Overview

The 10-Year Portfolio Plan (Plan) provides strategic direction for the 21-building, 5.8 million gross square foot (GSF) portfolio of state-owned office buildings under the jurisdiction of the Department of General Services (DGS) outside of the Sacramento area. The Plan, taken together with the department's Sacramento 10-Year Sequencing Plan, provides a statewide, strategic, and long-term asset management strategy for DGS' portfolio of office buildings.

This Plan derives in part from input DGS has received from client departments, particularly with respect to leasing strategy. The Portfolio Plan provides departmental partners and stakeholders with a more transparent lens into how we analyze and make decisions regarding our facility portfolio.

Distinction Between Sequencing and Portfolio Plans

DGS makes a distinction between state-owned office buildings outside of Sacramento and those within the Sacramento portfolio. This is largely due to the differences between the concentration of state workers in/out of Sacramento, and differences in the function of those state staff.

Sacramento, as the center of state government, has a dense concentration of state employees across dozens of departments. Sacramento government functions, while certainly including locations providing regional or local services to the public, is generally dominated by "headquarters" functions and the general support and administration of departments' statewide operations.

In contrast, outside of the Sacramento area, state functions slant heavier toward field offices, local provision of services, or regional offices. The density of state employees in traditional office space is likewise markedly different. This density has an impact on DGS' own building operations. The ability to find state tenants, the ability to adequately staff or share resources, and other issues are all impacted compared to Sacramento.

These distinctions require that DGS address its portfolio of buildings outside of Sacramento differently than it would Sacramento infrastructure.

Accordingly, the DGS Sequencing Plan emphasizes state ownership and is focused on the replacement or revitalization of existing infrastructure. In contrast, this Portfolio Plan is intended to provide an evaluation of the appropriateness of continued ownership of DGS-managed buildings, and provide the groundwork for a strategic plan with respect to state ownership of office space outside of Sacramento.

However, for both the Sequencing and Portfolio plans, a key component is the integration of the results from the Facility Condition Assessments completed for the 2015 State Facility Long Range Planning Study (Planning Study). The Planning Study provided DGS with an independent assessment of the DGS-managed office buildings and resulted in an analysis that identified the buildings with the highest need for repair or replacement. This Facility Condition Assessment (FCA) is foundational for DGS' own analysis of its buildings.

Shifting Variables and Analysis Updating

Like the Sequencing Plan, this DGS Portfolio Plan had to account for a large number of fluid variables, including market conditions, building conditions, necessity of state ownership, building valuation, and tenant program needs. Because these variables are subject to change over time, it is the intention of DGS to reevaluate the assumptions and data used in the plan on an annual basis and shift its recommendations as applicable. No building in this Plan is guaranteed to be sold or otherwise subject to disposition.

Planning Concepts and Principles

1. **Addressing Deficient Infrastructure:** The foremost goal of the Portfolio Plan is to address the deficient infrastructure owned by the state outside of Sacramento. For example, the average age of buildings proposed for surplus (less outliers) is approximately 50 years. Without intervention, these buildings will continue to degrade and will cost taxpayers more to address later than through a proactive approach.

2. **Long-Term Planning:** While the potential for large-scale agency consolidations is highly unlikely outside of Sacramento, there is significant opportunity to reevaluate how state agencies are distributed across the state. Over time, new space needs have been addressed on an ad hoc basis, and it is past time to take a comprehensive, strategic look at those spaces.

3. **Flexibility in Approach:** Unlike the Sequencing Plan, the Portfolio Plan is not limited to a single market. This means that not only will market factors change, one market may change in a vastly different way than another might. Additionally, not all buildings proposed for surplus can be sold at the same time, which means that even the surplus process needs some degree of sequencing. These dynamics require continuous analysis and flexibility to balance adaptation to the market with long-term planning.

4. **Cost-Sensitive Approaches:** In many markets, especially when there is little inventory available or projected to be built, owning a building is generally more cost-effective than long-term leasing. This is why it is critical that the decision to divest from a building is not seen as a decision to never again own in that area. That said, leasing can provide flexibility to account for unknown future needs, whereas state ownership does not. Rather than evaluating solely on the basis of the bottom line, DGS is recommending evaluating needs on the best, overall, holistic approach for state departments.

Executive Order N-06-19

In keeping with the process and priorities outlined in Executive Order (EO) N-06-19, DGS shall make every effort, including alternative development structures, to facilitate disposition of excess state office buildings in a way that is conducive to the development of affordable housing.

Timing and Execution

Because DGS buildings are currently occupied, any disposition of a building will generally require relocation into leased space. While the specific move duration will differ based upon the situation (the need for a Budget Change Proposal, market availability, tenant improvement needs/construction duration, regulatory approvals, etc.), it is reasonable to expect between 18 months and two years to successfully relocate state agencies.

