General Services Administration Lease Procurement: Opportunities and Challenges

by

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Bachelor of Science Management/Finance, 2006

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Submitted to the Center for Real Estate in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate Development

at the

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General Services Administration Lease Procurement: Opportunities and Challenges

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Massachusetts Institute of Technology

ABSTRACT

In 2009’s fragile real estate market, many developers are looking for safe investments for their invested capital. Developers are looking to the federal government, specifically the General Services Administration, for growth and safety. The General Services Administration (GSA) is the contracting body of the U.S. federal government. It is the nation’s largest public real estate organization. It leases space from private developers in over 7,100 facilities across the United States comprising office buildings, border patrol stations, courthouses, warehouses, clinics, post offices and many other uses. The GSA pays over $4.6 billion in rent to landlords annually on nearly 181 million square feet of space. GSA is authorized by law to acquire, manage, utilize, and dispose of real property for most federal agencies.

The thesis is primarily based on interviews conducted with industry professionals: developers, financiers, brokers, and GSA contracting officials. It looks at the opportunities and challenges of working with the General Services Administration on new lease construction build-to-suits. It focuses on four areas; 1) the lease procurement process; 2) opportunities for new procurements in 2009’s market; 3) developer financed new lease construction build-to-suit projects; and 4) opportunities and challenges of financing projects in 2009’s credit crunch.

Thesis Supervisor: Gloria Schuck
Title: Lecturer
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PHOTO 1: DEPARTMENT OF TRANSPORTATION FACILITY COMPLETED IN 2007 IN WASHINGTON, DC
2009’s turbulent real estate market is causing many developers to wonder where they can find safety and growth for their invested dollars. A question on many developers’ minds is: What are the opportunities and challenges of constructing build-to-suit buildings for the federal government? As many large companies go bankrupt and tenant credit risk becomes a greater concern when building a new facility for an occupying company, developers are looking to the federal government’s credit rating to lease new projects. The federal government is providing an abundance of opportunities for developers¹.

The objective of this thesis is to evaluate the opportunities and challenges within the General Services Administration lease procurement process. The thesis focuses primarily on new lease construction. The thesis explores three specific areas in the GSA lease procurement process: the current growth trend, the procurement process, and the financing process.

The General Services Administration (GSA) is the contracting body of the U.S. federal government. It is the nation’s largest public real estate organization. It leases space from private developers in over 7,100 facilities across the United States comprising office buildings, border patrol stations, courthouses, warehouses, clinics, post offices and many other uses. The GSA pays over $4.6 billion in rent to landlords annually on nearly 181 million square feet of space².

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² Leasing Overview, Leasing Space to the Government, http://www.gsa.gov/Portal/gsa/ep/contentView.do?contentType=GSA_OVERVIEW&contentId=8317
GSA is authorized by law to acquire, manage, utilize, and dispose of real property for most federal agencies. These authorities are contained in title 40 of the U.S. Code, and GSA is responsible for its implementation. The U.S. Code is law passed by the United States legislative branch. Agencies are subject to title 40 authorities unless they have their own specific real estate authority and are exempted from title 40. Under title 40, GSA is authorized to enter into lease agreements for up to 20 years. GSA uses its authority to lease space on behalf of many federal government agencies.

For example, when the General Services Administration needed a new border patrol station in Sunburst, Montana, a city on the Canadian, United States border, it turned to private sector developers to design, construct, finance, and lease it. The GSA now pays annual rent to the owner of the border patrol station building. In the process, the GSA had to ask whether it thought it would be feasible to get $12.5 million appropriated for the station or whether it would rather seek $1,250,000 annually for a 20 year lease.

The first topic this thesis addresses is the current procurement process for GSA new lease construction known commonly as the Package Approach. The Package Approach refers to the procurement approach used by the GSA. To engage potential offerors, the GSA puts out a Solicitation for Offers (SFO) outlining the lease project details and requirements, with desired lease term and budget.

