State of California | Business, Transportation and Housing Agency
DEPARTMENT OF TRANSPORTATION

M e m o r a n d u m

To: CHAIR AND COMMISSIONERS
CALIFORNIA TRANSPORTATION COMMISSION

CTC Meeting: August 11-12, 2010

Reference No.: 2.4c.(1)
Action Item

From: NORMA ORTEGA
Chief Financial Officer

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Chief
Division of Right of Way and Land Surveys

Subject: **AIRSPACE LEASE – REQUEST FOR MODIFICATION OF LONG TERM LEASE TERMS - SUTTER GALLERIA**

RECOMMENDATION:

The California Department of Transportation (Department) recommends the California Transportation Commission (Commission) approve modifications related to lease term extension, rental rate re-evaluation, and permitted uses to an existing long-term lease currently held by Government Real Estate Investment Trust, Sutter Square (GREIT), for the Sutter Galleria commercial retail complex located in downtown Sacramento.

BACKGROUND:

In 1985, the Department entered into a ground lease for the subject parcel (03-SAC051-0001) for the development of parking and office/retail space. A parking facility was constructed under State Route 51 (Business 80 viaduct) and multi-story office/retail towers were constructed “straddling” this viaduct. The leasehold initially experienced difficulty due to unforeseen viaduct rehabilitation issues resulting in a temporary disturbance to the lessees. These difficulties led to a lawsuit between the Department and the developer with resolution resulting in a financial settlement and an amended lease that was executed in 1996. Since execution of this amended lease, the leasehold interest has been sold or re-assigned, with Department concurrence, three times. The current leasehold interest expires on June 30, 2030 and, upon expiration, ownership of the improvements (i.e. parking structure and office/retail towers) will vest with the Department. At the date of expiration, current lease language allows for the leaseholder to exercise a unilateral 10-year option to extend the lease for the building and improvements to 2040. There is currently a major Caltrans project on the horizon planned for construction in 2040 that will impact the Business 80 viaduct. See attached Exhibit A for a photo of the subject office/retail facility, and Exhibit B for a location map.

Per the 1996 amended lease terms, ground rent for this parcel is currently 12.5 percent of gross revenue and in the past year monthly revenue for the leasehold has ranged from $5,183 to $11,059, although in past years monthly rent to the Department has amounted to over $19,000. In comparison, an airspace parcel consisting of two city blocks located adjacent to the subject parcel generates a set $17,850 per month ground lease rent per block for two-story parking structure use. These two two-story parking structures support a nearby hospital complex. Also in this same corridor, another city block of airspace used for surface parking that supports another medical care complex is renting for $11,745 per month. This $11,745 lease rate was established through a bid process.

The economic downturn has impacted the flow of capitol and the stability of all financial markets. Failing to acknowledge these market changes, and not modifying the current "aging" leasehold interest to make it a marketable investment vehicle, places the Department at risk of a worse case scenario involving the leasehold prematurely reverting back to Department ownership due to lessee default.

Four lease modifications are proposed for this airspace lease and are discussed below:

- Modification #1: Lease Term
  The current owner of the leasehold interest, GREIT, wishes to sell the leasehold interest to divest itself of its assets and dissolve. Currently, only 20 years remain on the leasehold interest. GREIT is having difficulty in marketing this leasehold because to loan funds to a buyer at a "reasonable" rate, financial institutions are requiring that at least 25 to 30 years remain on the leasehold. Extending the term of the lease would result in a prospective buyer's ability to obtain more favorable financing terms resulting in a successful sale. GREIT wishes to extend the leasehold interest by 15 years, with an expiration date of June 30, 2045. The Department, however, proposes an eight-year extension with a lease expiration date of 2038. This requested term extension is due to a high occupancy vehicle lane project planned with a 2040 construction start date that may impact the leased premises. The Department would like to avoid any possibility of creating a leasehold condemnation situation, due to project impacts, that will create a future financial loss to the Department.

- Modification #2: Removal of 10-year Option At Lease Expiration
  The current lease language relative to term states the following: "Tenant shall have the right, provided it is not then in default under any of the provisions of this Lease, to enter into an agreement with Landlord to lease the Premises and all improvements then situated thereon for an additional period of ten (10) years." Due to potential project impacts and the possible requirement for right of way clearance of tenant leasehold interests by 2040, it is recommended that this option language be deleted from the current lease terms. If the Department allows this option to remain without lead-time for right of way clearance between lease expiration date and project construction start date, there is a risk for future project delay. GREIT supports the deletion of this option language.

- Modification #3: Removal of Rental Rate Revaluation Clause
  Ground rent for this parcel is currently 12.5 percent of gross revenue. This 12.5 percent return has been in effect since February 1, 2002. Per the lease terms, prior rental rate returns for this parcel were the following:

February 1, 1996 to January 31, 1998	Two percent of gross revenue
February 1, 1998 to January 31, 2000	Four percent of gross revenue
February 1, 2000 to January 31, 2002	Six percent of gross revenue

  GREIT is prepared to market the leasehold interest with the current 12.5 percent return rate. Lease terms, however, also call for a potential re-evaluation of the lease rate commencing on February 1, 2017. The lease states that, "At the request of the Landlord, during the year beginning February 1, 2016, a fair market lease rate shall be determined in the manner set forth below and shall be established as the monthly rent commencing on February 1, 2017. This fair market lease rate shall not be in addition to the rent set forth in paragraph 4.1 above, but in substitution thereof." The current leasehold owner sees the uncertainty of the future lease rate as problematic in marketing the leasehold because it is difficult, if not impossible, for investors to determine an appropriate negotiated purchase price.

