March 6, 2013

To: Government Performance & Finance Committee
Tim Burgess, Chair
Nick Licata, Vice Chair
Sally J. Clark, Member
Mike O'Brien, Alternate

From: John McCoy
Council Central Staff

Re: Options Analysis for Pacific Place Garage Sale Proposal (CB 117719)

The Mayor and the Department of Finance & Administrative Services (FAS) have offered CB 117719, which proposes that the City sell the 1200-space garage under the Pacific Place mall for $55 million to the mall's owner, Pine Street Group, LLC. The sale proceeds would be used to defease some of the $59.6 million in outstanding City debt on the facility. The result would be a net loss to the City, as the debt exceeds the sale amount, and the City has an additional accumulated deficit in the Garage Fund.

Debt principal outstanding (YE 2012)	($59,589,078)
Projected defeasance w/ $55m sale proceeds	$46,000,000
Debt outstanding after defeasance	($13,589,078)
Closing costs	($40,000)
Credit for deferred maintenance	($700,000)
Garage Fund accumulated deficit (YE 2012)	($3,973,060)
Net Loss	($18,302,138)

This net loss figure does not include future interest on the outstanding debt or the accumulated Garage Fund deficit. Council may wish to request a fuller economic analysis with all amounts, including future debt service expressed in net present values.

Background

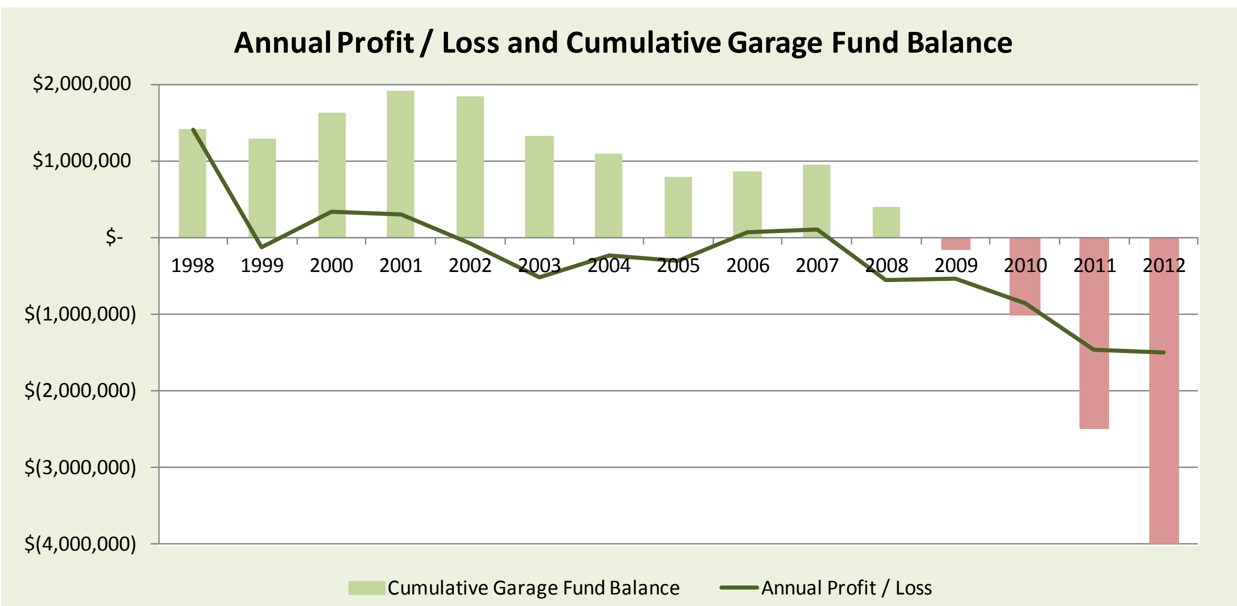
The City acquired the garage in 1998 as part of a 1996 re-development deal for downtown that included Pine Street and Nordstrom. The deal was intended to revitalize the then-struggling downtown retail core and address concerns among downtown retailers about competing with the free parking available in suburban-style shopping malls. The City paid $73 million into the deal, which included several elements:

- The 1,200-space garage, sold to the City as a condominium unit;
- A façade easement on the Frederick & Nelson (now Nordstrom) building that preserved the existing look;
- An air space easement limiting the height that the mall could build to; and

- Contracting guarantees for the construction of the garage and mall that specified the developer would pay prevailing wages, set aside 10% of the total construction value for women- and minority-owned business, and 15% of the hours worked to apprentices.

