

CITY AND COUNTY OF SAN FRANCISCO
BOARD OF SUPERVISORS
BUDGET AND LEGISLATIVE ANALYST

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TO: Budget and Finance Committee 
FROM: Budget and Legislative Analyst
SUBJECT: January 9, 2013 Budget and Finance Committee Meeting

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Item 6
File 12-1170

Department:
Port

EXECUTIVE SUMMARY

Legislative Objective

The resolution would approve a Second Amendment to the lease agreement between the Port and Autodesk, Inc. (Autodesk) for the lease of additional office space and unimproved shed space at Pier 9 in the Northern Waterfront for a ten-year term beginning on or about January 15, 2013 to approximately January 14, 2023.

Key Points

- On September 11, 2012, the Port Commission approved a 66-month lease with Autodesk from October 1, 2012 through March 31, 2018 for approximately 8,391 square feet of office space and unimproved shed space located at Pier 9. The original lease was not subject to Board of Supervisors approval because it was for less than ten years and \$1,000,000 in revenues.
- The proposed Second Amendment, approved by the Port Commission on October 23, 2012, would:
 - (a) Increase the lease term from 66 months to 120 months (ten years);
 - (b) Increase the leased space from 8,391 square feet to 27,190 square feet of office space and unimproved shed space, an increase of 18,799 square feet;
 - (c) Require minimum tenant improvements of \$7,000,000, which includes construction and renovations to the building's shell and interior structure, installation of building systems, and for other tenant improvements; and
 - (d) Provide a rent credit of \$2,861,311 for construction of the building shell and installation of building systems.
- At the time of writing this report, Autodesk's construction estimates were \$4,185,998 for core and shell improvements and \$4,898,563 for tenant improvements, totaling \$9,084,561, or \$2,084,561 more than the minimum required improvement amount of \$7,000,000.
- The proposed Second Amendment impacts two existing Pier 9 tenants, including (a) termination of the existing lease between the Port and DNA Direct (DNA), and (b) relocation of Cabouchon Properties, LLC (Cabouchon) to a different office space on Pier 9.

Fiscal Impact

- Under the proposed lease, Autodesk will pay monthly base rent of \$55,444 which will increase by 3% per year, as shown in the Attachment to this report. Base rent will be offset by six months of rent abatement from January 15, 2013 to July 14, 2013 to allow for construction of tenant improvements and rent credits, as noted above. Over the ten-year term of the lease, the Port will receive net rent of \$4,474,676, as shown in Table 3 below.

Policy Consideration

- The Port did not competitively bid the original lease with Autodesk, consistent with Port practice to not competitively bid office and warehouse (shed) space. According to Mr. Bauer, the Port considered competitive bidding of the original lease between the Port and Autodesk to be impractical because the lease was for functionally obsolete office space and unimproved shed space, requiring the tenant to make improvements of approximately \$3,230,745. Because the City's Administrative Code Section 2.6-1, requires that leases of City-owned property be competitively bid, unless the Board of Supervisors finds that the bidding procedures for the leases are impractical or impossible, and legislation was not previously submitted by the Port to the Board of Supervisors to make such a finding, the Budget and Legislative Analyst considers approval of the proposed Second Amendment to be a policy matter for the Board of Supervisors.

Recommendations

- Amend the proposed resolution by changing line 22 of page 1 from "approximately 18,499 square feet of existing office space" to "approximately 18,799 square of existing office space" to reflect the correct increase in square footage from Autodesk's original lease to the expanded space as set forth in the proposed Second Amendment.
- Approval of the proposed resolution, as amended, is a policy decision for the Board of Supervisors.

MANDATE STATEMENT / BACKGROUND

Mandate Statement

In accordance with City Charter Section 9.118(c), any lease of City-owned property, modification to lease, amendment or termination of lease exceeding ten years and/or having anticipated revenue to the City of \$1,000,000 or more, is subject to approval by the Board of Supervisors.