During the relocation process, DGS will concurrently work on the disposition of a given building, and if that disposition is a surplus property sale, will seek legislation to authorize the sale, market the building, etc. The goal would be to transfer or sell the building shortly after the tenants vacate.

Tenant and Staff Impacts

DGS acknowledges that this Plan will have an impact on state employees – both the tenants occupying the building, as well as those DGS staff who maintain them. The department is hopeful that any change enacted because of the Plan will be in the best interests of all impacted state employees.

Portfolio Plan Analysis Approach

For details, please see Attachment B – Retention Score Documentation and Attachment C – Alternatives Analysis

In the development of this Portfolio Plan, DGS undertook the following steps:

1. **Building Data Compilation:**
DGS compiled data about its buildings (such as age, bond status, gross and net square feet, and FCA costs). Buildings that are temporarily in DGS' jurisdiction,[1] and bond-funded buildings with more than five years of debt were excluded from the analysis.[2] Of the remaining buildings, DGS then compiled updated FCA costs, and noted building- and tenant-specific factors, such as whether tenant space was generic or specifically built out, and whether the building was occupied by a single tenant or had multiple tenants.

2. **State Ownership Analysis:**
DGS' intent was to analyze whether it is in the state's best interest to continue to own the current buildings in its portfolio.[3] To accomplish this, DGS combined the building data noted above with market-based data and criteria to be used in the evaluation, and then weighted the criteria and assigned each building a Retention Score. The market factors considered included:

    - **Approximate Building Sale Prices:** While formal appraisals were not conducted,[4] DGS evaluated recent comparable building sales. Numerous "comps" were considered, and an average sale price per foot was derived and then applied to the DGS building. This was intended to provide an order of magnitude estimate of building value that could then be evaluated in relation to the FCA costs.[5]

---

[1] Several buildings were constructed by DGS for other departments, but placed in DGS' jurisdiction for the purposes of bond financing. Once all bond obligations have been cleared, the buildings will transfer to the jurisdiction of the occupying department.

[2] These buildings will be reevaluated as the termination of their bond obligations approaches, unless the bonds are refinanced and the obligation period is extended.

[3] However, this was not an attempt to evaluate whether future ownership is appropriate or not.

[4] A formal appraisal at this point in the process would not be appropriate. Because appraisal information is time-limited, appraisals are not advised in conceptual planning.

- **Product (Leased) Availability:** DGS conducted a survey of potentially appropriate leased space in the same general area as the DGS building. This served two purposes: first, it provided confirmation (or a refutation) that moving from state space to leased space was viable; and second, the survey became the universe of buildings that were evaluated for costing alternatives.[6]

- **Current State and General Leased Costs:** The likely cost per foot for the identified available commercial buildings was then reviewed in light of DGS negotiating effectiveness, and a cost per foot representing that local market was established. This cost per foot was then used both as a comparison to the DGS cost-to-recover rate, and for the purposes of the alternatives analysis.

3. **Alternatives Analysis:**
   DGS produced a high-level, standardized alternatives analysis that provides an order of magnitude comparison of costs for each building where surplus is being recommended. The analysis compared: 1) the costs to vacate the building and move to leased space, 2) the costs to perform the FCA repairs over a period of time, and 3) the costs to retain the building and renovate.

   While each alternative was considered for each building, the specific condition and age of any given building in some cases preclude certain approaches. These factors were considered in DGS' final recommendation.

This data was compiled and analyzed, and recommendations for disposition have been made for each DGS building.

---

[5] If a given building's FCA cost is $20 million, and the potential sale price is $10 million, the FCA costs can then be expressed as 200 percent of the "value" of the building. This allows for a relative weight for the FCAs.

[6] It is important to note that further analysis is needed to determine whether the state departments need to be in the area where the DGS building is currently located. It is possible that the departments can be relocated to less expensive locations and still perform their functions effectively.

Planning Summary

DGS' statewide portfolio currently includes buildings that are old, and in some cases failing. The department believes it is in the best interest of the state to strategically divest of these buildings and engage in long-term regional planning. Departments would generally be moved – at least in the short term – to leased space while DGS works with them to plan out potential state consolidations or otherwise leverage space to make operations more efficient. Then, once that plan is established, the state can enact the corresponding regional plan through leasing, building, or buying in a strategic and data-informed way.

Recommended Building Disposition

Evaluation of state ownership of office buildings is complex, and will vary based upon factors such as the state of the building, the needs of tenants, and market conditions. In evaluating which buildings outside of Sacramento to retain or surplus, DGS utilized the following criteria in assigning points for the Retention Score:

***Ownership Criteria*[7]**

1. **Building Condition** – whether the value of the building is less than the cost to maintain or renovate it.

    a. **How it was used:** DGS used adjusted FCA costs, escalated to the present day, and divided that amount by the building's estimate of value to reflect the Building Condition as a percentage. DGS used the median value (40 percent) as the threshold for this criterion – 40 percent or above was considered in poor condition and those buildings were assigned points.