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3 GAO-08-197 Report, Federal Real Property.
4 Interview, May 28, 2009, Vice President, Jones Lang LaSalle.
5 “Bidding on Federal Leased Opportunities,” http://www.gsa.gov/Portal/gsa/ep/contentView.do?contentType=GSABASIC&contentId=25390
The real estate developer, known more commonly as an offeror, is expected to form a team of architects, engineers, and contractors to respond to the SFO. Many offerors take issue with the very high pursuit costs and protracted procurement processes. Some offerors are incurring as much as $500,000 to $1 million in direct costs to pursue a major GSA lease construction project, not including the opportunity costs involved in a one-year procurement process. This could explain why the best developers are shying away from GSA lease construction deals\(^6\). Other concerns with the current procurement approach is that the GSA never really gets the “dream team” to work on a project because the Package Approach forces the packaging of the team instead of allowing the GSA to choose the best of each team. The team is made up of a developer and a group of consultants such as an architect, mechanical and electrical engineer, and a general contractor. The team markets its experience in working together on past projects. This thesis explores whether there is a better way of GSA lease procurement than the Package Approach and what that may entail.

The second topic addressed in this thesis is the current growth trend in GSA lease procurement. Between 2007 and 2009, GSA leased space is expected to grow 7% from 175 million square feet to 187 million square feet\(^7\). The federal budget is strained with obligations to meet the global war on terrorism. With this drain on the Treasury, there has resulted a backlog of required projects and the search for privately financed methods for providing space. The federal government is using its authority granted under the Federal Property and Administrative Services Act of 1949. The Act grants the GSA leasing authority of up to 20 years for projects approved

\(^6\) Government Leasing News, Fall 2008, Patrick Keogh, AMV LLC.

\(^7\) David Winstead, Commissioner Public Buildings Service, U.S. General Services Administration, June 6, 2008
by prospectus submitted to special committees of both houses of Congress\textsuperscript{8}. The thesis explores whether the growth is expected to continue and where it is occurring. It also explores the question of how real estate developers are taking advantage of the growth in new lease construction with the GSA.

The third and final topic this thesis addresses is the financing process of the GSA new lease procurement process. The thesis explores what industry professionals see as innovative structures and what works and does not work in financing GSA leased projects.

The GSA has promised to issue a “securitized lease,” a lease with terms and conditions more attractive to the nation’s mainstream lending institutions\textsuperscript{9}. Without such a lease, the General Clauses of the standard GSA lease have continued to present underwriting concerns for financing facilities with GSA as a tenant. For example, the GSA can offset rent for failure in Landlord’s performance and may rightfully terminate for any casualty. The thesis explores whether it is more expensive to finance a GSA lease because of certain GSA lease provisions.

The thesis explores whether there are certain provisions in a GSA lease that can be changed in order to help a developer get less costly financing and in turn pass on the savings to the GSA. What tactics are developers using to get less costly financing?

\textsuperscript{8} Government Leasing News, Fall 2008, Patrick Keogh, AMV LLC.

\textsuperscript{9} Holland & Knight White Papers, Robert MacKichan, Summer 2007.
**METHODOLOGY:**

The views and opinions expressed in the thesis are based on interviews conducted with multiple industry professionals who are focused on the GSA lease procurement process. The comprehensive list of the interviewees is shown in the thesis as Figure 1.

<table>
<thead>
<tr>
<th>Organization</th>
<th>Category</th>
<th>Position</th>
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<tr>
<td>CB Richard Ellis</td>
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<td>28-May-09</td>
<td>Face-to-face</td>
<td>60 minutes</td>
</tr>
<tr>
<td>Studley</td>
<td>Broker</td>
<td>Executive Managing Director, Government Services</td>
<td>8-Jun-09</td>
<td>Phone</td>
<td>30 minutes</td>
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<tr>
<td>Jones Lang LaSalle</td>
<td>Broker</td>
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<td>27-May-09</td>
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<td>General Services Admin</td>
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<td>Assistant Commissioner</td>
<td>29-May-09</td>
<td>Face-to-face</td>
<td>45 minutes</td>
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<td>Government</td>
<td>Deputy Assistant Commissioner</td>
<td>29-May-09</td>
<td>Face-to-face</td>
<td>45 minutes</td>
</tr>
<tr>
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<td>29-May-09</td>
<td>Face-to-face</td>
<td>45 minutes</td>
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<td>JBG Companies</td>
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<td>Consultant, Urban Development</td>
<td>30-May-09</td>
<td>Face-to-face</td>
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<td>LCOR</td>
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<td>Vice President</td>
<td>28-May-09</td>
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<td>Duke Realty</td>
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<td>8-Jun-09</td>
<td>Phone</td>
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<td>Stonebridge Associates</td>
<td>Developer</td>
<td>Founding Principal</td>
<td>8-Jun-09</td>
<td>Phone</td>
<td>45 minutes</td>
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<tr>
<td>CTL Capital</td>
<td>Financier</td>
<td>Managing Partner</td>
<td>16-Jun-09</td>
<td>Phone</td>
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<tr>
<td>Bostonia Partners</td>
<td>Financier</td>
<td>Managing Partner</td>
<td>15-Jun-09</td>
<td>Phone</td>
<td>45 minutes</td>
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<tr>
<td>Asset Management Ventures, LLC</td>
<td>GSA consultant</td>
<td>President</td>
<td>27-May-09</td>
<td>Face-to-face</td>
<td>60 minutes</td>
</tr>
</tbody>
</table>