Background

Autodesk, Inc. (Autodesk) is a publicly traded, American multinational corporation that focuses on 3D design software used in a variety of industries. On September 11, 2012 the Port Commission approved a lease with Autodesk for approximately 8,391 square feet of office space and unimproved shed space located at Pier 9 for a 66-month term that commenced October 1, 2012. The original lease was not subject to Board of Supervisors approval because it was for less than ten years and \$1,000,000 in revenues.

Autodesk is rapidly expanding and needs additional space to accommodate its growth. Therefore, the Port is proposing an amendment to the existing lease to increase the leased space and modify the existing terms.

DETAILS OF PROPOSED LEGISLATION

The resolution would approve a Second Amendment to the existing lease agreement with Autodesk for the lease of office space and unimproved shed space at Pier 9 in the Northern Waterfront for a ten-year term beginning on the effective date of the Second Amendment which is expected to be on or about January 15, 2013.

The proposed Second Amendment, approved by the Port Commission on October 23, 2012 would:

- (a) Increase the lease term from 66 months to 120 months (ten years);
- (b) Increase the leased space from 8,391 square feet to 27,190 square feet of office space and unimproved shed space, an increase of 18,799 square feet;
- (c) Require minimum tenant improvements of \$7,000,000, which includes construction and renovations to the building's shell and interior structure, installation of building systems, and other tenant improvements; and
- (d) Provide a rent credit of \$2,861,311 (see Table 3 below) for construction of the building shell and installation of building systems.

Details of the proposed Second Amendment are provided in the Attachment to this report, which was prepared by the Budget and Legislative Analyst.

The unimproved shed space that Autodesk is proposing to lease is currently used for parking, to house a trash compactor for the Waterfront Restaurant, and to store construction material. According to Mr. Jeff Bauer, Leasing Manager for the Port of San Francisco, two of the four office spaces that would be incorporated into Autodesk's expansion have been vacant since 2010 and are functionally obsolete.¹

Impact on Existing Tenants

The proposed Second Amendment impacts three existing Pier 9 tenants, including (a) termination of the existing lease between the Port and DNA Direct (DNA), (b) relocation of Cabouchon Properties, LLC (Cabouchon), and (c) the relocation of the Waterfront Restaurant's trash compactor.

Termination of DNA Direct Lease

Under the original lease between the Port and DNA Direct, which was effective from September 1, 2010 to August 31, 2014, DNA paid a blended rate of approximately \$2.35 per square foot per month for 7,137 square feet of office space and for 1,314 square feet of unimproved shed space and non-exclusive bathroom space, totaling 8,451 square feet.

¹ The space is not compliant with the Americans with Disability Act (ADA) or building standards under Title 24 within the California Code of Regulations.

On October 18, 2012, the Port Commission approved a Mutual Termination Agreement between DNA and the Port which enabled Autodesk to incorporate DNA's office, shed and bathroom space into Autodesk's total expanded space (27,190 square feet) under the proposed Second Amendment. Autodesk would pay a blended rate of approximately \$2.25 per square foot per month for the entire 8,451 square foot space, including the unimproved shed and bathroom space, which is consistent with the Port's FY 2012-13 Monthly Rental Rate Schedule.

The total reduction in rent revenues to the Port under the proposed Second Amendment for DNA's 8,451 square foot space is \$10,141 per year. However, according to Mr. Bauer, the overall benefit of the (1) 10-year lease term, (2) total expanded square footage, (3) 3% annual rent increase, and (4) estimated \$9,000,000 investment in Port property (see Table 1 below) exceeds the \$10,141 reduction in annual rent revenues.

Relocation of Cabouchon

Cabouchon formerly occupied office space on Pier 9 and was relocated to make room for Autodesk's expansion. Although Cabouchon's lease was not set to terminate until March 31, 2016, Cabouchon agreed to relocate to a smaller suite on Pier 9.

Pursuant to Cabouchon's lease terms, the Port was required to provide Cabouchon with a functionally equivalent relocation space. Autodesk agreed to pay Cabouchon \$225,000 for improvements to their relocated office space and in exchange, Cabouchon terminated its lease early and entered into a new, five-year lease with the Port for Suite 105 on Pier 9. Under the prior First Amendment to the lease, the Port incurs no liability for the relocation of Cabouchon.

