1 Civic Center Drive
San Marcos, CA 92069

Staff Report

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MEETING DATE:
NOVEMBER 10, 2014

SUBJECT:

CONSIDERATION OF FINANCING OPTIONS FOR CAPITAL COSTS RELATED TO THE 600 RANCHEROS BUILDING FOR CONSTRUCTION AND OCCUPANCY BY THE DEPARTMENT OF MOTOR VEHICLES

Recommendation
CONSIDER AND DIRECT options for the City and, on behalf of LP Partnership, for financing related capital costs associated with the construction of the new Department of Motor Vehicle's (DMV) building at 600 Rancheros.

Board or Commission Action
Not applicable

Relevant Council Strategic Theme
Economic Development
Planning for the Future

Relevant Department Goal
Continuing to Maintain Fiscal and Financial Health to the City

Introduction
The City, acting in its capacity as a partner in the existing partnership known as Rancheros Commercial Park, is a financial participant in the development of an approximately 30,000 square foot net usable build-to-suit office building (the "Project") for the State of California Department of General Services to be used by the Department of Motor Vehicles (the "DMV") located at 600 Rancheros Drive. The site is currently owned by the City and leased to the partnership. The partnership is also the leaseholder of property at 570 Rancheros, owned by LBP Partnership and is directly adjacent to the DMV site. The cost to construct the building is estimated at approximately $11 million. The Project is under construction with occupancy by the DMV to occur in May 2015. Rent payments received from the DMV pursuant to a lease agreement are expected to commence with occupancy.

Discussion

History of Rancheros Commercial Park Partnership

On March 6, 1989, the Redevelopment Agency of San Marcos entered into a Limited Partnership Agreement with LBP Partnership (LBP). The purpose of the partnership was to engage in the business of leasing, developing, constructing, maintaining and operating commercial real estate known as 570 Rancheros Drive, owned by LBP, and 600 Rancheros Drive, owned by the City of San Marcos (City).

The property at 570 Rancheros Drive was developed as a commercial, multi-tenant office building. The building was constructed in 1991 and has been occupied by a variety of tenants over the past 23 years, including the City for a period of time.

The property at 600 Rancheros Drive, owned by the City, has remained undeveloped since the establishment of the limited partnership and is now intended to be developed as a State of California Department of Motor Vehicles (DMV) service center. A lease has been entered into between the partnership and the DMV.

The partnership agreement provides that LBP is the General Partner and the City (acting in lieu of the former Redevelopment Agency) is the Limited Partner. At the outset of the partnership, LBP provided initial capital to the partnership in the amount of $4,000 and the City contributed $6,000. The partnership agreement provides that each of the partners shall lease their land to the partnership. Those leases were executed at the outset of the partnership and run until 2055. The partnership agreement also provides that net profits of the partnership shall be allocated to the partners in proportion to their respective capital contributions and real estate. This is where the 60 - 40 split is established (City as the 60% partner). The partnership agreement establishes LBP as the General Partner and the City as the Limited Partner. The General Partner is vested with the “sole and exclusive control of the partnership”. It provides that LBP may conduct the business and affairs of the partnership, including without limitation to:

- “Acquire property, including real estate or personal property, for the use of the Partnership upon terms and conditions as the General Partner may, from time to time, determine to be advantageous to the Partnership;”
- “Dispose of Partnership property, except the real property leased to the Partnership by the Limited Partner, either in the ordinary course of the business of the Partnership or, from time to time, when the General Partners deem the disposition to be in the best interest of the Partnership;”
- “Finance the Partnership’s activities by borrowing money from third parties on the terms and under the conditions as the General Partner deems appropriate. Where money is borrowed for Partnership purposes, the General Partners shall be, and hereby are, authorized to pledge, mortgage, encumber, or grant a security interest in Partnership properties as security for the repayment of these loans;”
- “Employ, retain or otherwise secure the services of any personnel or firms deemed necessary by the General Partners for or to facilitate the conduct of the Partnership business affairs, all on the terms and for the consideration as the General Partner deems advisable; and”
- “Take any all other action that is permitted by law and that is customary in or reasonably related to the conduct of the Partnership business or affairs.”