*Figure 1: Thesis Interviewees*

The interviews were conducted between May 27, 2009 and June 15, 2009. The interviewees preferred to remain anonymous but were willing to have their company names published in the thesis.

I asked the same questions of each person. Each interviewee was able to freely respond to the questions as they interpreted them based on their different backgrounds. I formed the following statements into questions for the purposes of my interviews.

1) **Interviewee’s background and introduction to GSA lease procurement.**

2) **Industry description of GSA lease procurement.**
3) Market players in the GSA lease procurement space.

4) Views on the Package Approach in GSA lease procurement.

5) Views on expected growth in GSA lease procurement.

6) Views on financing GSA leases.

7) Opportunities in GSA lease procurement.

8) Challenges in GSA lease procurement.

This thesis explores and outlines the opportunities and challenges of the lease procurement process with the GSA. It does not comprehensively capture all that is currently going on in this area of commercial real estate; however, it was necessary to narrow the scope of this thesis due to time and length constraints of the project.

Chapter two discusses the procurement approach of new lease construction and offers professionals’ views on the current procurement approach. It also discusses possible improvements to the process as recommended by those in the industry. Most of the information presented in this chapter is based on interviews with those that have many years of experience working with the GSA. Another source of information is The Government Leasing News conference addressing the procurement process.

Chapter three discusses the growth in the GSA new lease construction sector. It presents data on upcoming procurements the GSA plans to put out to the private sector in the 2009 and 2010. It presents where the opportunities may be for growth in the GSA’s new lease construction program.
Chapter four deals with the financing of GSA new lease construction projects. It explores how projects are being financed throughout 2009’s credit crunch. The chapter explains how leases with the GSA can be securitized in order to provide lower rate financing. Much of the information presented in this chapter is based on a presentation given by CTL Capital, one of the leaders in financing GSA projects, at the Government Leasing News Conference.

This chapter outlined the thesis and introduced the three main topics: the procurement process, the growth in GSA new lease construction space, and the financing of GSA new lease construction deals. It also detailed the methodology of the thesis and provided a list of the interviewees and topics. The next chapter examines the GSA’s new lease construction process.
CHAPTER 2: THE NEW LEASE CONSTRUCTION PROCUREMENT PROCESS

The GSA’s typical procurement process follows a similar pattern for each new facility. First, the GSA considers three or more sites for its proposed project. Next, it sends out a Solicitation for Offers (SFO) outlining the square footage, the rent threshold GSA can pay, specific security requirements the agency needs, and all other specifics, to the market. It also outlines the award factors making it lawful to award a project to a developer that does not provide the lowest priced option. Instead it can grant the procurement award based upon the developer’s experience, qualifications, and overall team\textsuperscript{10}. The SFO outlines the procurement methodology that GSA will follow\textsuperscript{11}.

Most often, the GSA awards its projects to the SFO offeror that proposes the lowest priced and technically acceptable solution. Offerors are expected to assemble a team that includes an architecture and engineering firm, a lead designer, and a general contractor, in order to propose a completed design concept before contract award\textsuperscript{12}.

Figure 2 shows the four procurement methodologies used by the GSA for new lease construction.

\textsuperscript{10} Sample SFO, 2009, Honolulu, HI, FBI Project.

\textsuperscript{11} Presentation, March 2008, Industry Roundtable, Lease Construction Procurement Process, General Services Administration.

\textsuperscript{12} Presentation, March 2008, Industry Roundtable, Procurement Methodologies, General Services Administration.
Figure 2: Procurement Methodologies, Lowest Priced, Best Value Tradeoff

The first procurement methodology detailed in Figure 2 is the Lowest Priced, Technically Acceptable methodology. This consists of GSA simply choosing the lowest priced option in a single-phase procurement process.

The second methodology, Best Value Tradeoff, can be run as either a single or two phase procurement. The Architecture and Engineering firm and lead designer are chosen after
presenting a design concept. The best value tradeoff selection process permits tradeoffs among price and non-price factors\textsuperscript{14}.