2. **Building Capacity** – whether the building is of sufficient size to justify continued ownership. Generally speaking, state buildings that are smaller and house fewer state employees generally do not achieve the economies of scale to justify state ownership.

[7] DGS considered using market rent pricing as a factor. However, DGS building rates were less than the market in every jurisdiction when factoring in current pricing (and availability – some areas would require new construction on the part of a developer to address the state's space needs). This made market rent pricing useless as a criterion.

   a. **How it was used:** The threshold was set at 100,000 square feet (net). Buildings less than that amount were considered "small" and assigned points.

3. **Program Requirements** – whether the departments have specialized program requirements or necessary geographic proximities that would be costly or impractical to implement in a leased building.

   a. **How it was used:** DGS reviewed existing program information and attempted to characterize tenant space as either "Specialized," "Generic," or "Constituent Need." A specialized space is one that has been built out to needed program requirements, beyond what is customary (e.g., storage space for laboratory functions). Generic refers to typical office space, whereas constituent need reflects that either the functionality or location of the space is necessary to serve the tenant department's client (e.g., a public counter providing services to the public). Most buildings were either generic office space, or a combination of generic space and space for constituents. Buildings that were generally generic were assigned points.

4. **Regional Space Needs** – whether the state has a need for a significant footprint in the area. Likewise, whether that need comes from a single department with a significant space need or whether it consists of multiple departments with smaller footprints (and that would not benefit from a consolidation).

   a. **How it was used:** Buildings were either classified as single or multi-tenant, with points assigned for multi-tenant buildings.

5. **Ability to Maintain** – whether DGS can adequately maintain and operate the building to meet customer needs. DGS' ability to maintain buildings is compromised when the department operates so few buildings in the region that staffing is overly expensive or there is otherwise no economy of scale, and/or where the ability to hire and retain qualified maintenance staff is compromised by labor supply limitations or the region's high cost of living.

   a. **How it was used:** Buildings were classified as "easy," "moderate," or "difficult," with points assigned for moderate and difficult buildings.

6. **Debt Service** – whether the building currently is indentured by bonds. Buildings subject to indenture cannot be sold and must be well maintained.

   a. **How it was used:** Buildings with any bond debt were assigned points. However, because bond debt changes over time, buildings were assigned more or fewer points based upon the duration of remaining debt service.

7. **Commercially Available Space** – whether there is a general availability of commercially available space in the market sufficient for the state's needs (including growth).

   a. **How it was used:** A building was assigned points when a commensurate amount of occupied space was available in the market at present in the same location.

Recommended Building Disposition

The table below shows the recommendations for disposition based upon the 2018 analysis. These may change as the analysis is performed in 2019 based upon market and building conditions at that time.

Building Name	Poor Cond.	Small Bldg.	Generic Prog.	Can Disperse	Hard to Maintain	Can Lease	DGS Rec.	Surplus Timing[8]
Leo J. Trombatore			X		X		Transfer	N/A
Wadie P. Deddeh			X		X	X	Transfer	N/A
4th District Court	X	X			X	X	Transfer	N/A
Elihu M. Harris			X	X	X		Bond	N/A
Mission Valley			X	X	X	X	Bond	N/A
California Tower	X		X	X	X	X	Bond	N/A
Santa Ana	X		X	X	X	X	Surplused	N/A
Edmund G. Brown			X		X		Retain	N/A
Earl Warren			X		X		Retain	N/A
Ronald Reagan			X	X	X		Retain	N/A
Hiram W. Johnson			X	X	X		Retain	N/A
Van Nuys			X	X	X	X	Retain	N/A
San Diego	X		X	X	X	X	Surplus	19/20
Fresno	X	X	X	X	X	X	Surplus	19/20
Alfred E. Alquist	X	X	X	X	X	X	Surplus	19/20
Stockton	X	X	X	X	X	X	Surplus	TBD
Hugh Burns	X		X	X	X		Surplus	TBD
Redding	X	X		X	X		Surplus	TBD
Red Bluff	X	X	X		X		Surplus	TBD
Junipero Serra			X	X	X	X	Surplus	TBD
Joseph A. Rattigan	X	X	X	X	X	X	Surplus	TBD

[8] "Surplus Timing" refers to the beginning of the disposition process. As noted above, the actual disposition of a given building is likely to occur between 18 months and two years after DGS begins work.