The deal also included a complex and comprehensive umbrella agreement on how the garage would be operated by the City in support of a "first class" shopping center, Pacific Place, which currently features more than 50 retail and restaurant businesses and an 11-screen movie theater. The agreement specifies how rates may be set, the operating hours, valet parking services, limits on the share of all-day parking, as well as a maintenance schedule for pressure washing and re-striping.

The agreement specifies that the City must set rates to encourage short-term parking and use of the garage. Rates are further constrained by the financial performance of the City's Garage Fund. If the Garage Fund turns an annual profit, then the following year, the rates must be reduced to no more than 80% of the area market rate. If the Garage Fund has an annual loss, then City has discretion to set rates. In practice, this structure implies that the Garage Fund will have a hard time making a profit more than one year in a row.



As shown in the chart above, the Garage Fund has seen a mixture of profits and losses since 1998, and it ended 2008 in net positive territory. Utilization declined in the recession of 2008 and has not fully recovered. FAS attempted to spur additional utilization in 2011 with a drop in parking rates, but this only caused the Garage Fund deficit to increase, as the necessary demand failed to materialize, and rates have since been re-raised. Also affecting Garage Fund Balances are a rising debt service schedule, which increases payments by 3% per year, and the City's decision to impose a commercial parking tax in mid-2007. This tax, originally 5% and now 12.5%, is an expense to the Garage Fund but a revenue to the Transportation Operating Fund.

While the City has been incurring operating losses on the garage since the recession of 2008, it appears that the overall re-development deal has achieved its macro objectives. The area surrounding the garage has seen substantial re-development since 1998 and now features a variety of active retail stores and restaurants. And while precise figures by retail location are not available, an analysis by FAS found that the surrounding area has been roughly associated with about $34 million in increased tax revenues since 1998. These include sales tax, business & occupation tax, property tax, admissions tax, and commercial parking tax. Of course, it is impossible to determine what share of this re-development and tax boost would have happened absent the deal.

Analysis

The City's decision to either sell the garage or continue operating it per the terms of the contract is not clear cut. Much depends on the City's and mall owner's outlook on future Garage Fund revenues, expenses, and risks.

"Put" Option Starting in 2018

The umbrella agreement between the City and Pine Street does address the scenario we find ourselves in, where the City suffers operating losses, and it provides a mechanism to make the City whole. Starting in 2018 (and annually thereafter) the agreement's "put" option allows the City to require Pine Street to purchase the garage for the lesser of:

a) $50 million, or
b) The City's outstanding debt principal + accumulated operating losses with 5% interest

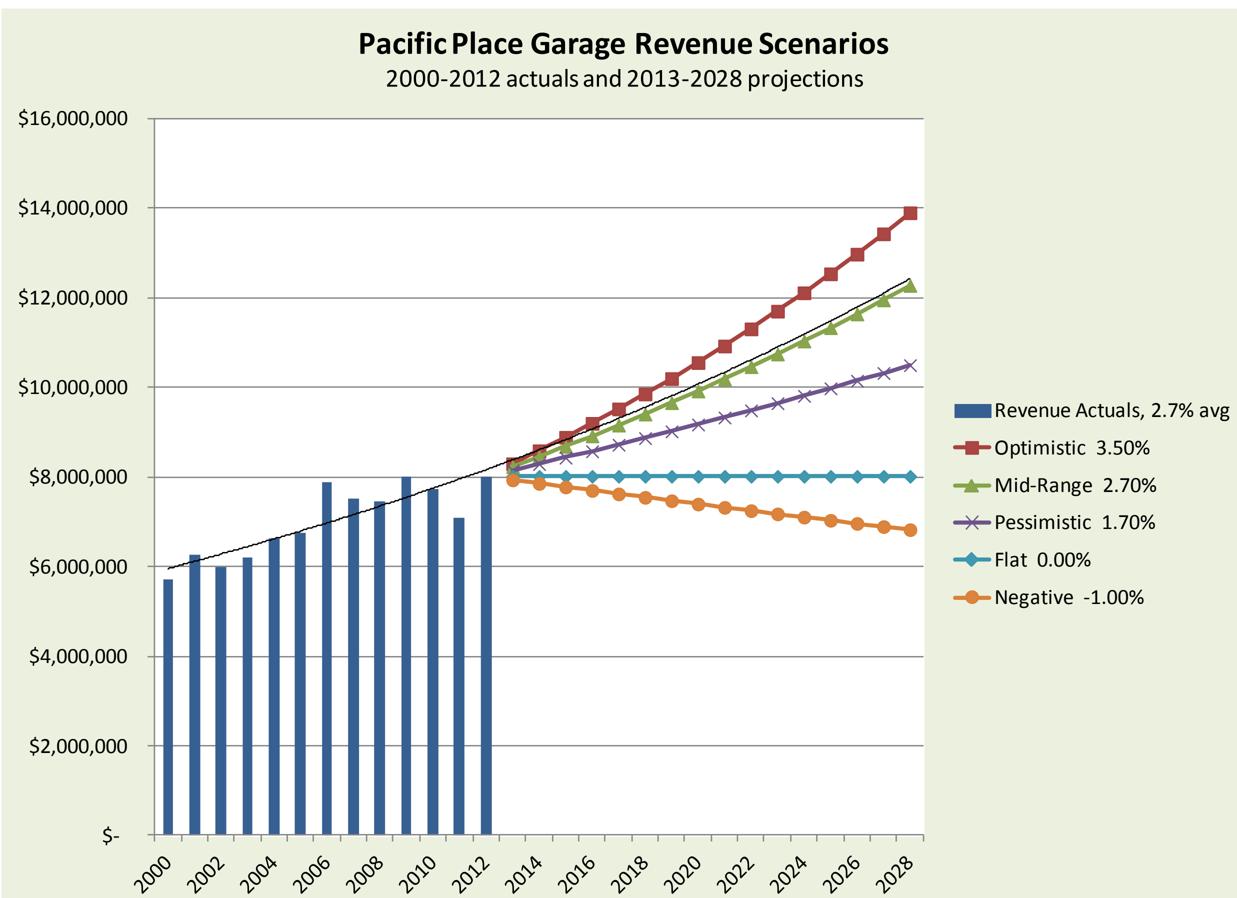
In theory, the City should stay the course and exercise this option in 2018 or later, if we have reason to believe that it would leave the Garage Fund better off than the current offer.

