**MEMORANDUM**

February 21, 2020

**TO:** MEMBERS, PORT COMMISSION
Hon. Kimberly Brandon, President
Hon. Willie Adams, Vice President
Hon. Gail Gilman
Hon. Victor Makras
Hon. Doreen Woo Ho

**FROM:** Elaine Forbes
Executive Director

**SUBJECT:** Request authorization for staff to enter into a 99-year ground lease for Parcel E2 at the appraised value of $5,000,000 (185 Maryland Street; Assessor's Block 4116, Lot 008)

**DIRECTOR'S RECOMMENDATION**: Approve attached resolution

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**Executive Summary**

Port staff and the Port's development partner for the 28-acre Pier 70 mixed-use project site, Brookfield Properties ("Brookfield" or "Developer"), received appraised values for 99-year prepaid leases for two parcels. At the February 11, 2020 Port Commission meeting, Port staff described that one value is significantly above the expected value (office Parcel A appraised at $66 million, compared to a threshold value of $12.9 million, called a Down Market Threshold) and the other is below the Down Market Threshold value (rental residential Parcel E2, appraised at $5 million, compared to a Down Market Threshold of $11.3 million). To advance Port Commissioner's understanding of the values, Port staff met with several Commissioners after February 11th meeting and have included a new section in this staff report, formatted as underlined in the text below.

Unlike the lease process for Parcel A, which exceeds the Down Market Threshold and therefore triggers defined steps under the Development and Disposition Agreement (DDA) for Brookfield and the Port to follow to enter a lease, the $5 million value for Parcel E2 prompts a decision for each party – the parties may elect to proceed toward entering a lease at a value less than the Down Market Threshold, each in its sole discretion, or the parties may delay the lease and await improved market conditions.

To take advantage of the current strong office market conditions while also moving residential parcels towards delivery of much-needed housing units, Port staff have constructed the following offer for Port Commission consideration. In exchange for the

Port offering Brookfield an option on Parcel E2 at the appraised value, but below the Down Market Threshold for Parcel E2, Brookfield would align the schedules for Parcels E2 and A, exercise options for both parcels, and agree to shorten the time to complete closing on the Parcel A lease from 410 days, under the transaction documents, to not more than 180 days.

Because the value of these 99-year prepaid parcel leases will be used to repay Brookfield's horizontal costs expended plus the 18 percent return on those costs, the shorter closing period would save the project about $6.5 million in avoided developer return, assuming the Developer used all of its allowable time to close on the lease.[1] In addition to this monetary benefit to the project, proceeding toward closing on Parcel E2 allows the first apartment parcel at the 28-acre site to advance toward eventual construction. The delivery of the 281 total apartment units, 56 units of which are required to be affordable to households earning not more than 80 percent of area median income, is a key project benefit.

It is important to note that Brookfield has requested up to 120 days (within the 180 days noted above) to exercise its options and enter into binding contracts to lease each site. During this 120 days, the Developer will work to ensure that it can deliver both the apartment and office buildings in a financially feasible project.[2] If the Developer does not exercise options for Parcel E2 and Parcel A, both the Port and Developer would revert to existing rights under the DDA, which include disputing parcel values and extending performance timeframes, among other rights.

Port Staff is seeking approval of the attached resolution, authorizing staff to offer Brookfield an option to enter into a lease for Parcel E2 at the appraised value of $5 million, below the Down Market Threshold of approximately $11.3 million, in exchange for (a) tying the exercise of the Parcel E2 and Parcel A options together and (b) accelerating the closing timeline for Parcel A.

## Strategic Plan Alignment

Approval of the proposed resolution would advance the Port's achievement of Goal #6 in the Strategic Plan, Productivity, by furthering the Pier 70 development.

## Project Background

In September 2017, the Port Commission adopted a series of resolutions authorizing a mixed-use development project on the 28-Acre Site, the Illinois/20th Street parcels known as Parcel K North and Parcel K South, and the Hoedown Yard (together, the "Pier 70 Mixed-Use District Project" or "Project"). Subsequently, in October 2017, the San Francisco Board of Supervisors approved the Project, and on November 15, 2017, Mayor Lee signed all Project-related legislation.

[1] The costs saved under a shorter closing period is calculated by applying the $66M lease value at earlier points in time in the project cashflow model, with the savings achieved through the $66M lease revenues repaying the estimated outstanding developer capital plus return of about $100M, accruing an 18% return per year.

[2] New development of apartment buildings in San Francisco have faced financial difficulty. See December 16, 2019 San Francisco Chronicle article about the high cost of construction: https://www.sfchronicle.com/bayarea/article/SF-is-one-of-the-most-expensive-places-in-the-14888205.php

The Port's development partner for development of the 28-Acre Site is FC Pier 70, LLC, now an affiliate of Brookfield Properties. The 28-Acre Site project is governed by a DDA dated as of May 2, 2018 and related agreements between the Port and the Developer.