Two-Phase Design-Build is the third methodology. It provides for a two-phase procurement process. The first phase is a submittal by offerors of their experience and past performance. Once Phase I is completed, Phase II proceeds and technical evaluation and price are considered. The design concept is completed before award.

The final procurement method is essentially the same as the last. It is a Two-Phase Design-Build process. However instead of requiring a complete design concept before award, design concept drawings are required after award. Massing and early schematics are a requirement before the award is made.

Proposing new lease construction build-to-suits to the GSA can seem like a guessing game. What is the government looking for in their building? The procurement process is not a negotiation; it’s a bidding process. You don’t get a chance to sit down and negotiate a deal like you would if you were chasing a private sector tenant like IBM. Being able to navigate the procurement process is both a science and an art. It takes special skill to bring the private and public sector together. One broker commented that he felt like a translator between the language of the private sector and the language of the public sector\textsuperscript{15}.

\textsuperscript{14} General Services Administration, Subchapter C – Real Property.

\textsuperscript{15} Interview, Executive Director, CB Richard Ellis.
Developers have to be judicious about choosing which requirements to offer\textsuperscript{16}. The procurement process can take up to one year or more. It is imperative that the cost of capital outlay to chase the procurement is taken into account.

If a developer does not have a competitive advantage no offer should be made\textsuperscript{17}. Most of the developers interviewed for the thesis said they like to have a piece of ground under option or ownership that lies within the approved SFO area before they propose on any SFOs. Otherwise, it is hard to see where a developer can have a competitive advantage.

Stonebridge Associates, the developer of the new Department of Justice space in Washington, DC, said the GSA set out a timeline to have initial proposals in by late May 2008 with a final decision in September 2008 for a procurement it was chasing. The timing seemed reasonable. September came and went and the final award did not get awarded until February 29\textsuperscript{th}, 2009. During this time, four offerors were left wondering if they would be chosen. Their plans to build new buildings were on hold. The offerors took a chance in hopes they would get the award. Between $2-300,000 had been spent and put at risk by each offeror at this point. Each developer interviewed for the thesis expressed similar sentiment highlighting the protracted waiting periods and long procurement processes.

\textsuperscript{16} Interview, Executive Director, Duke Realty.

\textsuperscript{17} Interview, Partner, Stonebridge Associates.
The procurement process is different from a typical private sector procurement process for a reason. It creates a level playing field. After a SFO is put out, the GSA may get 40 offers back and they must consider them all18.

The reason for GSA’s current procurement process is simple. One executive director at a large brokerage said, “If GSA gave its employees wide ranging discretion to make their own decisions then you would likely have a lot of people committing fraud and it could easily cause a lot of screw ups19.”

Other criticisms of the process come from a GSA veteran, Patrick Keogh, who runs Asset Management Ventures, LLC (AMV). AMV is a firm that specializes in the formation of public and private partnerships. The private sector has many criticisms of the approach including the very high pursuit costs, protracted procurement process, no reasonable assurance of success, financing risks being inefficiently assigned, and the GSA never gets the “dream team.”20 Figure 3 lists difficulties private industry encounters in the current procurement process.

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18 Interview, May 28, 2009, Executive Director, CB Richard Ellis.

19 Interview, May 28, 2009, Executive Director, CB Richard Ellis.

As outlined in Figure 3, the high pursuit costs for each procurement make it a challenge for developers to go after more than a few of these deals at any given time. One developer spent over $100,000 pursuing a courthouse procurement in Montana only to see the prospectus rent decrease, making the 70% design drawings unfeasible to construct. In the end, another developer who was willing to re-design to adapt to the much lower rent prospectus won the procurement. Each of the four final offerors estimated total pursuit costs of $100-125,000 each for the project.

Figure 3 also highlights the adversarial relationship that can form in selecting the team with the lowest bid. The bidding process forces developers to commit to a fixed rent based upon the building it expects to build. Problems arise when the developer realizes the building costs much more than its general contractor had previously estimated. Suddenly what started as a friendly

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business relationship becomes an adversarial GSA to client relationship. If the developer cannot stick to its original bid, delays in the delivery of the completed facility can occur.

