

# *Generating Returns from Federal Real Estate Assets*

by Patrick J. Keogh, AMV, LLC

There has been considerable attention focused recently on underperforming public real estate. With recent budget pressures and deficits some states and the federal government have started to look to their assets as a source of savings and revenue. This article will concentrate on the evolving federal thinking about accessing the value of federal real property.

In recent times the federal government has employed four distinctly different approaches or models to underutilized real property. Each model has been used by a different agency at a different time to accomplish different purposes.

### **The Excess and Surplus Model**

This is the typical approach used by federal agencies in dealing with real property that is no longer needed for its original purpose. The model is prescribed for in the basic enabling legislation for the U.S. General Services Administration; the Federal Property and Administrative Services Act of 1949. The Excess and Surplus model is based on the premise that improved real estate is mostly a tool for delivering public services or performing a governmental function. When that tool is no longer needed the owning agency initiates what we will refer to as the “excess and surplus” process. This involves the using agency first determining the property to be excess to the agency’s needs. Typically, the property is then transferred to GSA and GSA conducts a search of other agencies’ needs for the property. If an agency expresses an interest, the property is transferred to the new user. If there is no need, the property is declared surplus by the government. Once considered surplus, the property can be acquired by state and local governments for their purpose and if not needed the property may be available to a variety of private, non profit enterprises. Only after this disposition gauntlet has been run is the property made available for sale with the proceeds going to an account maintained by the Department of the Interior for the benefit of wildlife programs. It is important to note that the proceeds generated by any sale of surplus property

accrue to the benefit of a public enterprise external to the managers of the Excess and Surplus Model. That means there is no self-interest in GSA to attempt any special effort to maximize the cash return from a property disposition.

The Excess and Surplus Model, then, is based on a perspective of real estate facilities as a tool. The model’s purpose is to redeploy property for use in a public purpose and not to maximize the financial return to the public from the disposition of the property.

The Excess and Surplus Model is almost exclusively a government driven process. It is run by government employees and relies little on private sector participation. In any relative measure of public vs. private sector content the Excess and Surplus Model is very high on public content.

### **The BRAC Model**

First created in 1988, the Base Realignment and Closure Model is the disposition tool uniquely designed for military facilities. Throughout our history there has been an ebb and flow of commitment to military resources as threats to national security have arisen and subsided. Military facilities can be significant value generators in the communities in which they are located. They can create large numbers of jobs and other business for local communities. It is no surprise, then, that the closure of a military installation which is no longer required for its intended purpose can meet with considerable local resistance. A community’s elected leadership commonly fights vigorously to maintain military facilities long after their usefulness has ended. Historically, military installation closings have met with intense political battles that often led to something less than ideal results from the standpoint of the military’s mission.

The BRAC process was designed to depoliticize the military disposition process. There have now been five rounds of the BRAC process. The current, fifth round of the BRAC process is headed by a nine member commission. They conduct studies on the Admini-

*(Continued on page 6)*

## *Generating Returns from Federal Real Estate Assets (cont'd)*

*(Continued from page 5)*

stration's recommended closures and form their own recommendations. The Commission's final recommendations get an up or down vote by the Congress. There is no opportunity for the Congress to pick or choose among individual installations.

The BRAC Model, much like the Excess and Surplus Model, is based on a perception of installations and real estate as tools in accomplishing the military's mission. Those tools must be disposed of when no longer required. The motive behind base closure and disposition is mostly to shed the significant costs associated with tools that are no longer required. For example, the goals of the current BRAC round is best summarized in the \$37 billion in savings the Commission originally estimated would be generated from the proposed closures.

The BRAC Model is also like the Excess and Surplus Model in another significant respect. In the BRAC disposition process there is strong preference given to a transfer to local public entities. It is quite common for state and county governments to be active participants in the process of redeveloping former military installations. Also, the BRAC Model is like the Excess and Surplus Model in that there is little incentive in the military to attempt to use the process to generate income. BRAC is about achieving savings; not generating income. Finally, in any measure of public sector vs. private sector content in the overall process the BRAC model is very high on public content. There is likely higher relative private participation in the execution of the BRAC model than the Excess and Surplus Model but that content is in the form of consulting, due diligence and similar contract-type services.

There is one additional feature of the current phase of BRAC that makes it popular among its military sponsors. This current, fifth round of BRAC is the first to be focused primarily on force transformation rather than infrastructure reduction or disposal. By that we mean that the nature of military operations is changing requiring different facilities and distribution of the

force. So that the BRAC authorities extend not only to the authorities required to dispose of facilities but also to the authorities necessary to provide for substitute facilities.

### **The Resolution Trust Corporation Model**

The Resolution Trust Corporation represents one of the most successful relationships between the public and private sectors since World War II. On February 9, 1989, President George H.W. Bush signed into law the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) creating the RTC and promising that the nation's financial crisis would be resolved by December, 1995.