Assessing the value of the put option requires forecasting the Garage Fund's revenues and expenses for the next 16 years, which involves considerable uncertainty. A range of scenarios is presented below, mapping out several possible futures with respect to revenues and expenses, and taking into account the City's debt schedule.

Revenues

The Garage Fund has seen average annual revenue growth of 2.7% since 2000.[1] Faster growth before 2008 has given way to flatter revenues since. FAS reports that utilization has declined since 2004, with the implication being that revenue growth has been driven mainly by price increases. The revenue chart below considers several possibilities:

> Optimistic Scenario – Revenue growth accelerates to 3.5%. This would be consistent with a robust economic recovery and increasing utilization of the garage.
>
> Mid-Range Scenario – Revenue growth continues at its 2.7% historical pace.
>
> Pessimistic Scenario – Revenue growth decelerates to 1.7%.
>
> Flat Scenario – Revenue does not grow. This would reflect a future where continued utilization declines exactly offset price increases.
>
> Negative Scenario – Revenue declines by 1% per year. This would reflect lower utilization that more than offsets future price increases.



[1] Exponential trend line estimate. As 1998 and 1999 were start-up years, they have been dropped from the series to get a better sense of the established trend. Including them would raise the estimate.

Expenses

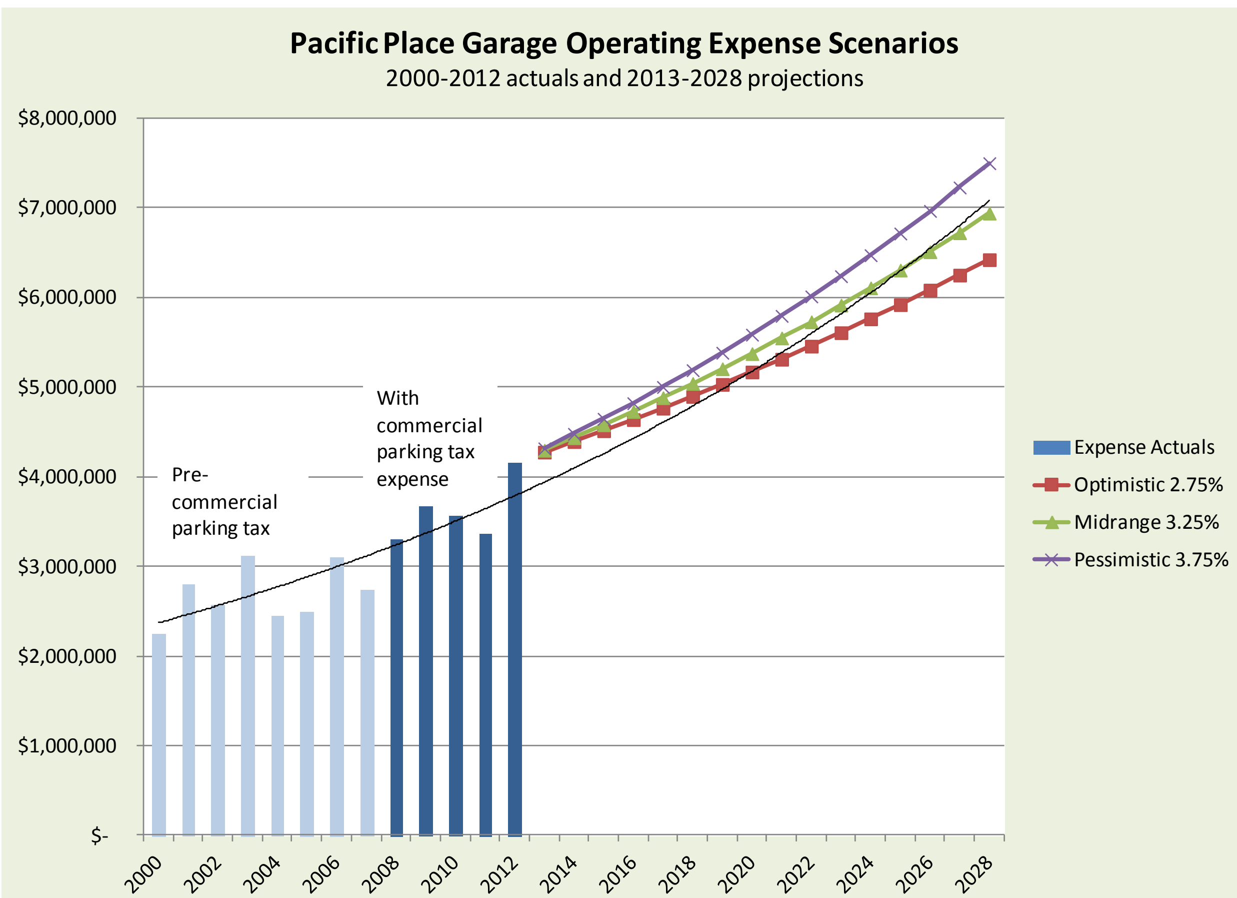
Operating expenses in the Garage Fund have grown at about a 3.2% average annual rate since 2000.[2] Expense growth began accelerating about the same time that revenues began flattening in 2008, leading to the wider deficits seen of late. One significant contributor to the expense growth was the enactment of a commercial parking tax in 2007. The expense chart below shows several future scenarios.

Optimistic Scenario – Expense growth decelerates to 2.75%, closer to its pre-2008 rate.

Mid-Range Scenario – Expense growth continues at its 3.25% historical pace.

Pessimistic Scenario – Expense growth accelerates to 3.75%. This may be more consistent with a scenario in which an aging facility requires additional equipment replacement and major maintenance.

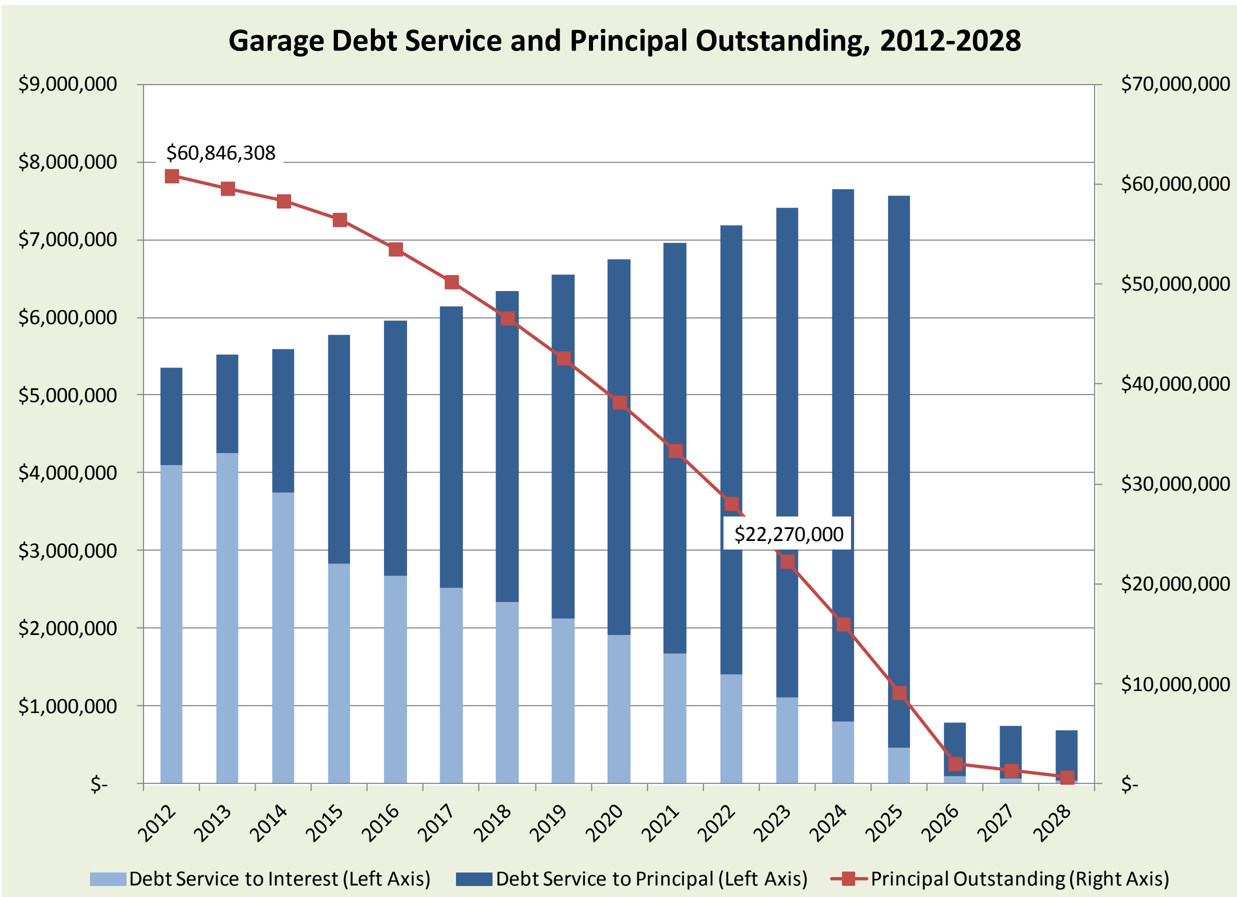
Flat / Negative Scenarios – Expenses grow as per the Mid-Range scenario.