The Waterfront Restaurant's Trash Compactor

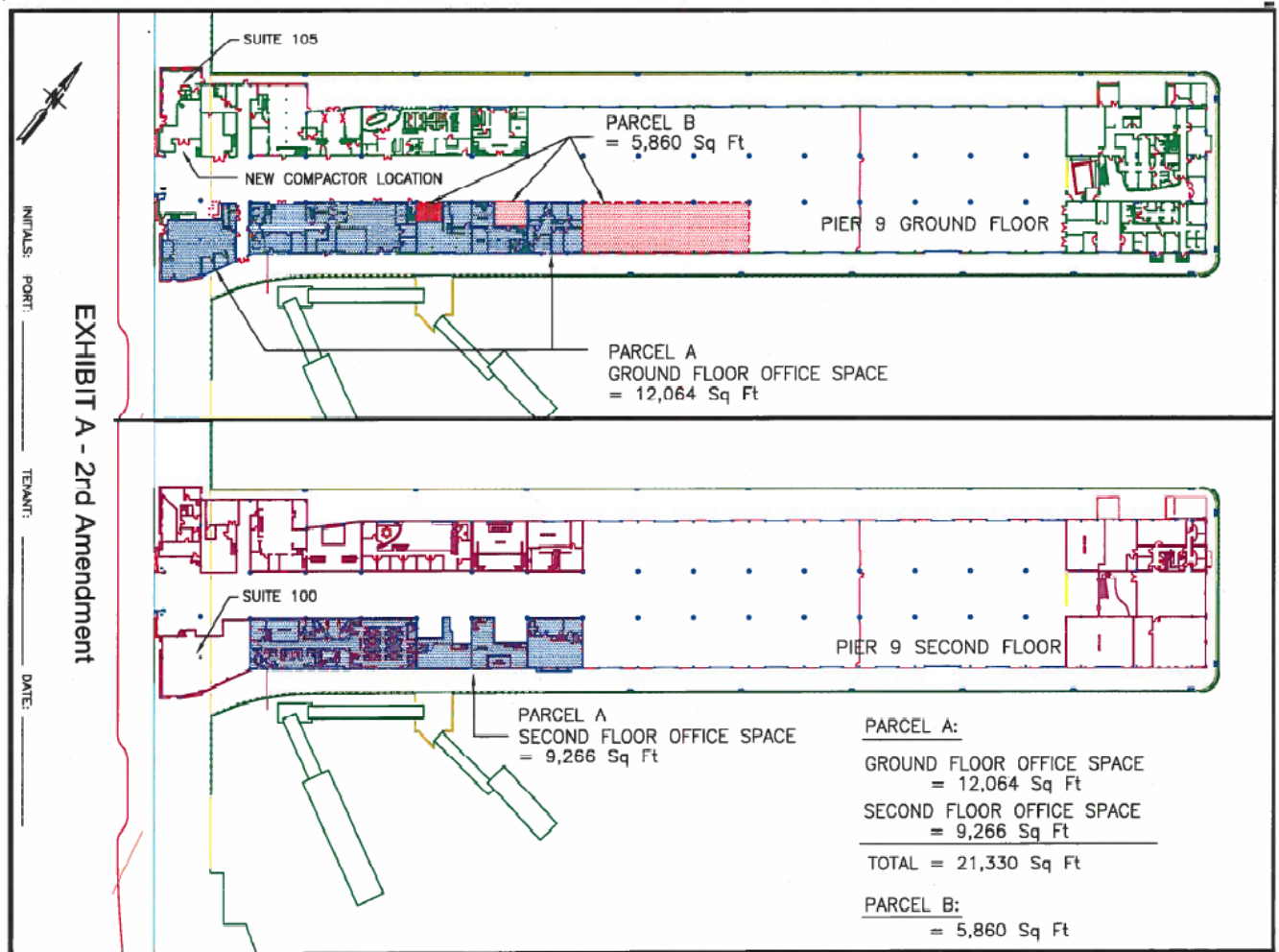
According to the original lease between Autodesk and the Port, Autodesk is required to relocate the Waterfront Restaurant's trash compactor at Autodesk's sole cost to a new trash room or to implement a new waste system within 30-days of the original lease's commencement date, which was October 31, 2012. The Port and Autodesk agreed to extend the date for the relocation until December 31, 2012 which Autodesk has completed on time.