In addition to providing these specific powers to the General Partner, the partnership agreement also establishes specific restrictions on the Limited Partner (City). The section of the partnership regarding those restrictions reads as follows:

“The Limited Partner shall not have either the obligation or the right to take part, directly or indirectly, in the active management or control of the business of the Partnership, except as otherwise permitted in this

Agreement. Specifically, the Limited Partner many not act as a contractor or agent with regard to any Construction Contracts which the Partnership may enter. The Limited Partner may act in the following instances:

(a) Acting as a contractor for or an agent or employee of the Partnership or a General Partner, or an officer, director, or shareholder of a corporate General Partner, except as a contractor or agent with regard to any Construction Contracts which the Partnership may enter.

(b) Consulting with and advising a General Partner with respect to the business of the Partnership.

(c) Acting as a lender to or a surety for the Partnership or guaranteeing one or more specific debts of the Partnership, except that the Limited Partner may not act as a surety or guarantee any construction financing for which the Partnership may become indebted.

(d) Approving or disapproving an amendment to this Agreement."

Staff provides this actual language of the partnership agreement so that the City Council has a clear understanding of the framework of the partnership and respective abilities, restrictions and obligations of the parties. It is clearly the intent of the agreement that the General Partner has control of essentially all of the business activities of the partnership and is free to secure financing from a third party to further the business of the Partnership. While there may be elements of the partnership agreement that either the City or LBP may approach differently if the partnership was getting established now, the agreement has been in place since 1989 and significant revenues and expenses have been incurred by the parties over the years.

The partnership has generated revenues for both the General Partner and the Limited Partner via the development of 570 Rancheros Drive. That property has generated rental income as well as construction, management, operational and maintenance expenses. The net cash that the City has realized since the inception of the partnership is $1,046,957 through 12/31/2013. The breakdown of city contributions and distributions from the partnership to the City is below:

City Cash Contributions Since Inception Through 12/31/2013	
Calendar Year	Amount Paid
1989	$10,200
1990	$3,000
1991	$44,743
1992	$39,000
1995	$30,000
1997	$138,000
2005	$158,100

Total	$423,043

City Cash Distributions From Partnership Since Inception Through 12/31/2013	
Calendar Year	Amount Received
2000	$120,000
2001	$120,000
2002	$120,000
2008	$210,000
2009	$300,000
2010	$300,000
2012	$300,000
Total	$1,470,000
TOTAL NET CASH PROCEEDS SINCE INCEPTION THROUGH 12/31/2013 --- $1,046,957	

In addition to the net cash proceeds detailed above, the Redevelopment Agency provided construction funding to the partnership for 570 Rancheros Drive. The principal amount of that financing was $2,495,277. The financing occurred in 1991 and the terms of the financing were for 15 years at an interest rate equal to the Prime Lending Rate at the time of the execution of the financing. The Prime Lending Rate at that time in 1991 was 8.5%. That loan yielded interest earnings of $2,011,959 and that loan was paid in full on schedule.

The General Partner also retains a Capital Account within the partnership which it utilizes for various capital improvements, such as upgrades, tenant improvements, etc. The General Partner attempts to utilize those reserves, while maintaining a comfortable reserve level without asking the Limited Partner to contribute funds for each construction effort. This explains the uneven distribution of payments by and to the City over the years. The Capital account had a total balance of $1,808,825 as of 12/31/2013. The City's 60% share of that is $1,085,295.

Lastly, with respect to background information on the partnership, the City owned parcel at 600 Rancheros has not generated any revenue to the partnership since its establishment. Minor costs have occurred over the years related to basic maintenance issues. All of the funds the City has received via the partnership are from the property owned by LBP.

DMV Project

The partnership entered into a 20 year lease with the DMV earlier this year. That lease established the partnership's obligations to construct and turn over the DMV an approximate 30,000 square foot, one story office building with associated site improvements. It also established the base rental rates and other provisions typical in commercial real estate leases.

Focusing on just the operating revenues and expenses, the below table details those out. The operating expenses do not assume any debt service.