The Port approved the Phase Submittal for Phase 1 of the Project in May 2018. Horizontal construction of Phase 1 is underway and includes the development of 3 acres of parks and backbone infrastructure to support an anticipated 665 residential units and more than 100,000 square feet of maker/PDR/retail space.

## Local Business Enterprise Background

The Pier 70 project led by Brookfield has a 17% LBE participation goal. Contracts awarded through the Q3-2019 (end of September) were comprised primarily of Phase 1 horizontal improvement construction work and design consultants for upcoming vertical projects. Brookfield hired RDJ Enterprises, a LBE-MBE firm, to tailor LBE engagement efforts in order to maximize LBE participation on trade packages. Through Q3-2019, Pier 70 has awarded $100 million in contracts, of which $38.9 million or 38.9% have been awarded to LBE firms, including SBA-LBEs. $34.7 million or 34.7% has been awarded to small and micro-LBE firms. $17.6M or 17.6% of total contract dollars were awarded to small and micro-LBE firms located in the three zip codes (94107, 94124 & 94134) located next to the project area. Brookfield has been proactively working to increase the diversity of its team. Since November 2019, Brookfield has awarded and committed over $18 million to minority and women-owned businesses, including both LBE and non-LBEs (these contracts will be reflected in the reporting for Q4-2019 and Q1-2020).

## Parcel E2 and Parcel A

Under the DDA, the Developer has an option to purchase or lease all development parcels within the 28-Acre Site except the 100% affordable housing parcels (Parcels C1B and C2A), Parcel C1A, historic buildings 12 and 21, and the arts building parcel (Parcel E4). The Developer initiated the joint appraisal process for Parcels E2 and A in mid- and late-2019, respectively.

- Parcel E2 is a 50,875-square foot residential parcel entitled for approximately 280 rental dwelling units, 20% of which must be offered to households earning an average of no more than 80% of area median income ("BMR Units"), over ground floor retail and subterranean parking.

- Parcel A is a 53,981-square-foot office parcel entitled for development of approximately 350,000 gross square feet of commercial office over retail and subterranean parking.

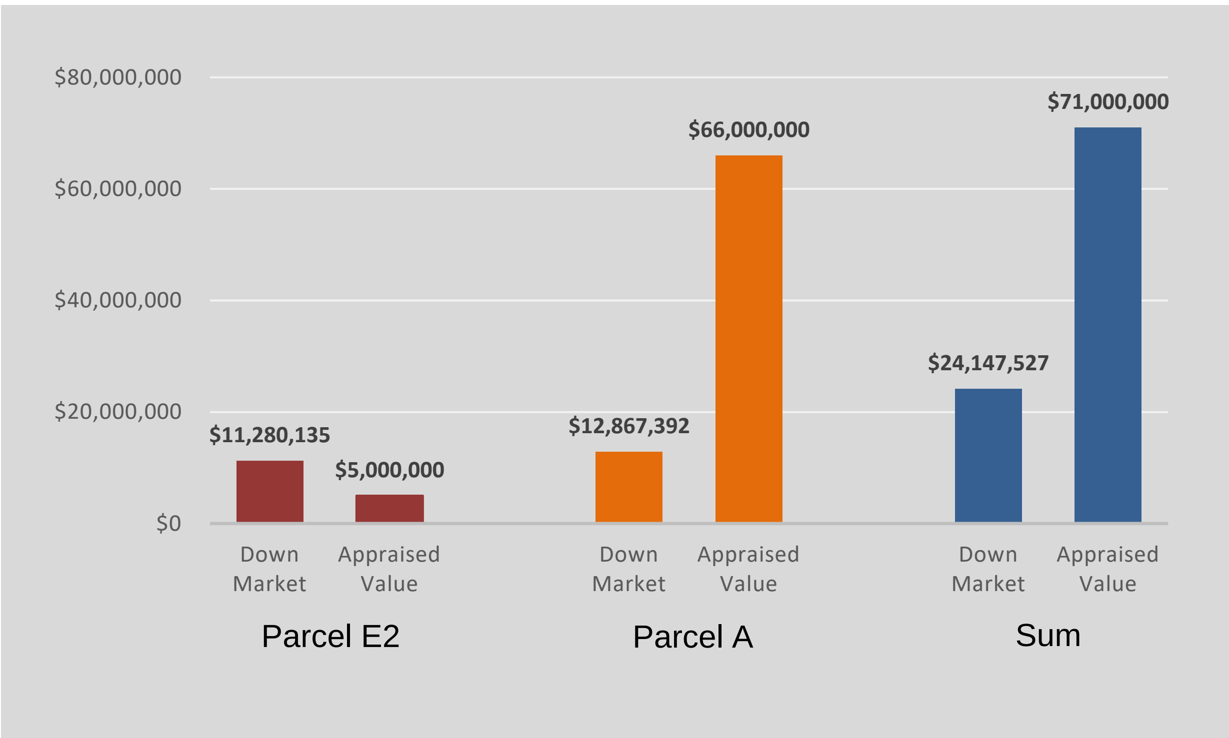
To aid Port's staff review of the appraisals, the Port retained two appraisal review consultants who assisted staff in a thorough review of the draft appraisals and submitted dozens of questions and comments to the appraiser. The appraised values in this report reflect the appraiser's independent evaluation of the fair market value of the parcels, after considering both Brookfield's and Port's comments and questions on draft appraisal reports.

