municipal Transportation Agency (SFMTA), and would position the TJPA to deliver a fully-activated facility consistent with the Merchandising Policy; now, therefore, be it

RESOLVED, That the TJPA Board of Directors directs the Executive Director to proceed with efforts to secure approval to use the Interim Financing provided by the City and MTC for the cost of Base Building Improvements and the TJPA's market share of Tenant Improvements, and otherwise to proceed with applying the full amount of the early term payment under the Naming Rights Agreement to the TJPA's market share of Tenant Improvements and secure approval to use the Interim Financing for the cost of Base Building Improvements and the remaining cost of the TJPA's market share of Tenant Improvements; and, be it

FURTHER RESOLVED, That the TJPA Board of Directors authorizes the Executive Director to take all actions and execute all documents as he deems reasonably necessary to implement and effectuate the above approval.

I hereby certify that the foregoing resolution was adopted by the Transbay Joint Powers Authority Board of Directors at its meeting of November 9, 2017.

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Secretary, Transbay Joint Powers Authority