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TO: Sarah Knecht, Assistant Agency Counsel, City of Santa Barbara

DATE: July 25, 2013

CC: Stephen Wiley, Agency Counsel

FROM: Allan D. Kotin

RE: **WHY THE PASEO NUEVO GROUND LEASE REPRESENTS AN OBLIGATION RATHER THAN AN ASSET TO THE SUCCESSOR AGENCY**

In the preparation of the long range property management program (LRPMP) for the Successor Agency to the Redevelopment Agency of the City of Santa Barbara, it was natural to assume that the 6-acre site on State Street owned by the Redevelopment Agency and subject to a long-term ground lease to the shopping center owner was a potential real property asset. The purpose of this memorandum is to review some of the history that leads to the conclusion that at least through the year 2065, this is not an asset but rather an obligation of the Successor Agency to the Redevelopment Agency.[1]

Briefly stated there were a series of sequential changes which converted this project from being a revenue-generating asset to being an expense-requiring obligation:

1. The draft lease originally provided for both minimum and percentage rent where the percentage rent was called Participation Rent. The provision for minimum rent paid to the Agency was waived entirely in consideration for the developer advancing $7.8 million in additional funds to permit the Agency to pay for its parking and land acquisition obligations after Agency funds were exhausted.
2. The provisions for Participation Rent (the percentage rent portion of ground rent) provided that Participation Rent would be paid equal to 20% of the amount by which income from the center exceeded a defined Base Income threshold in the Establishment Year. Due to slow lease up, this Base Amount was not even set until 1997 nor was it actually achieved for many years thereafter.
3. At the very end of the development period the Agency unexpectedly required an additional $2 million to meet its obligation. As there were no public sources for this funding, the $2 million was advanced by the Developer in the Fiscal Year 1989-1990 with the understanding that it would accrue interest at 10% and would be repaid only by crediting Annual Participation Rent when and if such rent was due to the Agency as Landlord.

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[1] The author of this memorandum has been involved in the Paseo Nuevo transaction intermittently since 1986 when the city/Agency first considered issuing an RFP for development of the center. As the project manager for the Agency's economic consultant, Kotin, Regan & Mouchly, Allan Kotin actively participated in developer selection, lease negotiation, and support services to the Santa Barbara redevelopment Agency. Many years later when the property was changing ownership for the second time, Allan Kotin was again engaged by the Agency to review the percentage rent clause and to then opine on whether or not there was any meaningful prospect for payment of participation rent to the Agency.

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4. In the absence of high enough income to warrant any payment of Participation Rent, the $2 million grew to approximately $3.7 million by the end of 1997.
5. An analysis by the Agency's consultant in 1997 concluded that because the interest on the loan was then accruing at a rate of roughly $370,000 year and no Participation Rent was likely for several years, it was extremely unlikely that the Agency would ever receive any actual cash payments of Participation Rent except in the event that two very unlikely events occurred: (1) retail space rents at high occupancy levels would grow continuously at a relatively high rate; and (2) the lessee as the owner of the shopping center would not incur capital costs for which the interest charges were to be added to the Base Amount thereby shrinking or eliminating any Participation Rent otherwise due.
6. In the period since that analysis neither of the two conditions has applied; rental growth has been slow and uneven combined with periodic vacancy; re-tenanting has required significant capital investment not recovered by "excess" rents and therefore causing the Base Amount to increase and further deferring any Participation Rent.
7. The project opened at a time of unprecedented real estate recession, as a consequence of which it was sold at a significant loss from its original cost a few years after opening. Notwithstanding this lower cost to the new buyer, the accrual of interest on the now almost $4 million loan (1997) at 10% continued causing the threshold for the receipt of any actual Participation Rent continue to rise.
8. A set of presumably "minor and technical" obligations from the Agency as landlord to the lessee were negotiated into the ground lease. These included the provision that the Agency would pay local assessment fees in excess of a defined threshold and obligations to maintain available parking for the shopping center.
9. The center and its tenants are charged annual fees known as Parking and Business Improvement Area (PBIA) fees to partially offset the cost of providing extensive public parking. These fees have ranged from $155,000 to over $206,000 between 2003 and 2012. Under the terms of the ground lease the lessee's obligation is capped at $100,000 with the balance payable by the landlord (former RDA and now Successor Agency). In the ten year period ending in 2012, total fees were almost $1.8 million leaving the landlord with a total payment of $769,000 or an average of roughly $77,000 per year. Note that fees, which are tied to shopping volume, declined sharply in 2008 and 2009 but are again recovering, suggesting that this amount may increase over time.

