A Public-Private Partnering Approach to GSA's Existing Leases

by Patrick J. Keogh, AMV, and Dennis Eisen, GLN

President Obama and his new Administration have done a great deal to bring stimulus to our economy. Listening carefully to the President you also hear a message of investing and spending smartly. The various stimulus initiatives are not spending for spending's sake. Rather, the President counsels the country and his Administration to act wisely. This article will focus on an approach that is smart for this market. It is smart for the government as the largest lessee in the country and it is smart for lessors who are facing increasingly uncertain equity and credit markets. Working together in public-private partnering relationships the government and property owners can help stabilize markets and reduce the cost of leased space to the government.

We will use GSA as the example for the principles discussed in this article, but the same approach would be applicable to any agency, civilian or military, with a significant portfolio of leased properties.

The Scale of the GSA Leasing Program

The Federal government, as the country's largest tenant, leases over three-quarters of a billion square feet of space and owns another three billion square feet of space. Of this, the General Services Administration through its real estate arm, the Public Buildings Service, had on mid-May of this year exactly 8,790 leases in over 7,100 buildings totaling 180,635,295 rentable square feet of space. At the very same time, GSA owned exactly 1,500 active federal buildings containing 174,712,173 rentable square feet of space. These figures clearly show that the amount of GSA's leased space has now definitely overtaken and surpassed the amount GSA's owned spaces, and stands at 50.83 percent of GSA's space inventory.

The current gross rental on this leased inventory is now vey close to $4.6 billion, and averages $25.46 per rentable square foot per year, nationwide.

What is far more significant, given the present economic environment, is the number of GSA leases that are expiring in the near future. The average lease term of the leasing portfolio when the leases were initiated was 9.1 years. But as of May 15, 2009, the average remaining lease term was just 4.0 years, and the median remaining lease term of the portfolio was just 3.25 years. That is, <u>fully</u> <u>half</u> <u>the</u> <u>leases</u> in GSA's leasing portfolio are due to expire within the next 39 months. A breakdown by expiration reveals that 2,013 leases are due to expire within one year from May 15, 2009; 1,243 more within two years; 843 more within three years; 931 more within four years; and another 796 within five years. This compression has been due in part to the fact that 1,803 of GSA's leases currently represent short-term extensions.

By the way, the above figures are conservative in that the GSA data base shows that there were an additional 197 leases that were due to expire prior to May 15, 2009, whose current status is unrecorded—some of these may have been re-competed and replaced by long-term leases, and some may have been granted short-term extensions.

Just imagine what is going through the minds of the more than five thousand lessors faced with lease expiration within the next four years. Some will not be terribly concerned because government occupancy represents just a very small percentage of their building. But we estimate that for as many as two thousand or more of these lessors, their GSA leases that are due to expire within four years reflect situations where government occupancy is 50 percent or more. (Only an estimate is possible to come by because about 13 percent of the leases in the GSA data base do not specify the percentage of government occupancy.)

For most of these lessors, the possibility that the government will go elsewhere is a serious concern, made even more so because the vacated space will be very difficult to fill with private-sector tenants because of the downturn in commercial real estate that is or will be soon occurring. Faced with such situations, lessors are finding that the financing for sale or modernization are very difficult if not almost impossible to obtain in today's economic climate. This greatly limits options available to them, leaving them vulnerable to threat of default and foreclosure, with consequential loss of equity. Such uncertainty will further disrupt local commercial real estate markets, which is now an important consideration for federal policy makers.

From Process-Driven to Strategic

But here's how things could play out to the simultaneous benefit of GSA, building owners and lenders. Suppose the rental rate the government has been paying for many years is not far from the national average of $25.46, say $25 per square foot, and suppose that looking ahead the market rate that GSA would likely pay upon renewal in a matter of months or a very few years would be, say, $32 per square foot. And further suppose that the government is perfectly satisfied with the space and would not at all mind staying in place. Then an optimal course of action for GSA to pursue is to negotiate for and replace the current lease with a superseding lease for, say, ten years at $27 per square foot. Doing so would save the government $5 or so (the difference between $32 and $27) per square foot per year over the term of the superseding lease. The cost savings to the government under this scenario can be substantial. For a 50,000 square foot lease a $5 a year savings over ten years will be $2.5 million. For a 100,000 square foot lease a $5 a year savings over 20 years could amount to $10 million. And that's

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just for one lease.

From the owner's perspective, there would be a modest increase in cash flow by $2 per square foot as measured from the current rent levels. But besides the assurance of continued cash flow from a triple-A tenant, by far the even greater benefit to the building owner would be the fact that having a firm ten-year lease from such a triple-A tenant would go a long way in mitigating default risk from the perspective of a potential lender. This would greatly improve the marketability of the property to a subsequent investor, as well as enhancing the possibility of refinancing the mortgage, thus enabling the owner to cash out the investment—and by investing the proceeds further help the economy along.