As summarized in Table 1 and Figure 1, Parcel E2 appraised at a value significantly lower than the Down Market Threshold. Parcel A, on the other hand, appraised at a value significantly above the Down Market Threshold. These results reflect the current market conditions, where office rents are keeping pace with high construction cost inflation while residential rental rates are not.

***Table 1. Parcels A and E2: Summary of Use, Size and Value***

| *Item* | *Parcel A* | *Parcel E2* |
|---|---|---|
| *Primary Use* | Office | Rental Residential |
| *Building Gross Sq.Ft. (GSF)* | 350,000 | 319,000 |
| *99-year year, Down Market Threshold* | $12,867,392 | $11,280,135 |
| *$/GSF* | $36.76 | $35.36 |
| *99-year lease, Appraised Value* | $66,000,000 | $5,000,000 |
| *$/GSF* | $188.87 | $15.67 |

***Figure 1. Parcels E2 and A: Down Market Threshold and Appraised Values***



## Analysis

Per the terms of process set forth in the DDA, the Port and the Developer jointly contracted with an appraiser for parcel E2 and issued the joint appraisal instructions which are approved as part of the Pier 70 DDA. The appraiser submitted an initial draft report which both the Port and Developer were able to review and comment on. The draft appraisal had a value conclusion of $1,000,0000 (leasehold) and $5,000,000 (fee simple). Following receipt of the draft report, Port staff and two consultant firms hired by the Port submitted substantive feedback on various assumptions and conclusions in the draft report and requesting upward revisions to the concluded values. The Developer also submitted substantive feedback to the draft appraisal's value conclusions. After jointly meeting with the parties to discuss the comments, the appraiser submitted a final report with a value conclusion of $5,000,0000 (leasehold) and $9,000,000 (fee simple).

The appraisal used two key approaches to support the value conclusions: a residual analysis approach (which considered three component approaches: cost, sales comparison, and income capitalization) and a land-sales comparison approach.

- **Residual analysis approach.** The residual analysis considered the parcel-specific costs (e.g. special taxes, inclusionary requirements). The residual analysis approach considers the specific costs and revenues anticipated from the apartment development. This approach to value resulted in a negative value of parcel E2, implying that the development was not financially feasible. The draft appraisal residual land value approach resulted in a negative $13,435,558 valuation; after considering Port's and Developer's feedback on the draft, the final appraisal was revised up to negative $9,370,909.

- **Sales comparison approach.** The appraiser's land-sales comparison approach to valuation considers comparable sales of land for development. The appraiser identified three comparable land sale, including Parcel K North, the condominium site the Port sold in February 2019 located near parcel E2 at the corner of 20th and Illinois Streets. The sales comparison approach concluded a draft value of $7.1 million and then a final value of $14,100,000.

**The appraisal considers both approaches to value,** leading to the final reconciled value conclusion of $9,000,000 for sale of the E2 parcel and $5,000,000 for the prepaid 99-year ground lease. Note that the Port is only considering the 99-year prepaid lease value, the land sale figures are reported only for comparability to other transactions.

**Table 2** below summarizes both approaches in the parcel E2 appraisal.

*Table 2. Summary of Appraisal's Valuation Approaches*

| ***Summary of Value Indications*** | ***Fee Simple*** *(Sell the land)* | ***Leasehold **** *(99-yr ground lease)* |
|---|---|---|
| ***Residual Value Approach*** | | |
| *Stabilized Value* | $197,000,000 | $193,000,000 |
| *Replacement Cost* | ($206,370,908) | ($206,370,908) |
| ***Residual Value Conclusion*** | **($9,370,909)** | **($13,370,908)** |
| ***Land Sales Comparison Value*** | **$14,100,000** | **$10,100,000** |
| ***Reconciled Value Conclusion,*** *Considers both Residual Value Approach and Land Sales Comparison Value approaches* | **$9,000,000** | **$5,000,000** |

* The E2 parcel will be disposed of via a 99-year ground lease. The fee simple column is included for comparison purposes, as most real estate professionals are more familiar with land sale market data.