[2] Simple average of two exponential trend lines (2000-2007) and (2008-2012) to account for the introduction of the commercial parking tax, which increased the cost level of the Garage Fund.

Debt Service

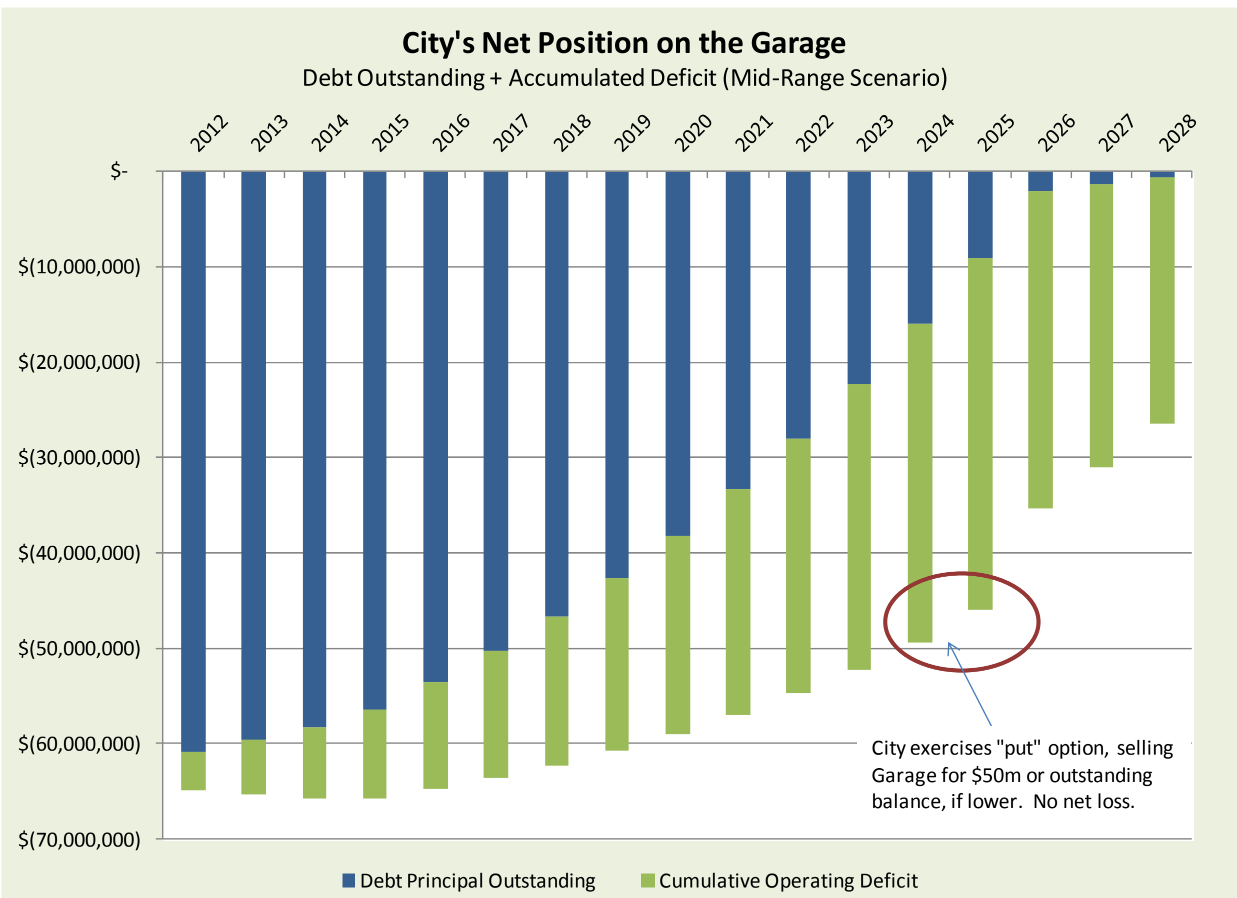
The City's debt service payment schedule and outstanding principal balance are the other relevant factors in analyzing the value of the put option. The City's debt service grows at 3% per year until 2026, at which point it drops dramatically. This debt service contributes to annual and accumulated Garage Fund deficits. In addition, it's noteworthy that the debt service is increasingly devoted to principal repayment after about 2015 – to the tune of $4 million per year in 2018 rising to over $7 million a year by 2025.