Proposed Lease Space

As shown in Chart 1 below, the proposed lease contains a total of 27,190 square feet:

- (1) 12,064 square feet of office space on the ground floor and 9,266 square feet of office space on the second floor totaling 21,330 square feet of office space, and
- (2) 5,860 square feet of shed space.

Chart 1
Pier 9 Parcel A Office Space and Parcel B Shed Space



Pier 9 Improvements

Pier 9’s exterior space would be rented to Autodesk “as is” without any improvements or alternations by the Port. According to the proposed Second Amendment, Autodesk would be required to complete a minimum of \$7,000,000 of improvements consisting of core and shell improvements that would be offset by rent credits provided by the Port and tenant improvements that would be funded completely by Autodesk.

If Autodesk does not complete the improvements within six months of the Second Amendment commencement date, Autodesk is required to provide the Port with a deposit, either a cash or letter of credit, to complete the improvements.²

² According to Mr. Bauer, the Port generally requires a payment and performance bond for construction of improvements on Port property to protect the Port if the tenant fails to complete the improvements. However, it was agreed that Autodesk could provide cash or letter of credit because Autodesk has sufficient cash on hand.

As shown in Table 1 below, Autodesk will be making an estimated:

- (1) \$4,185,998 in improvements to Pier 9's core and shell which is Port property and can be offset by rent credits, and
- (2) \$4,898,563 in tenant improvements which benefit the tenant and cannot be offset by rent credits.

The major improvements that Autodesk will be making to the core and shell include: (1) an Americans with Disabilities Act (ADA) compliant elevator, (2) heating ventilation and air conditioning system, (3) fire sprinkler system, (4) flooring, (5) new electrical and natural gas service, (6) structure supports and seismic bracing, and (6) wall construction to enclose the unimproved shed space.

Table 1
Construction Costs for Pier 9 Improvements

Category	Core & Shell Improvements	Tenant Improvements	Total
Demolition	\$159,778	\$159,778	\$319,556
Sitework	46,707	11,676	58,383
Substructure	651,521	0	651,521
Superstructure	1,158,612	0	1,158,612
Exterior Skin	976,288	0	976,288
Roofing	199,473	0	199,473
Interior Construction	278,863	2,509,763	2,788,626
Conveying	73,358	0	73,358
Special Construction	0	70,000	70,000
Plumbing/Process Piping	115,299	214,127	329,426
Fire Protection	26,716	106,864	133,580
Mechanical	100,337	568,579	668,916
Electrical	99,007	891,061	990,068
Jobsite Management	240,732	294,228	534,960
Project Requirements	59,307	72,487	131,794
Total	\$4,185,998	\$4,898,563	\$9,084,561

Autodesk's total estimated construction costs of improvements of \$9,084,561, as shown in Table 1 above, are \$2,084,561 more than the minimum required improvement amount of \$7,000,000 set forth in the lease.

Rent Credits

Under the proposed Second Amendment, Autodesk would receive rent credits up to \$2,861,311, as shown in Table 2 below, which is intended to offset Autodesk's costs for improvements to the Port's property. The rent credits may be deducted in equal installments of \$25,099 per month

beginning the seventh month of the lease term and continuing until the end of the ten-year lease term.

Table 2
Pier 9's Capital Improvement Investments

Proposed Improvements	Total Cost	Less Port Rent Credits	Autodesk Costs
Core & Shell	\$4,185,998	\$2,861,311	\$1,324,687
Tenant Improvements	4,898,563	0	4,898,563
Total	\$9,084,561	\$2,861,311	\$6,223,250
Investment Percentage	100%	31%	69%

Six-Month Rent Abatement

Under the proposed Second Amendment, Autodesk would not be required to pay rent for the additional 18,799 square feet of existing office space and unimproved shed space for the first six-months of the Second Amendment, coinciding with the expected length of time to construct the above-noted improvements. The foregone rent during this six-month period, from approximately January 15, 2013 to July 14, 2013, is approximately \$332,664 (six months times \$55,444).