For public real estate and financial practitioners the RTC experience represents a record of huge accomplishment. Even now it is hard to believe that \$400 billion in assets and 750 failed financial institutions could be sold or "resolved" in so short a period of time by a new federal organization. It is important to remember that it happened in an environment where real estate values had plummeted and equities in financial institutions were seriously depressed.

At the time, the RTC effort represented the largest privatization of public assets in history. It might also be helpful to note that other countries employed RTC-like solutions to the privatization of their public assets. Most notable, in that regard, was the almost contemporaneous (1990-1994) experience of the Federal Republic of Germany's Treuhandanstalt (translated as "Trustee Agency" and referred to as "THA") in privatizing the public assets of East Germany upon the country's reunification. The THA successfully accomplished the privatization of 13,000 East German industrial firms in only four years. Taken together these two agencies, the RTC and THA, in a relatively short period of time, fulfilled their legislative mandates and divested what amounted to history's greatest transfer of wealth from the public to the private sector.

FIRREA created a complex mandate for the RTC. The new organization was to quickly privatize failing

*(Continued on page 7)*

## Generating Returns from Federal Real Estate Assets (cont'd)

(Continued from page 6)

thrifts and their assets. The RTC was to minimize the impact of its resolutions on local real estate and financial markets and maximize the availability of housing for low- and moderate-income individuals. Finally, the agency was to maximize the opportunity for minority- and women-owned businesses to participate as contractors and purchasers of assets. So there was the compelling business mission of disposing of the assets for top dollar but that was to be accomplished in the context of some important qualitative goals.

The record of the RTC seems to indicate that success was a function of a number of key factors:

1. The legislative sunset date served as a Kennedyesque “going-to-the-moon” goal. It became the objective of everyone in the organization. Unlike the standard perception of a bureaucracy where the goal is to perpetuate its own existence, the employees at RTC

measured their success by their progress toward their going-out-of-business date.

2. They created a decentralized structure. Although RTC had a Washington headquarters, operations and responsibility were mostly managed in the field. Local personnel were charged with selling and making decisions based on local circumstances.

3. RTC had an entrepreneurial culture. There was a strong sense of mission and reliance on individual initiative rather than a reliance of prescribed processes and procedures.

4. RTC had very significant private sector involvement. Although the original staff of the RTC came from the FDIC and elsewhere in government those individuals were quickly replaced with private, contract employees. Similarly, the transaction structures, like securitization of assets, represented the best tools then available in the private markets.

(Continued on page 8)

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## *Generating Returns from Federal Real Estate Assets (cont'd)*

*(Continued from page 7)*

### **The USPS Model**

The federal government, unlike businesses, does not operate with a full set of financial statements. Sure, they have an income and expense statement which accounts for appropriations and the expenses incurred to operate the government. But the Feds lack a balance sheet. Although they may inventory property, nowhere do they properly account for their assets. Government accounting is all about income and expenses with no real accounting for value. Examples of smart, aggressive, return-based asset management in the Federal government are few to almost nonexistent. As discussed above, with the exception of the one-time RTC Model, most examples of federal real estate disposition efforts are about achieving savings. To say that the government's real estate practices are not structured to yield the best returns is a gross understatement.

The federal entity that owns the property generally does not get to retain the proceeds from the sale and often funds appropriated for real estate may not be used for other purposes. There is one outstanding example of a federal organization managing its assets to the best standards anywhere. That's the United States Postal Service in the period from 1980 to 1995. Think what you might about the USPS and their mail handling, their asset management activities were without peer. During that time the USPS felt the full brunt of change in the way mail was distributed. Previously, mail was mostly transported by rail to major urban hubs. There, it was sorted and distributed throughout the metropolitan area. As populations became more dispersed, mail was carried by plane and distributed by truck to mail handling centers throughout the metro area. That left major downtown postal facilities mostly unused in central city locations. What the USPS did next is a striking example of public entrepreneuring at its best. And in public real estate circles the story remains largely untold.

First, the USPS did not see these center city properties as "excess" or "surplus." They did not do any

studies to determine highest and best use. They did not pay for appraisals and they certainly never considered giving anything away. In short, they avoided all the practices characteristic of most federal agencies in such circumstances. In fact, they spent little to no effort on determining "what" should be done with the properties. All their attention went into determining "who" to work with to create the highest possible return to the USPS. And, at the outset, they determined the "who" would not be defined by a classic public contracting paradigm. Rather, they decided early that they wanted to partner with private developers. Developers create value in real estate and the USPS wanted to create and capture the greatest value from their assets.

Because the USPS was looking for the right developer for each property but did not want to prescribe a solution they created a new form of procurement for the Federal government; a Request for Qualifications or RFQ. Don't confuse that with the RFQ (Request for Quotes) in the Federal Acquisition Regulations. Also do not confuse it with the current form of Request for Qualifications used by some agencies in a two-step procurement where a standard Request for Proposals follows a first phase RFQ. No, the Postal Service used a one-step RFQ process for selecting developer partners. The solicitations (RFQs) were often only a few pages and the procurement cycles (issuance to selection) were usually no more than a month or two. Developers' pursuit costs were negligible because they were confined to stating their qualifications for partnering with the USPS. Protests were unknown because pursuit costs were negligible and offerors were anxious to avoid conflict and get on to the next deal. There were no architect's concepts or financial pro formas; no financing sources or contractors identified. All that would come later in a joint developer-USPS business planning/team building process. RFQs are a common form of procurement at the local government level and the preferred form of solicitation in commercial practice.