PBS generally views its leasing program from an administrative, process-driven perspective. That is, lease space is sought when a federal agency has a requirement for space that cannot be satisfied in a government owned building. A solicitation for space is issued, offers evaluated and a lease executed with the successful landlord. When a lease expires a new solicitation is issued or an extension to the existing lease is negotiated. The process is driven mostly by the occupant agency's requirement. This article will discuss some of the economic and public policy advantages that might accrue from adopting a broader, more strategic dimension to PBS's leasing program.

There is growing evidence that the distress experienced in residential real estate is migrating into the commercial real estate markets. We think that an adaptive, flexible approach to the government's real estate practices can offer significant opportunity for savings and promoting sound public policy. These are "lemonade times" for the government's real estate professionals; when the market gets lemons you should make lemonade.

Commercial Markets will Continue to Deteriorate

The Wall Street Journal reports that rents for office space declined 1.2% in the fourth quarter of 2008, nationwide. That was the largest one-quarter decline since 2003 and came after rents rose 10.6% in 2007. Effective rents fell in 65 out of 79 urban markets. Newmark Knight Frank estimates in its "U.S. Office Property Sector Market Outlook, 2009" that vacancy rates will increase

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in 2009 for all 39 major markets they monitor. Reis Inc., a New York real estate research firm, reports that in 2008 office tenants vacated 42 million square feet of office space more than they took. That increased the U.S. office vacancy rate to 14.4% from 12.6% a year earlier. Reis has said it expects vacancy rates to rise through 2010. According to "Emerging Trends in Real Estate 2009," a report issued jointly by the Urban Land Institute and Pricewaterhouse-Coopers, real estate professionals expect markets to flounder through 2010. "Commercial real estate faces its worst year since the wrenching 1991–1992 industry depression" conclude industry experts interviewed for the report. The report projects losses of 15% to 20% in real estate values from the mid-2007 peak. "Only when property financing gets restructured will pricing re-correct so we can find the floor; and this transition could wipe out companies," said one respondent interviewed for the report. Those of us old enough to have been in the business in 1991 know that declines in many markets were significantly higher than 20%. So many indications are that commercial real estate owners are headed for some tough times.

Credit Markets are Compounding the Problems

Many property owners have substantial debt and lenders are not lending. The massive disruptions in our credit markets have resulted in an unprecedented avoidance of risk. Even high quality corporate bond rates are at historically high spreads over Treasuries. For commercial real estate, credit is either not available or the cost and terms are prohibitive. Declining property income, increased vacancy, declining values and high cost debt make for a terrible combination of factors for commercial property owners. Increasingly, our public policy leaders understand that a more stable and prosperous market is in the general public's interest. In residential markets there is a growing consensus that mortgage debt must be restructured. The realization is not far off that commercial real estate debt must also be restructured so that pricing can be stabilized and the industry can start to dig out of this economic hole.

A Preemptive Public-Private Partnering Approach

As in the early 1990's, the tenant is king again—and a credit tenant is king of kings. In this kind of market a credit tenant has considerable leverage in renegotiating lease terms. A proactive credit tenant can often substantially improve its terms, particularly if lease expiration is approaching. A government credit tenant might have the added objective of using its position to mitigate their landlord's tenancy risks and help stabilize local credit and equity markets. Helping landlords by offering below-market rents may seem a contradiction in terms, but that is not necessarily the case. In these markets mitigating perceived risks can be in both the landlord's and government's interest.

A public-private partnering approach to these issues might involve GSA indicating receptiveness to landlords' proposals to restructure terms on leases of 10,000 or more square feet, having a minimum annual rent of $100,000, and with a remaining term of less than four years. There were 1,674 such leases in the GSA leasing portfolio that fell into that category on May 15, 2009, encompassing almost 72 million square feet of space with a current annual rental cost of very close to $1.74 billion. The proposals would have to be "open book" so that the government could assess all the financial circumstances surrounding the proposal. GSA would engage a team of real estate and financial experts to help evaluate and negotiate responses to their landlords' proposals. The team of experts would consult with occupant agencies and determine the future prospects for continuing requirement for the lease. They would also evaluate the local market to determine reasonable rates. The financial representative on the team should be someone with experience in financing federal credit tenant leases. As such, the financial expert could evaluate refinancing opportunities available to the lessor and advise the government on the value created and means for the tenant's participation in that value. Also, the financing expert would be available to advise the government on the risks associated with restructuring lease terms in order to facilitate lower-cost refinancing options.

Compensation for the advisory team could be made out of the proceeds of any refinancing or from the owner in the form of a brokerage fee for securing the extension and/or the changed terms. This kind of cooperative, open book process could result in a lower cost of leasing to the government while also helping to stabilize the commercial real estate market in which government occupancy in those buildings is significant. Although many GSA leases fail to show the percentage of the building that is government occupied, based on long experience we estimate that in 40 to 45 percent of the 1,674 lease situations enumerated, the government occupies 50 percent or more of the building.

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