  The Department supports the removal of this re-evaluation clause based on two factors. The first is that 12.5 percent is considered a very healthy return rate in today's market and secondly, future escalations can be captured through the percentage-based rent calculations, i.e. the higher the rent charged to tenants due to market factors, the higher the return to the Department.

- Modification #4: Modification of Use Clause
  In order to offer more clarity relative to approved uses, the Department and GREIT mutually wish to clarify the current Use Clause to include the specific "medical office" use. This is an administrative change only since the current Use Clause allows "office" use and can be interpreted to include "medical office" use.

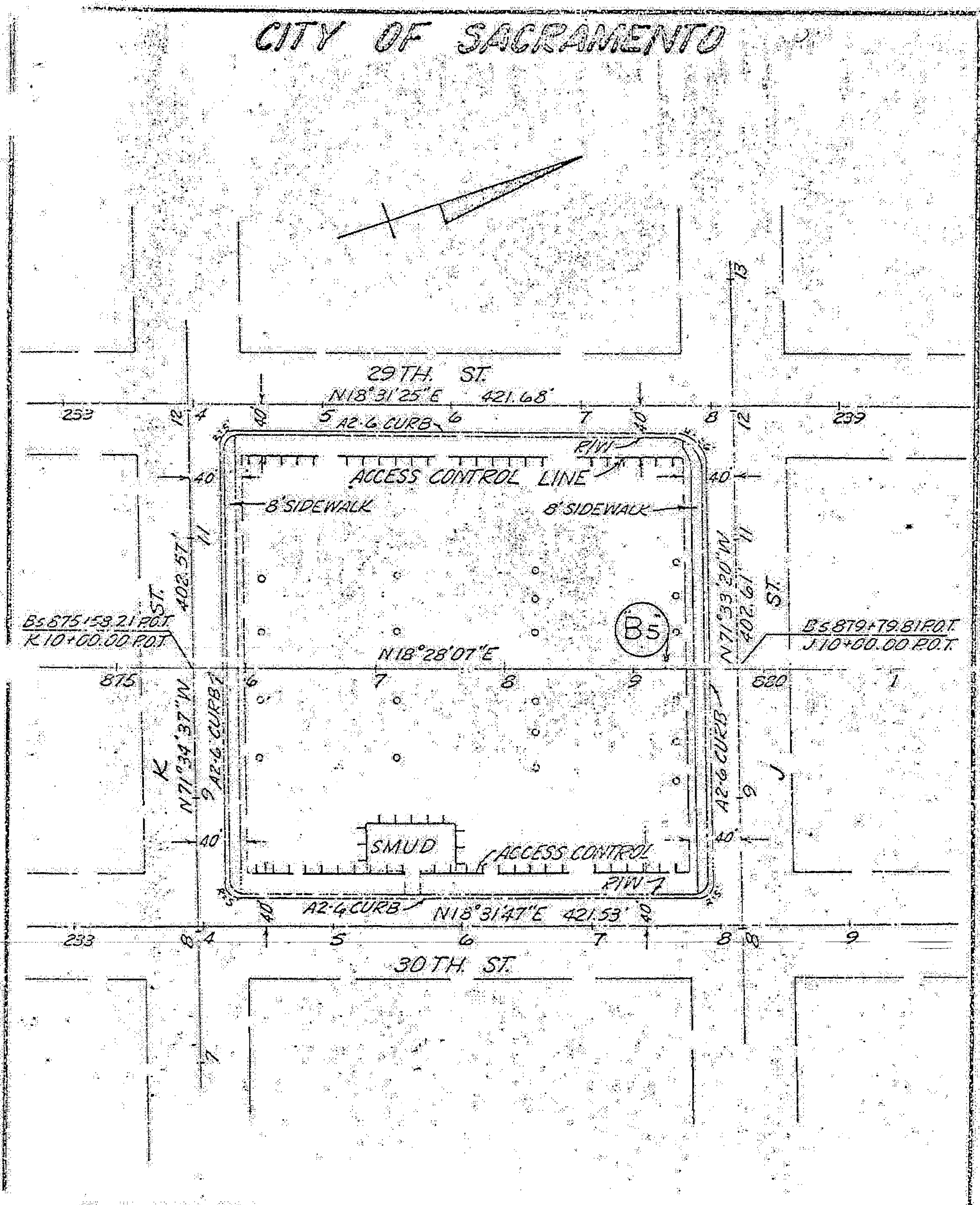
SUMMARY

It is requested that the Commission grant the Department permission to execute the lease modifications discussed above as it would be in the best interest of the Department by providing perpetuation of a healthy lease return rate. In addition, it will result in having a lessee that is motivated and financially capable to continue their investment to improve, maintain and enhance the lease area's physical improvements during a time of less favorable market conditions.

Attachments:
Exhibit A: Photo of the Facility
Exhibit B: Location Map

Airspace Tenancy Number 03-SAC051-0001-03
Sutter Galleria

EXHIBIT A



F.L.A. -SAC-804
PROPOSED LEASE AREA SHOWN THUS:
PIERS SHOWN THUS: o
NET AREA 106,925 SQ.FT.± (EXCLUDES 37.5 S.F. PER COLUMN)

SHEET 4 OF 4
SCALE 1"=100'

Exhibit B