How the Put Option May Make the Garage Fund Whole

With these elements in place, we can model the value of the put option under various conditions. The chart below shows the Mid-Range Scenario. Under these assumptions, the Garage Fund continues to operate at a loss and accrues a deficit of around $33 million by 2024, up from $4 million today. However, the City's garage debt is being retired even faster, so that by 2024 the City could exercise the put, sell the garage to Pine Street for around $50 million, and suffer $0 net loss.

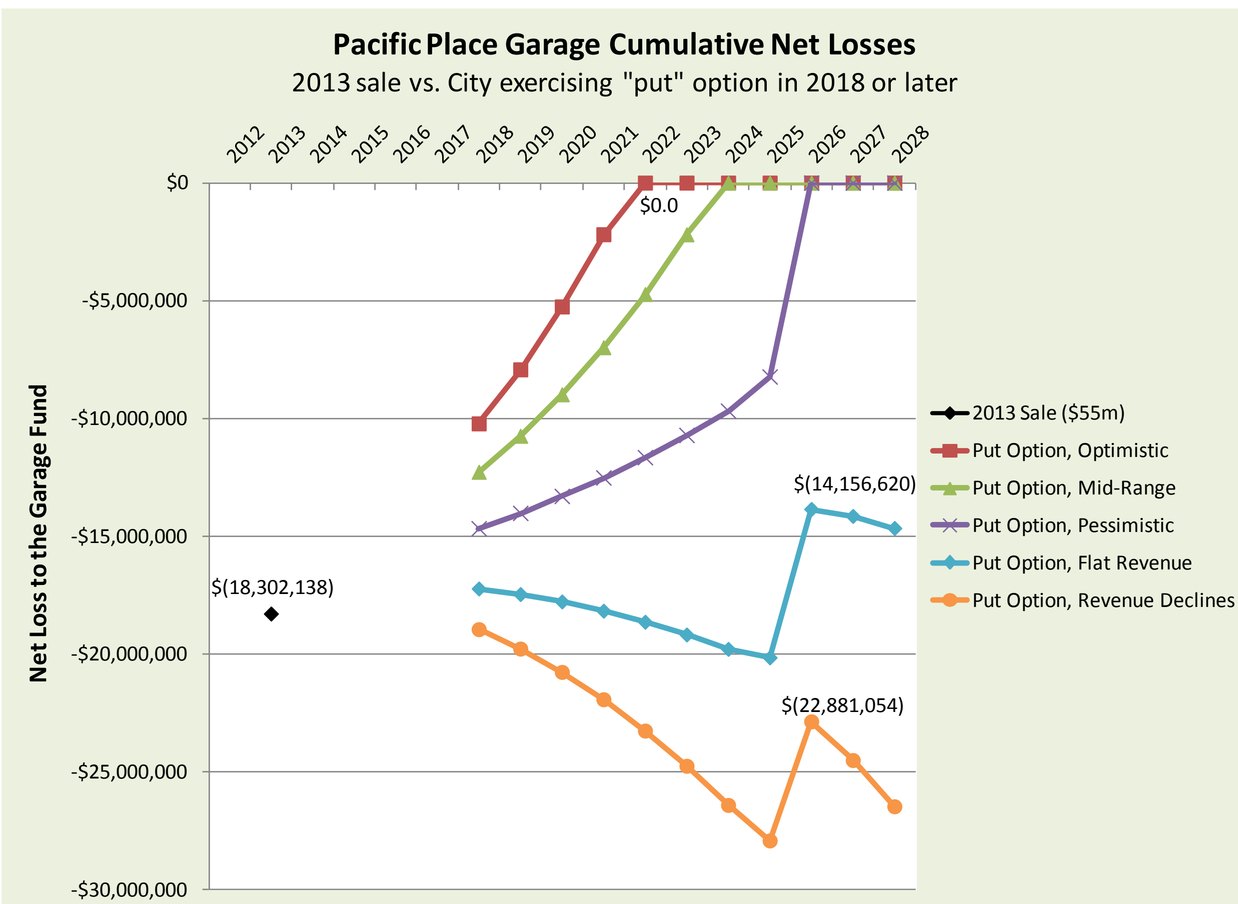
<u>It's worth noting that all the scenarios presented here — even the "Optimistic" view — show the Garage Fund continuing to operate at an annual loss until 2026</u>. Profitability appears quite difficult to achieve at this point, absent some fundamental increase in demand or renegotiation of the operating rules under which the garage operates.