Existing Port policy allows Port staff to provide one-month of rent abatement for each year of the lease term, up to three-months without Port Commission approval. Under the Second Amendment, Autodesk would receive six-months of rent abatement which requires the Port Commission's approval. The Port Commission approved the six-month rent abatement period when the lease was approved by the Port Commission on October 23, 2012.

FISCAL IMPACT

The total net revenue that the Port would receive under the proposed Second Amendment for the first year would be approximately \$223,532 and approximately \$4,474,676 over the ten-year lease term, as shown in Table 3 below. The initial monthly rent for the approximately 27,190 square feet at Pier 9 is \$55,444 (see Attachment) and is projected to commence on July 15, 2013 after a six-month rent abatement period.

Rent for the space under the original lease for approximately 8,391 square feet is \$13,822 a month and is scheduled to commence on April 1, 2013, which is three-months earlier than the commencement date for the additional 18,799 square feet of space. This three-month period of rent of \$41,463 is included in the first year's total net revenues under "Three-Month Original Contract Rent" as shown in Table 3 below. The six-month rent abatement period for the original lease will not be reset by the Second Amendment.

The Port has negotiated a 3% annual rent increase per year over the ten-year lease term beginning on the first anniversary of the effective date of the proposed Second Amendment which is expected to be on or about January 15, 2013.

Table 3
Total Rent under the Proposed Lease

Year	Annual Rent	Three-Month Original Lease Rent	Six-Month Rent Abatement	Rent Credits	Total Net Revenues
1	\$665,328	\$41,463	(\$332,664)	(\$150,595)	\$223,532
2	685,284	0	0	(\$301,191)	384,093
3	705,840	0	0	(\$301,191)	404,649
4	727,020	0	0	(\$301,191)	425,829
5	748,824	0	0	(\$301,191)	447,633
6	771,288	0	0	(\$301,191)	470,097
7	794,436	0	0	(\$301,191)	493,245
8	818,268	0	0	(\$301,191)	517,077
9	842,808	0	0	(\$301,191)	541,617
10	868,092	0	0	(\$301,191)	566,901
Total³	\$7,627,188	\$41,463	(\$332,664)	(\$2,861,311)	\$4,474,676

Source: Budget and Legislative Analyst

Financial Feasibility

According to Mr. Bauer, Autodesk is in good financial standing based on the Port's criteria for determining credit worthiness. Autodesk's publicly available financial reports indicate that Autodesk's total net revenue to date for fiscal year 2013 is \$1,705,000,000; Autodesk's total cash and short-term securities to date for fiscal year 2013 is \$1,737,000,000.⁴

Minimum Net Effective Rental Rate

Each year, the Port Commission establishes "Minimum Net Effective Rental Rates" also referred to as parameters, according to commercial property use and location, and based on fair market value. The current Net Effective Rental Rates for Pier 9 are \$2.20 per square foot per year for office space and \$1.25 per square foot per year for shed space.

According to existing Port policy:

"Port staff has the authority to issue tenant improvement allowances for floor and wall coverings if those credits do not result in the net rent over the term of the lease to be below the Minimum Net Effective Rental Rates found in the Rental Rate Schedule."

Mr. Bauer noted that, with the exception of two suites located on Pier 9, the 27,190 square foot space that Autodesk is proposing to lease could not be leased at current Net Effective Rental Rates because it is functionally obsolete. Therefore, the proposed Second Amendment is consistent with the aforementioned Port policy as the Port will begin to receive rent revenues for space that could not currently be leased at Minimum Net Effective Rental Rates.

³ \$3 difference (\$4,474,676 compared to \$4,474,673) is due to rounding.

⁴ Autodesk, Inc. Quarter 3 Fiscal Year 2013 Earnings Release, November 15, 2012.