Lease Year	Gross Monthly Rent	Annual Gross Rent	Monthly Expenses	Annual Expenses	Net Monthly Rent	Net Annual Rent	60% City Share
1	$ 107,497	$ 1,289,960	$ 17,586	$ 211,032	$ 89,911	$ 1,078,928	$ 647,357
2	$ 110,669	$ 1,328,030	$ 18,114	$ 217,368	$ 92,555	$ 1,110,662	$ 666,397
3	$ 113,937	$ 1,367,243	$ 18,657	$ 223,884	$ 95,280	$ 1,143,359	$ 686,015
4	$ 117,303	$ 1,407,632	$ 19,217	$ 230,604	$ 98,086	$ 1,177,028	$ 706,217
5	$ 120,769	$ 1,449,232	$ 19,794	$ 237,528	$ 100,975	$ 1,211,704	$ 727,023
6	$ 124,340	$ 1,492,081	$ 20,388	$ 244,656	$ 103,952	$ 1,247,425	$ 748,455
7	$ 128,018	$ 1,536,215	$ 20,999	$ 251,988	$ 107,019	$ 1,284,227	$ 770,536
8	$ 131,806	$ 1,581,673	$ 21,629	$ 259,548	$ 110,177	$ 1,322,125	$ 793,275
9	$ 135,708	$ 1,628,494	$ 22,278	$ 267,336	$ 113,430	$ 1,361,158	$ 816,695
10	$ 139,727	$ 1,676,721	$ 22,946	$ 275,352	$ 116,781	$ 1,401,369	$ 840,821
Subtotal	$1,229,773	$ 14,757,280	$ 201,608	$2,419,296	$ 1,028,165	$12,337,984	$ 7,402,791
11	$ 142,121	$ 1,705,446	$ 23,635	$ 283,620	$ 118,486	$ 1,421,826	$ 853,096
12	$ 146,384	$ 1,756,610	$ 24,344	$ 292,128	$ 122,040	$ 1,464,482	$ 878,689
13	$ 150,776	$ 1,809,308	$ 25,074	$ 300,888	$ 125,702	$ 1,508,420	$ 905,052
14	$ 155,299	$ 1,863,587	$ 25,826	$ 309,912	$ 129,473	$ 1,553,675	$ 932,205
15	$ 159,958	$ 1,919,495	$ 26,601	$ 319,212	$ 133,357	$ 1,600,283	$ 960,170
16	$ 164,757	$ 1,977,080	$ 27,399	$ 328,788	$ 137,358	$ 1,648,292	$ 988,975
17	$ 169,699	$ 2,036,392	$ 28,221	$ 338,652	$ 141,478	$ 1,697,740	$ 1,018,644
18	$ 174,790	$ 2,097,484	$ 29,068	$ 348,816	$ 145,722	$ 1,748,668	$ 1,049,201
19	$ 180,034	$ 2,160,408	$ 29,940	$ 359,280	$ 150,094	$ 1,801,128	$ 1,080,677
20	$ 185,435	$ 2,225,220	$ 30,838	$ 370,056	$ 154,597	$ 1,855,164	$ 1,113,099
Grand Total	$2,859,026	$ 34,308,309	$ 472,554	$5,670,648	$ 2,386,472	$28,637,661	$17,182,597

As the table indicates the City's net return would be just over $7.4 million in the first ten years and over $17 million by Year 20.

DMV Financing

After thorough market analysis into construction financing in terms of both short and long term loan financing, staff is recommending the City utilizes its existing general fund reserves, and specifically, the One Time Opportunity Reserves to pay for the City's 60% share of the construction costs. Staff investigated a number of other options including having the City finance 100% of the construction costs under either a discounted and market rate financing program as well as seeking outside third party financing. Information regarding these non-recommended financing options are included should the Council desire to consider them instead of the staff's recommendation.

The total construction cost of the project is projected to be $11,491,000. The table below details the various construction components:

Project Component	Projected Cost	
Building Costs	$	3,900,00
Additional Construction Costs	$	3,407,00
Project Labor Costs	$	884,00
Permits and Fees	$	1,233,00
PFF Credits	$	(584,00
Off Site Traffic Improvements	$	1,138,00
Testing and Inspections	$	75,00
Legal and Miscellaneous	$	75,00
Developer Fee	$	637,00
Brokerage Fee	$	726,00
Total	$	11,491,00
Less Spent from Partnership Capital Fund	$	(595,16
Amount Needed to Complete Project	$	10,895,83
City 60% Share	$	6,537,50

- Recommended Option 1 - Use of One-time Opportunity Reserves for City's 60% portion of construction costs of approximately $6,537,501 million.

On October 28, 2014, the City Council authorized the use of $8,850,425 of general fund reserves for use on the acquisition and construction of the former Lowe's building in the Creekside Marketplace. The use of those funds brought the total general fund reserve level down to $34,199,291 or 53.6% of FY 2014/15 budgeted expenditures.

a. If City uses reserves instead of outside financing, it would save those financing costs to both the City and the Partnership.
b. Loss of interest earnings at 1% for ten years would be approximately $683,967 loss to the City.
c. After transfer of approved appropriation for Creekside Funding in the amount of $8,850,425, another $6,537,501 drop reserve levels to approximately 43.4%.
d. Based on the net operating revenues shown below, the replenishment of the $6.5 million in reserves, assuming no other revenues or expenditures affect the overall reserve levels, would take 10 years.