Value of the Proposed Sale vs. the "Put" Option Under Various Conditions

The chart below summarizes the value the City could realize by exercising the put option in 2018-2028, compared with the proposed sale today. In 2018 when the put option first becomes available, the City's deficit exceeds $50 million, leading to a net loss. However, the value of the put rises rapidly after 2018 in some scenarios. This is primarily due to the rapid retirement of the garage debt in those years.

- Optimistic – If revenue picks up, the City could sell the garage for $0 net loss in 2022.
- Mid-Range – If the future looks like the past, in 2024, the City could sell the garage for $0 net loss.
- Pessimistic – If revenue growth decelerates and expenses accelerate, the optimal put date would be pushed back to 2026, but the City could still exit the garage venture for no net loss.
- Flat Revenue – If revenue does not grow at all, the put will be unable to make the City whole. In this scenario, the City could exercise the option for a $14.2 million net loss in 2026, less than the $18.3 million proposed today. However, this scenario is highly dependent on expenses. If they accelerate further, the net loss could be more than $18.3 million.
- Declining Revenue – Under all declining revenue scenarios, the City would be better off selling today.



Summary of Potential City Strategies for the Pacific Place Garage

Scenario	Revenue Growth	Expense Growth	Qualitative Description	Strategy	Outcome
Sell now for $55 million			Current deal on the table.	Avoid further operating losses.	City loses $18.3 million.
Optimistic	3.5%	2.75%	Market turns back up post-recession.	Exercise “put” option in 2022.	City loses $0.
Mid-Range	2.7%	3.25%	Future of the Garage Fund looks like its first 14 years.	Exercise “put” option in 2024.	City loses $0.
Pessimistic	1.7%	3.75%	Revenue growth declines permanently, expenses accelerate.	Exercise “put” option in 2026.	City loses $0.
Flat Revenue	0.0%	3.25%	Revenue growth stalls. Utilization declines continue, offsetting price increases.	Exercise “put” option in 2026.	City loses $14.2 million. Loss is very sensitive to expenses and could be higher than $18.3 million if expenses grow faster than 3.25%.
Declining Revenue	-1.0%	3.25%	Utilization declines continue, more than offsetting price increases.	Exercise “put” option in 2026.	City loses $22.9 million. Or, the City could continue to operate garage past 2028 after bonds are retired.

Other Risks Inherent in the Put Option

The Council may wish to consider other factors in the City's ability to hold out for the put option. Additional risks include:

- Expenses rise faster than assumed. As the 1998-vintage structure ages, more equipment, such as lights and HVAC systems, may require replacement. The scenarios outlined above may understate such costs.

- The counterparty defaults. Central Staff currently have no information about the profitability or capital reserves of the Pine Street Group. However, it is not guaranteed that any business operating today will be in existence and able to pay $50 million to buy the garage in another 9-15 years. Brick-and-mortar retail operations face unprecedented competition from online retailers, such as Seattle's own Amazon.com, for many items, including electronic books. Movie theaters are similarly facing increased competition from download services, such as Netflix, that stream films to consumers' increasingly elaborate home entertainment systems. Future technology, such as 3-D printing capable of cheaply manufacturing household items, could increase such competition in the near future.

Options for Council Consideration

In evaluating CB 117719, the Council may wish to consider the following options, each of which has advantages and disadvantages.