Calculation Error

According to page 1, line 22 of the proposed resolution, the increase in square footage from the Original Lease to the proposed Second Amendment is shown as “18,499 square feet.” The correct amount is an increase of 18,799 square feet. Therefore, the Budget and Legislative Analyst recommends amending the resolution to reflect the correct increase in square footage.

POLICY CONSIDERATION

The Port did not competitively bid the original lease with Autodesk, consistent with Port practice to not competitively bid office and warehouse (shed) space. According to the Port’s Leasing Policy:

“The Port usually enters into non-retail leases without competitive bidding, based on the Port’s Commission’s approved parameter rental rate policy and a finding, upon public hearing of the Port Commission, that bidding office, warehouse, open land or other (non-retail) leases is impractical.”

According to Mr. Bauer, the Port considered competitive bidding of the original lease between the Port and Autodesk to be impractical because the lease was for functionally obsolete office space and unimproved shed space, requiring the tenant to make improvements of approximately \$3,230,745.

Because the City’s Administrative Code Section 2.6-1, requires that leases of City-owned property be competitively bid unless the Board of Supervisors finds that the bidding procedures for the leases are impractical or impossible, and legislation was not previously submitted by the Port to the Board of Supervisors to make such a finding, the Budget and Legislative Analyst considers approval of the proposed Second Amendment to be a policy matter for the Board of Supervisors.

RECOMMENDATIONS

1. As noted above, amend the proposed resolution by changing line 22 of page 1 from “approximately 18,499 square feet of existing office space” to “approximately 18,799 square feet of existing office space” to reflect the correct increase in square footage from Autodesk’s original lease to the expanded space set as forth in the proposed Second Amendment.
2. Approval of the proposed resolution, as amended, is a policy decision for the Board of Supervisors.

Term	120 months (10 years)
Commencement Date	Approximately January 15, 2013, upon Board of Supervisors approval and Port execution of lease
Premises	<u>Parcel A</u> : 21,330 square feet of general office space, Pier 9 <u>Parcel B</u> : 5,860 square feet of shed space, Pier 9
Use	Office, research and development and workshop space
Initial Monthly Rent	Approximately \$2.25 for 21,330 square feet of general office space, Pier 9, Parcel A Approximately \$1.25 for 5,860 square feet of shed space, Pier 9, Parcel B Total: \$55,444
Rent Commencement Date	181 days from the Second Amendment (6 months) commencement date which is on or around July 15, 2013.
Lease Expiration Date	Anticipated January 15, 30, 2023
Rent Increase	3% increase on each anniversary of the Rent Commencement Date
Tenant Improvements	No less than \$7,000,000 of core and shell and tenant improvements within 180 days of the Commencement Date.
Rent Abatement Period	180 days for initial Lease and 180 days for expanded premises
Rent Credits	Autodesk will receive a maximum rent credit of \$2,861,311 from months 7-120 at a rate of approximately \$25,099.22 per month to offset the costs of core and shell improvements. Rent credits are contingent upon completion of improvements and will not be provided until a Certificate of Completion is issued.
Security Deposit	\$144,638.68 due no later than 3 days after the Second Amendment Commencement Date.
Termination Rights	Upon issuance of a Certificate of Completion for Tenant Improvements, the Autodesk can terminate the Lease on the last day of the 60 th month of the term with no fewer than 6 months' notice without a termination fee. Autodesk will not be entitled to any outstanding or unused Rent Credit for any of the unamortized tenant improvement costs.

Sublease Rights	The Port does not have an option to recapture any proposed sublease area if Autodesk requests Port's consent to a sublease. If Autodesk subleases space for more than Autodesk's monthly base rent, Autodesk must pay the Port the excess rent less the subletting expenses.
Maintenance and Repair	If the Port fails to maintain and repair the exterior of Pier 9, such as the roof, roof membrane, and exterior walls and doors, then Autodesk is permitted to make repairs at its sole cost and expense with the Port's consent.
Utilities	Autodesk is responsible for utilities.
Rights to Negotiate for Pier 9 Suites 100 and 105	Autodesk will have a one-time right to make an offer to amend this lease to add Suite 100 and/or Suite 105 if the current tenants do not wish to continue their lease.