As a consequence of this series of events, the obligations of the landlord to the lessee, as noted in item 5 above, continue in the complete absence of any net rent payment to the Agency by the lessee.

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What had apparently been a potential asset has in fact become an ongoing financial drain to the Agency and the Successor Agency which will continue on until the lease terminates in 2065.

Some limited elaboration on each point is probably important.

Initial Cost Over-runs

The parking garages on the opposite side of State Street are widely admired for their design. The land acquisition cost and the construction cost for these garages were much higher than anticipated. Combined with the acquisition costs for the property underneath the shopping center, the obligations of this project completely exhausted the available funds of the Santa Barbara Redevelopment Agency project area. The first series of overruns amounted to $7.8 million which was advanced by the developer in consideration for the elimination of any fixed minimum rent. As is so often the case, costs continued to increase and to meet this increase, the developer was asked late in the project development cycle to provide an additional $2 million in cash to the Agency so it could pay for its final costs. The only source of repayment of that $2 million—because the Agency had nothing else to pledge, was a credit against Participation Rent when and if such Participation Rent was actually payable to the Landlord. Since that time, the loan balance continues to grow at 10% per year compounded.

The Absence of Participation Rent

Participation Rent was set at a share of revenue in excess of an income to the developer which itself was subject to upward adjustment making Participation Rent something of a retreating horizon. This retreating horizon is created by a rising threshold of Base Income making the possibility of earned Participation Rent for the landlord less and less likely. That possibility has effectively been eliminated by the continuing accrual of interest at 10% per annum on an original $2 million loan balance which, without any payments, doubles every seven years. The project opened into a very depressed economy and failed to make any profit in the first several years which allowed the loan balance to grow and has generally generated less income than the threshold for participation since then.

Opening in a Poor Market Environment

Beginning in the early '90's the California and national real estate markets went into a long decline from which they did not recover until after 2000. This was just when this center was opening.

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A few years after the project opened, it was sold for $34 million at a very substantial loss. Notwithstanding this loss, the terms of the ground lease required that the threshold rent continued to be calculated on the original cost basis.

To be sure there was some significant recovery in the early 2000's but virtually all of that was wiped out in the major recession which began in 2008.

The Landlords Financial Obligations under the Lease

Even in the 1980s, developers were concerned about the prospect of steadily rising local fees. To that end, the developer/lessee negotiated a provision by which fees in excess of $100,000 per year would actually be borne by the Agency so as to "cap" the developer/lessee risk. Those fees have risen sharply and now the Successor Agency is obligated to pay almost $80,000 per year in fulfillment of these obligations.

Furthermore for the entire time that the shopping center is open during the term of this lease, the Agency, and now the City, is required to maintain adjacent public parking at favorable cost to the shoppers.

Combined, these two obligations represent a significant ongoing obligation of the landlord whether that landlord be the original Redevelopment Agency, the Successor Agency or at some point in time perhaps the city. There are no net rent revenues to offset these costs nor is there any prospect there will ever be such rent.

While it may reasonably be argued that the reversionary interest in the land when the lease terminates in 2065 could have a high value, that value is more than fully offset by the ongoing obligations of the landlord under the terms of the lease and the huge uncertainties associated with potential re-use in 52 years.