## Recommendation

Port staff recommend moving forward with the agreement summarized above to ensure that the project takes advantage of the current strong office market conditions while also moving residential parcels towards delivery of much-needed housing units. In exchange for the Port's agreement to offer the Parcel E2 option at the appraised value, Brookfield has agreed to shorten the closing period for Parcel A and to match the exercise of options for Parcels E2 and A to the same day. The closing period is the time between the parties entering a contract to close on a lease and the lease closing date, at which time the full $66 million parcel value is directed to repay the outstanding Developer costs plus 18 percent return. If Brookfield does exercise its options, this reduction in closing time period from 410days to 180 days would save the project about $6.5 million in Developer return accrual, assuming the Developer took the maximum time period to close on the parcel.

Staff requests that the Port Commission adopt the attached resolution authorizing staff to offer Brookfield an option to enter into a lease for Parcel E2 at the appraised value of $5 million, below the Down Market Threshold of approximately $11.3 million, in exchange for (a) tying the exercise of the Parcel E2 and Parcel A options together and (b) accelerating the closing timeline for Parcel A.

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See Attachment 1: Pier 70 Phase 1 Parcels

**PORT COMMISSION**
**CITY AND COUNTY OF SAN FRANCISCO**

**RESOLUTION NO. 20-07**

WHEREAS, Charter Section B3.581 empowers the Port Commission with the authority and duty to use, conduct, operate, maintain, manage, regulate and control the lands within Port jurisdiction; and

WHEREAS, On September 26, 2017, the Port Commission approved a mixed-use development project on the Pier 70 28-Acre Site, the Illinois/20th Street parcel known as Parcel K, and the Hoedown Yard (the "Project"); and

WHEREAS, On October 31, 2017, the San Francisco Board of Supervisors approved the Project and Mayor Lee subsequently signed all necessary legislation; and

WHEREAS, The Port's development partner for development of the 28-Acre Site is FC Pier 70, LLC ("Developer"), an affiliate of Brookfield Properties; and

WHEREAS, The 28-Acre Site project is governed by the Disposition and Development Agreement dated as of May 2, 2018 ("DDA") and related agreements between the Port and the Developer;

WHEREAS, Under the DDA, the Developer has on option to purchase or lease all development parcels within the 28-Acre Site except the 100% affordable housing parcels (Parcels C1B and C2A), Parcel C1A, historic buildings 12 and 21, and the arts building parcel (Parcel E4);

WHEREAS, In mid-late 2019, the parties initiated the joint appraisal process set forth in the DDA for development parcels: (1) Parcel E2, a 50,875-square foot residential parcel entitled for approximately 280 rental dwelling units, of which 20% must be offered to households earning an average of no more than 80% of area median income, over ground floor retail and subterranean parking and (2) Parcel A, a 53,981-square-foot office parcel entitled for development of approximately 240,000 gross square feet of commercial office over retail and subterranean parking;

WHEREAS, Parcel E2 appraised at a fair market value significantly lower than the minimum price, or "Down Market Threshold", set forth in the DDA (Down Market Threshold of $11,280,135 vs. appraised value of $5,000,000), while Parcel A appraised at a value significantly higher than the Down Market Threshold (Down Market Threshold of $12,867,392 vs. appraised value of $66,000,000);

WHEREAS, Pursuant to Section 7.4(d) of the DDA, if a parcel appraises at a value equal or less to the Down Market Threshold, the Developer may still elect to exercise its option at a price equal to the Down Market Threshold, or at an amount that is less than the Down Market Threshold by agreement between the Port and Developer, each in its sole discretion;

WHEREAS, Port staff recommend offering the Developer an option to enter into a 99-year parcel lease for Parcel E2 at the appraised value of $5,000,000. In exchange, the Developer has agreed to shorten the time it has to complete closing on the Parcel A parcel lease from up to 410 days under the DDA to not more than 180 days;

WHEREAS, Because the value of these 99-year prepaid parcel leases will be used to repay Brookfield's horizontal costs expended to date plus the 18 percent return on those costs, the shorter closing period on Parcel A would be worth more than $6.5 million, if the Developer uses the full time allowed to close on the lease. In addition to this monetary benefit to the project, proceeding toward closing on Parcel E2 allows the first apartment parcel at the 28-acre site to advance toward eventual construction; now therefore, be it

RESOLVED, That the Port Commission authorizes the Executive Director to offer Brookfield an option to enter into a lease for Parcel E2 at the appraised value of $5 million, below the Down Market Threshold of approximately $11.3 million, in exchange for (a) tying the exercise of the Parcel E2 and Parcel A options together and (b) accelerating the closing timeline for Parcel A.

***I hereby certify that the foregoing resolution was adopted by the Port Commission at its meeting of February 25, 2020.***

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***Secretary***