Approach to Leasing

Given the number of office buildings proposed for surplus, leased space is a critical element of DGS' management of office space needs for state departments. It is fitting that this Plan includes an outline of the general leasing strategies/approaches available to the department as DGS strategically transitions away from state ownership on a case-by-case basis.

As a general rule, DGS follows industry standards of maintaining a healthy mixture of regular and long-term leases. The following reflects the types of leases entered into by DGS on behalf of state departments:

Regular-Term Leases:

DGS has traditionally emphasized an eight-year contract for regular-term leasing in order to maximize flexibility. These leases have between a four- and five-year firm term, with a soft term for the remaining years that provides the state the option of vacating the lease without a penalty. This allows DGS to terminate leases if the lessee has a programmatic change, needs to relocate, can no longer afford the lease, etc. It also allows DGS to renegotiate lease terms if market conditions have changed in the state's favor.

Generally speaking, regular-term leases should be considered when:

1. A below-market rate can be achieved without increasing the firm term past a five-year term.

2. The lessee requires a standard office build-out and/or the lessor is willing to provide a significant amount of build-out dollars to cover improvement costs.

3. Market rates in the area have been increasing in a meaningful way.

4. The build-out is not specialized like a DMV or CHP field office.

5. The likelihood of near-term growth or programmatic change in the lessee is probable.

Long-Term Leases

DGS has traditionally defined a long-term lease as any lease with a firm term longer than eight years. Typically, because long-term leases increase the saleable value of a building for the lessor (and facilitate borrowing against the future income of the lease), lessors are willing to lease at more favorable rates when the term of the lease is longer. In these leases, the state typically enjoys lower rent and more funding for tenant improvements, with long-term stability.

While long-term leases require specification notification to the Legislature per Government Code Section 13332.10, these leases are a significant benefit when entered into appropriately.

Generally speaking, long-term leases should be considered when:

1. The lessor is willing to materially reduce the rental rate or rent escalation, or otherwise offer financial incentives to make the lack of flexibility worthwhile.

2. The lessee requires significant build-out or alterations in a space prior to taking occupancy.

3. Market rates in the area have been decreasing in a meaningful way.

4. It would cost the lessee a significant amount of money to relocate in the future, and that fact can be used against them in future negotiations.

5. The likelihood of regular growth (or significant program change) of the lessee is small.

6. The lessee's finances are stable and can reasonably be predicted.

7. The lessee is unlikely to need to change locations for programmatic reasons.

Lease Consolidation
Any responsible approach to leasing must include strategic use of lease consolidations. Because of timing and programmatic differences, DGS sometimes manages multiple separate leases within the same building. Consolidating the leases, where possible, into a single lease enables DGS to increase its negotiating leverage with lessors at both the initial execution and subsequent renewals. Finally, lease consolidation reduces the number of new leases and lease renewals that DGS staff must negotiate, thereby streamlining workload and enabling DGS to focus more on strategic facility planning.

However, not all lease consolidations are in the best interest of the state. In the same way that a lessee's likelihood of growth, financial stability, likelihood of relocation and similar factors impact whether a long-term lease is advisable, so too do these factors influence whether a consolidation is appropriate. Careful analysis of each situation is required before a consolidation should be pursued.

Purchase Options and Capitalized Leases

Since capitalized leases are tantamount to ownership, they are only appropriate in those markets where state ownership is preferred (or will likely be preferred) or for a specialized facility (Laboratories, CHP, DMV, and parole field offices). In fact, some of the same factors that determine whether the state should retain or surplus an existing building would drive the decision to enter into a capitalized lease.

However, where lessors are willing, non-equity purchase options are an excellent way to secure potential ownership without compromising flexibility. Non-equity options (whether variable or fixed rate) are purchase options where the lessor has agreed to include terms in the lease giving the state the option to purchase the building at an agreed-upon price or formula. Unfortunately, lessors are not always willing to enter into these types of arrangements as they can impede future borrowing and, as such, may require less favorable lease terms in order to reach an agreement.

To the extent that it does not compromise terms, in appropriate markets, where the state is the sole tenant and for buildings that are ideal for state ownership, DGS recommends the inclusion of non-equity purchase options in leases.

Conclusion

To successfully manage a portfolio of 21 office buildings totaling 5.8 million gross square feet, continuing with the current approach of simple cost recovery for operations and maintenance and extremely limited reinvestment is not a prudent or effective long-term portfolio management strategy.

This strategic, proactive Portfolio Plan is the department's first meaningful step toward optimizing state-owned office buildings outside of Sacramento, ensuring that remaining buildings are well-maintained, and enabling DGS to leverage the state's buying power to negotiate the best lease terms for the state – including purchase options for leased buildings when they serve the state's interest.

Appendices

- Attachment A – Building Narratives
- Attachment B – Retention Score Documentation
- Attachment C – Alternatives Analysis