

Sale and Leaseback of Government Buildings

Commentary

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PSAC

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1 Background

The government is seeking bids to purchase nine buildings, after reviewing about 40 properties, with a scheme that proposes to sell the building and land to a buyer and then to leaseback the space for twenty-five years. There are options to extend the lease for several periods at market rates, to repurchase the building at the end of 25 years according to a specified formula, or to have an option to buy the property if the current buyer offers to sell it or receives a bona fide offer for it.

The key question in a commercial real estate purchase: “Is the cash flow real and will it support the purchase price?” In this case, most of the risk is taken out of the transaction with the 25-year lease to a tenant that will pay the rent in full and on time, cover all the operating expenses including taxes. This eliminates the risks of vacancies. (Vacancies create operating expenses and taxes that cannot be recovered and marketing and renovation costs, not all of which can be recovered.)

This is the real risk in obtaining financing and normally, in new construction, permanent financing for a project cannot be finalized until the leasing exceeds a pre-determined percentage or a major "anchor" tenant is signed. The cash flow is always evaluated on the strength of the leases, term and quality discounted for tenant default, etc.

In this case, with the guaranteed 25 years of lease plus the potential for three 10-year renewals at the then current market rental, the operating risk is almost non-existent.

1.1 Headlines

Conclusions from our review of the details of the properties include:

- The properties are some of the gems in the federal property portfolio
- The values in our tables are higher than those released to the Globe & Mail in March 2007
- Additional costs and overruns on operations remain the liability of government

The differences between the property values are attributable either to different interest rate assumptions or to the omission of other factors in either or both of the studies. Resolution of the differences should be an early step to promote a useful discussion.

2 Adequate Value for Property

2.1 Stream of Net Operating Income (NOI)

The Tenant (Government of Canada) commits to pay a lease, all maintenance costs, and property taxes. The payments are adjusted for inflation by 10% every five years. Estimated operating costs are calculated but do not affect the results from the owner's perspective except through the management fee. The net operating income stream represents the income to the owner

2.2 Committed Capital Costs

One of the motivations for the sale of the buildings is to ensure that they are brought up to a high standard and kept there by the Owner. Estimated capital costs for building improvements have been identified and are to be implemented by the new owner at the Owner's expense. The Tenant pays repair costs, operating costs, and other costs.

2.3 "Residual" Value

After the initial lease of 25 years, the Owner may sell the building at its market value at that time. The Tenant has a right to buy the building at that point in time. This is referred to as the **Right of First Offer** and the **Right of First Refusal**. The Tenant may also **offer to purchase** the building at the end of its lease by paying a sum equal to the Net Operating Income (NOI) divided by the specified "cap rate" included in the lease offer by the new Owner. (Reference is made to Section 14.05c of the lease.) If the net operating income at the end of the lease was much lower than the amount implicit in current market values, then it could be in the Tenant's interest to exercise the option to purchase.

In any case, there will be a value of the property after 25 years, which will affect the offer price for the initial sale. We have assigned the value based on the tenant buying back the property based on the NOI at the end and a cap rate equal to the discount rate used to calculate the present value of the overall transaction.

2.4 A Fair Offer Price

The sum of these three elements represents the value of the property. By discounting the streams of income to the net present value today, the value as of 2007 is defined. The appropriate discount rate in our view is the government's current borrowing rate for debt with a similar maturity (e.g., 25 years). **This net present value at the interest rate of 4.5% is our estimate of the fair market value.** If the offer price matches or exceeds this amount then the government is obtaining a sum that could be described as consistent with its financial capacities and good fiscal management.

3 Data Issues

In the calculations, adjustments for inflation are treated differently in various segments. Although there is an underlying assumption of 2% inflation, in line with government targets, it is interpreted as a 10% adjustment every five years on the net lease, as 2% compounded when applied to capital costs, and increased to 2.5% compounded when applied to parking revenue.

4 Other Options

The Government could sell the building while offering a ground lease to the building owner for 25 years. This would ensure that the government retains any capital gains on the land and controls its subsequent use. The expert studies seem to emphasize the new manager's interest in proper asset management of the building with a return secured by their skills in making the right choices to maximize the value of the building and to ensure efficient operations.

The government could hire skilled people to train staff and manage the DPW functions of building asset management, with funds earmarked through a rotating fund with contributions from departmental subtenants of the government space. The identified capital costs look like about 5% of operating costs, a modest amount.

5 Other Considerations for Government

The major risk is any "disaster" or unidentified structural problems that occur while undertaking the major repairs. If the costs are not recovered from the contractors, will this be a problem for the new owner or the Lessee (government?)

Potential for income tax revenue for the governments is not reasonable to estimate from the limited information available. The rental revenue would be offset by interest expenses and CCA on the building, equipment and leaseholds. If there is taxable income generated by the property it will depend on the taxability of the purchaser, i.e., whether it is a pension fund, a REIT, a partnership, tenants-in-common, a taxable company, or a combination of the aforementioned.

The other questions to be considered are:

- How does the government expect to benefit from better asset management when there is a 25-year lease for the existing space? There is no incentive to restructure the space to increase utilization as all of the floor space is covered by the lease. The purchaser is not going to redesign the floor plate to improve the space or expand the utilization of the space. That will continue to be determined by the tenant. If there is a change in the tenant [department.] then the owner may be included in any reconfiguration, design or space planning undertaken. It will not result in additional space.
- Is there an opportunity for further development on any of the properties, additional floors, wings or land for an additional building/tower? This space would enhance the value to the buyer.
- Will PWGSC be able to reduce its staff involved in property management or is it all subcontracted out now? They will still need staff to manage the leasing, the relationship with the client [department occupying the building], and with the owner on behalf of the client. It may change the role of PWGSC but to what extent is the question. The building owner would manage the capital projects, but PWGSC would still have a limited role to ensure the work is done properly.

- Property taxes - if the buildings are privately owned will the taxes be set by the city/municipality instead of grants in lieu, and, if so, will this result in any increase in taxes payable?

Total Estimated Value of Properties

Location	Total Net Present Value (4/5%)	Value per sq. ft.	G&M value (March 07)
Harry Hays Building, Calgary, Alberta	\$ 423,205,835	\$ 867	\$ 250,000,000
Canada Place, Edmonton, Alberta	\$ 427,693,085	\$ 512	\$ 265,000,000
CRA Building, Montréal, Québec	\$ 147,929,443	\$ 445	\$ 85,000,000
RCMP Building, Montréal, Québec	\$ 76,615,009	\$ 403	\$ 40,000,000
Thomas D'Arcy McGee Building, Ottawa, Ontario	\$ 252,847,284	\$ 621	\$ 140,000,000
Skyline Complex, Ottawa, Ontario	\$ 324,695,710	\$ 443	\$ 200,000,000
Joseph Shepard Building, Toronto, Ontario	\$ 294,846,821	\$ 526	\$ 180,000,000
Government of Canada Building, Vancouver BC	\$ 166,745,167	\$ 832	\$ 105,000,000
Sinclair Centre, Vancouver, British Columbia	\$ 161,924,595	\$ 652	\$ 100,000,000
Total Value	\$ 2,276,502,949		\$1,365,000,000