*(Continued on page 9)*

## *Generating Returns from Federal Real Estate Assets (cont'd)*

*(Continued from page 8)*

The other thing the USPS insisted on was the best private representation. Because they expected to design the best commercial deal they wanted the same kind of professional representation as that available to their developer partners. For that reason USPS in-house counsel partnered with specialized private development counsel. The USPS wanted “the same kind of development counsel as representing their developer partner so they could speak the same language.” That’s really important in the classic public-private contracting deal. Government counsel tends to speak the language of “process” and private counsel is speaking “deal.” In the USPS transactions both sides were speaking the language of “deal” and government counsel tended to be the “process interpreter.” Incidentally, it’s important to note that all costs of private representation were to be borne by the financing of the deal and not by the USPS.

The business planning process followed the developer’s selection. The developer took the lead in finding prospective tenants for the former mail handling facility and that could be residential, office, big screen theaters, retail and any number of other uses depending on the demands of the individual market.

Where relevant, the USPS often adopted a deal first then authorization approach. To understand what this means let’s consider the standard GSA process. Put simply, GSA first determines a requirement for space. It then seeks either leasing or direct appropria-

tion authorization for a project. Once authorized or appropriated the agency proceeds to procure to deliver the space necessary to satisfy the requirement. The USPS process was often quite different. Where a federal tenancy made sense the USPS and their development team would often structure the business deal and implementation would be subject to subsequent authorization and/or appropriation.

Finally, the USPS established a small asset management group at its headquarters facility. They operated as an internal Real Estate Investment Trust capitalized by USPS underperforming assets. Their success was measured by their return to the USPS. Their performance incentives were crystal clear. Their work was always secondary to postal operations but where property was underutilized or local postmasters could be convinced that the proposed use was not inconsistent with the postal mission the asset management group operated with relative independence.

Let’s just take one example to see how all these factors converged to make for an enormously successful deal. That’s the former Washington DC central Post Office and now Postal Square which is located just west of Union Station in Washington DC. The USPS no longer required a 1.1 million square foot mail handling facility in the center of the city. So using an RFQ they selected Hines as their developer partner to determine what their options might be. The USPS also engaged Pillsbury Winthrop Shaw Pittman to serve as

*(Continued on page 10)*

### **Summary of the Models**

	<b>Excess/Surplus</b>	<b>BRAC</b>	<b>RTC</b>	<b>USPS</b>
Financial Objective	Savings	Savings + New Facilities	Maximize sale Proceeds	Maximize return
View of real estate	It’s a tool	Tool	Asset	Asset
Public vs Private Content	High public	High public	High private	Very high private
Organizational Incentives	Low	High	Very high	Very high

## *Generating Returns from Federal Real Estate Assets (cont'd)*

*(Continued from page 9)*

development counsel. Working with Hines they assembled the development team and solicited prospective tenants. Eventually those tenants included 10,000 square feet for the Capitol Brew Pub, 950,000 square feet for the Bureau of Labor Statistics and the Office of the Architect of the Capitol. Also included were a 40,000 square foot retail post office and a 75,000 square foot postal museum for the Smithsonian Institution.

Hines served as the managing partner and participated in the cash flows from the project. The USPS cashed out its participation in the cash flows by financings that have yielded them about \$150 million. In another 10 years or so the full ownership of the property reverts to the USPS. Remembering that the USPS put no capital into the deal and its redevelopment you have to marvel at the returns achieved by the USPS. And they did similar deals with other properties around the country. A summary of the key features of each of the four models is shown in the preceding table.

### **The Way Forward**

If the federal government wants to maximize the return from underperforming real property assets it should abandon any hope that either the Excess and Surplus Model or the BRAC Model offers any real opportunity. It should create an independent public enter-

prise modeled on the dynamics of a real estate investment trust. That way, incentives of management can be aligned with the government owner. The approach to the market should employ high private content just as a commercial REIT would employ in capturing value for its investors. That does not mean that the financial objectives cannot be conditioned by relevant public policies as was the case with the RTC. The public REIT would best be located in a financial agency and not connected to any of the agencies currently controlling real property assets. The Federal Financing Bank within the Treasury Department might be a good example of organizational location. The FFB was created to make federal credit markets operate more efficiently. Another way of saying the same thing is that the FFB was established to get the best return to government from a wide range of federal financing obligations. A similar internal Federal Real Estate Trust could be organized to maximize return from underperforming federal real property assets.

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*Patrick J. Keogh, Esq. was previously a program manager at GSA. He is currently President of AMV, LLC a firm that specializes in asset management, financing and public-private partnering. He can be contacted at pkeogh@amv-llc.com or by phone at, 703.790.8471.*

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