1) <u>Sell the garage to Pine Street now, as proposed, for $55 million</u> and use the proceeds to defease some of the outstanding garage bonds. The General Subfund would need to support the remaining debt service through 2028, or until bonds can be called in 2018, whichever is preferable. The General Subfund would also support a re-payment schedule for the $4 million accumulated deficit in the Garage Fund.

   Pros
   - Provides certainty that the Garage Fund's financial position will not worsen.
   - Simplifies City operations by taking FAS out of the business of running a retail parking garage.
   - Reduces conflicts with Pine Street, who, after the sale, may set parking rates in a vertically integrated fashion (e.g. validation with purchase) that maximizes its overall utilization and retail revenue.
   - Future sales taxes and commercial parking taxes collected at the garage would become a net revenue to the City, since they would no longer also be a cost to the Garage Fund.

   Cons
   - About a $18 million net loss (plus interest on the debt) to the City. Note: this loss may be counterbalanced in view of the roughly $34 million in associated tax revenue increases since 1998 estimated by FAS.
   - The City's operating loss may reduce public confidence in future public/private partnerships.

2) <u>Solicit additional bids</u>. The City could market the garage condominium for general sale with the aim of securing a bid higher than the $55 million offered by Pine Street. However, there are several impediments to this approach. First, the umbrella agreement says that the City must receive Pine Street's "prior written consent" if selling to a private, non-governmental entity. It's not clear under what conditions Pine Street would offer such consent. Also, the garage recently appraised for $4-$5 million less than the offered price of $55 million, and an analysis from commercial real estate firm Colliers International concluded that any prospective purchaser besides the mall owner would likely discount that appraisal still further, given the restrictive operating conditions that would continue to attach to the operating agreement.

   Pros
   - A potential higher bid could reduce the net loss to the City.

   Cons
   - Changing course could cause Pine Street to rescind its offer.
   - Pine Street could refuse to provide its consent for the sale.

- The Garage Fund's accumulated deficit may grow in the time it would take to pursue other offers.
- Additional offers may not exceed $55 million.

3) Continue negotiations with Pine Street in an effort to improve the offer. The City could take the position that the "put" option in our contract gives us reason to believe that our costs will be covered in the future, so any sale today should come closer to making the City whole. This option would require the City to reasonably believe that Garage Fund revenue would increase at least nominally in the future, and that Pine Street would be able to make the purchase in 9-13 years.

Pros

- The City may be able to secure more than $55 million from Pine Street, lowering the net loss.

Cons

- Seeking further negotiations could cause Pine Street to rescind the offer.
- The Garage Fund's accumulated deficit may grow in the time it would take to pursue additional negotiations.
- The "put" could ultimately prove non-viable due to declining revenues, accelerating expenses, or a counterparty default.

4) Continue to operate the garage until the "put" option would make the City whole, then exercise the option. As explained above, this scenario would almost certainly require the City to float operational losses for an additional 9-13 years in the hopes that those losses were smaller than the debt principal payments.

Pros

- The City may be able to sell the garage to Pine Street in 9-13 years with $0 net loss.
- A good outcome for the City may increase public confidence in future public/private partnerships.

Cons

- Continued operation of the garage could increase FAS conflicts with Pine Street over pricing and garage upkeep.
- The "put" option could ultimately prove non-viable due to declining revenues, accelerating expenses, or a counterparty default.

5) Continue to operate the garage through the contract period (2028) and attempt to sell it for a profit. This would almost certainly require the City to float operational losses for the next 15 years. The sale could be accomplished in one of two ways:

a. <u>Pine Street exercises its "call" option</u>. The umbrella agreement also features a symmetrical "call" option under which, starting in 2018, Pine Street may compel the City to sell the garage for the greater of $73 million or 90% of fair market value. It's unclear whether Pine Street would choose to exercise this option in that timeframe.

b. <u>The City, bonds paid off, sells the garage to the highest bidder</u>. After 2028, the City may sell the garage to any party. At that point, the contract gives Pine Street the right to match the offer, plus 1.5%.

Pros

- Once the bonds are paid off, the City could continue to operate the garage and retire its accumulated deficit. The City could also potentially turn a profit on the sale of the garage.
- A good outcome for the City may increase public confidence in future public/private partnerships.

Cons

- Continued operation of the garage could increase FAS conflicts with Pine Street over pricing and garage upkeep.
- It's highly uncertain whether the 30-year-old garage would be worth $73 million before 2028.
- The garage is likely to require significant major maintenance over that time period.
- The City could suffer a net loss in a scenario that features both declining revenue and accelerating expenses. It's possible that the accumulated Garage Fund deficit could exceed $73 million by 2028.
- Letting an operating fund remain in a substantial negative position over this timeframe could impact the City's creditworthiness.