Year	Net Annual DMV Related City Revenues	Cumulative Tota
1	$ 647,357	$ 647,357
2	$ 666,397	$ 1,313,754
3	$ 686,015	$ 1,999,769
4	$ 706,217	$ 2,705,986
5	$ 727,023	$ 3,433,009
6	$ 748,455	$ 4,181,464
7	$ 770,536	$ 4,952,000
8	$ 793,275	$ 5,745,275
9	$ 816,695	$ 6,561,970
10	$ 840,821	$ 7,402,791

The City Council approved General Fund Reserve Policy requires that in the event that the total reserve level drops below 50% due to the use of reserves, that a plan be developed to return the reserve level to the 50% minimum within 5 years. The DMV project, while clearly providing a long term financial benefit, will not, on its own, be able to generate sufficient revenue to do that.

In the fiscal impact section of this staff report, staff will provide a recommendation as to how the reserve level can be brought back to 50% within the five year required timeframe.

- Option 2 - City Cash Contribution/Below Market Rate of Interest Loan to LP Partnership

    a. Construction costs of approximately $10.9million loaned to partnership at a below market rate of interest (2.5%) funded on a monthly disbursement schedule sufficient to cover anticipated monthly expenditures based on draw schedule from contractor using General Fund one-time opportunity reserves. Assumes 10 years of DMV pledged net leave revenue. This option would have a greater immediate impact of the City's reserve level, however, over the long run, the reserve levels would be in a more positive place due to the positive return on loaning the funds out at a higher interest rate, though below market rate, than the City's current investment return.

- Option 3 - City Cash Contribution/Market Rate of Interest Loan to LP Partnership

    a. Construction costs of approximately $10.9million loaned to partnership at a market rate of interest (4.5%) funded on a monthly disbursement schedule sufficient to cover anticipated monthly expenditures based on draw schedule from contractor using General Fund one-time opportunity reserves. City would also consider charging one-time transactional (in the case, administrative fees) to LP Partnership. This option would have a greater immediate impact of the City's reserve level, however, over the long run, the reserve levels would be in a more positive place due to the positive return on loaning the funds out at a higher interest rate, than the City's current investment return.

- Option 4 - Use outside lender to finance all DMV costs using a market rate of interest along with loan transaction fees

    a. Construction costs of approximately $10.9 million would be funded by securing outside financing. Anticipated market rate of interest (4.5%) funded on a monthly disbursement schedule sufficient to cover anticipated monthly expenditures based on draw schedule from contractor using General Fund one-time opportunity reserves. One-time transactional loan fees would be charged to Rancheros Commercial Park Partnership. The table below provides a breakdown of the additional costs of the project if it was financed by a third party lender.

LOAN PAYMENT SCHEDULE

Principal:	**$10,895,835**
Interest Rate:	**4.50%**
Term (Years):	**10**
Number of Payment Periods per Year:	**1**
Payment Amount:	**$1,377,003**

Payment Number	Payment Amount	Principal	Interest	Balance
0				$10,895,835.
1	$1,377,002.79	$886,690.21	$490,312.58	10,009,144.
2	1,377,002.79	926,591.27	450,411.52	9,082,553.5
3	1,377,002.79	968,287.88	408,714.91	8,114,265.6
4	1,377,002.79	1,011,860.84	365,141.95	7,102,404.8
5	1,377,002.79	1,057,394.57	319,608.22	6,045,010.2
6	1,377,002.79	1,104,977.33	272,025.46	4,940,032.8
7	1,377,002.79	1,154,701.31	222,301.48	3,785,331.5
8	1,377,002.79	1,206,662.87	170,339.92	2,578,668.7
9	1,377,002.79	1,260,962.70	116,040.09	1,317,706.0
10	1,377,002.79	1,317,706.02	59,296.77	(0.00
Totals	$13,770,027.89	$10,895,835.00	$2,874,192.89	

	City (60%)	Partnership (4
Interest Costs	$1,724,515.74	$689,806.2
Loan Transactional Fee of 1%	$65,375.01	$43,583.3
Total Outside Funding Costs	$1,789,890.75	$733,389.6

If the City uses reserves instead of outside financing, it would save those financing costs; however, it would lose interest earnings on those funds in the city's investment portfolio as well as the flexibility of having those funds on hand. Based on current investment earnings of 1%, that $6,537,501 million would generate approximately $683,967 of interest earnings over a ten year period. The net result in terms of real project costs would be that the use of outside financing would increase the costs of the project by approximately $1.1 million.

Fiscal Impact

The City Council previously adopted a policy that the City should have general fund liquid cash reserves of 50% of budgeted expenditures. At the close of Fiscal Year 2013/14, the City has $43,409,716 (un-audited) of liquid general fund cash reserves. The adopted general fund budget for Fiscal Year 2014/15 is $63,744,113. In order to be minimally compliant with the adopted policy, the City would need to have $31,872,056 in liquid cash reserves (50% of $63,744,113). The actual liquid cash reserve level was $43,409,716 and represents 68% of budgeted expenditures and exceeded the 50% requirement by $11,537,660.

After City Council approval at the October 28th City Council meeting of the appropriation for the purchase of the former Lowe's Building in the amount of $4,479,004 and costs of tenant improvements estimated to be $4,371,421, the General Fund reserve level was lowered to $34,199,291 or 53.6% of budgeted expenditures and still in compliance with the adopted policy.
With respect to the DMV Project, other than the option of financing the construction via a third party, either paying cash for the City's share or financing the entire construction project will reduce the reserve level below 50%.

The recommended option of the City paying its 60% share in cash brings the reserve level down to $27,661,790 or 43.2% of the FY 2014/15 budgeted expenditures. The Council adopted General Fund reserve policy provides that in the event that the reserve levels drop below 50%, that a plan to restore the reserves to the 50% level within 5 years be implemented. Since the DMV revenues, on their own, will not replenish the reserves to the 50% level within five years, staff recommends that the City Council adopt a plan that combines the DMV revenues with a portion of the additional lease revenues from the reuse of the former Lowe's building. The table below depicts how much of those new, additional Creekside revenues would need to be set aside to restore the reserve level to 50% within 5 years. In order to account for inflation, the analysis assumes that City general fund expenditures increase 2% per year through the five year plan.

Year	General Fund Budget	Minimum 50% Reserve Level	Reserve Leve at Beginning Year	DMV Revenue Pledged to Reserves	Creekside Revenue Pledged to Reserves	Total Revenue Pledged to Reserves	Reserve Leve at End of Yea	End of Yea Reserve Percentage
1	$ 63,744,113	$ 31,872,057	$ 27,554,390	$ 647,357	$ 700,000	$1,347,357	$28,901,747	45.3%
2	$ 65,018,995	$ 32,509,498	$ 28,901,747	$ 666,397	$ 700,000	$1,366,397	$30,268,144	46.6%
3	$ 66,319,375	$ 33,159,688	$ 30,268,144	$ 686,015	$ 700,000	$1,386,015	$31,654,159	47.7%
4	$ 67,645,763	$ 33,822,881	$ 31,654,159	$ 706,217	$ 700,000	$1,406,217	$33,060,376	48.9%
5	$ 68,998,678	$ 34,499,339	$ 33,060,376	$ 727,023	$ 700,000	$1,427,023	$34,487,399	50.0%

The above analysis does not take into account the conservative assumptions that the City made with respect to May 2014 wildfire suppression costs and post fire costs. As the Council will recall, the budget assumed an expenditure of $1,000,000 for direct fire suppression costs. Between Federal and State reimbursements, we expect those costs to be closer to $300,000. That would result in an immediate lifting of the reserve level by $700,000. Additionally, we programmed in this year's budget $2.5 million for post fire costs associated with repair and replacement of damaged city property and potential erosion control/slope stabilization issues. Since we are only now entering the rainy season, it is too early to say whether any savings will be realized in that area, however, any that do materialize would immediately lift the reserve level as well.

With respect to Creekside, Council will recall that the City received approximately $600,000 in rent from the former Lowe's and will receive approximately $1.5 million in base rent from Winco and Hobby Lobby when both are fully operational in 2015. Dedicating $700,000 per year of that amount for the replenishment of reserves would yield an increase in net operating revenue of approximately $200,000 from Lowes to the new tenants. The Council could certainly program more from the Winco/Hobby Lobby building to shorten the time frame, however, it should be noted that the City's operational budget would be impacted if the revenues from that building were not brought back to at least the former Lowe's level.

Under staff's recommendation and five year replenishment program per the adopted policy, the City's operational budget revenues should remain consistent and after five years the general fund would see an influx of revenue of approximately $2.3 million between the DMV and Winco/Hobby Lobby.

Attachment(s)
None

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