JBG Companies constructed the 1.35 million square foot Department of Transportation facility (See Photo 1). Instead of demanding that developers put together a full design for the buildings upfront, the GSA had its top four offerors propose a budget for the building it would build. In other words, the GSA outlined all the specifications of what it was looking for square footage wise, office layout wise, material wise, and location wise. This was pioneered for this single procurement by the consultant at JBG. The practice has not been used since at JBG Companies. However, it proved to be highly effective\textsuperscript{22}.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{department_of_transportation_facility_1024.jpg}
\caption{Department of Transportation Facility completed in 2007 in Washington, DC}
\end{figure}

\textsuperscript{22} Interview, May 29, 2009, Consultant, JBG Companies.
GSA chose its developer, JBG, for the project based on the best building budget and reputation. Its budget had the most money allocated to the actual construction of the building. GSA was looking to find the developer that could minimize soft costs in the budget in order to be able to allocate more money to hard costs and the actual construction of the building. This format worked well because it kept the procurement process short and to the point. JBG and all offerors spent less money chasing the procurement and were able to see an award decision made quicker than in a full design process. GSA was able to open up its offerors’ books and see the numbers behind the deal\(^\text{23}\).

Patrick Keogh, Asset Management Ventures, LLC, makes the case that GSA’s current new lease construction procurement approach is not used as best practice in the private sector for procuring major build-to-suit projects. Its current process is not prescribed by law or the Federal Acquisition Regulation (FAR) office so legislative barriers do not exist. Other methods have been tried before and Patrick Keogh of AMV believes that they have been more successful\(^\text{24}\).

Keogh proposes a method that would disaggregate the financing from the proposal. The financing is the single largest component cost of the project and the lessor does not control that, the markets do. The current process makes financing a zero sum game because the government cannot win. The GSA should amend all SFOs to allow for government provided financing and simply engage an advisor to design a financing structure. Upon the award, it can select the best financing proposal.

\(^{23}\) Interview, May 29, 2009, Consultant, JBG Companies.

While scoring rules from the Office of Management and Budget (OMB) precludes the
government from owning the lease construction property, they do not prevent the government
from harvesting the value of the ownership. This means the GSA can be certain the offeror
gets the best financing which can be passed on to the tenant through rent payments. Successful
financing structures could result in financing proceeds that help pay “rent” during construction.

Instead of choosing the team with the lowest bid on a project, a Request for Qualifications
process would be put in place. This would allow the GSA to focus on getting the best architect,
engineer, and developer all on the same team that the GSA puts together, effectively forming the
“dream team.” The GSA effectively focuses on “who” in the beginning and then says we will
figure out the “what” and “how” together. The process is open book.

Keogh argues that the disaggregation model puts both the GSA and the offeror on the same side
of the negotiating table. Because the team is selected before seeking pricing and financing, the
spirit of the process is ‘We’ll figure it out together’ as opposed to ‘We [GSA] prescribe. You
provide.’

Figure 4 shows the comparison between the current method of procurement and Keogh’s view
on the changes that may be possible through the disaggregation procurement model.

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By using a single-step “Request for Qualifications” process the procurement is advantaged; it goes from being potentially adversarial to cooperative. While a developer is usually worried about bidding within authorization limits, this single-step process allows the developer to design, build, and finance the project to the budget with the GSA and developer’s collective oversight.

In short, the developer is not forced to work in a vacuum and guess what the GSA is looking for in its facility. Instead, the developer has the advantage of being chosen early in the process and going through the design and construction with the GSA by its side.

Figure 5 outlines some of the advantages of the disaggregated process from the current procedure to Keogh’s new proposal:

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From a compensation perspective, the disaggregated procurement process changes the rules completely. Where the GSA does not have rights to view an offeror’s compensation model in the current process, the new approach allows the GSA to see what fees and other contingencies the offeror has in its budget. It becomes a fully open book. The GSA can negotiate these terms and provide incentives for the offeror if it can deliver the project below the budget as opposed to providing a basic fixed price contract\textsuperscript{28}.

Figure 6 shows the characteristics of the current form of compensation (left) versus the new process characteristics (right):

\textsuperscript{28} Presentation, May 27, 2009, Patrick Keogh, Contracting Public Private Partnering, Compensation, Government Leasing News Conference.
Keogh has presented this model to the GSA and they consider it “provocative\textsuperscript{30}.” However, there is no indication that the GSA is considering a shift in this direction. Many critics are worried that this will bombard the GSA with too much handholding and control through the development process as it actually sits side-by-side with the developer to make decisions. It proposes taking the pieces of development incrementally as opposed to tackling the whole thing at once. Critics worry about the GSA choosing members of the development team. What if the team is dysfunctional because they have never worked together on a project before? Others worry the process will give the developer a lack of incentive to find the best prices if it is not competing against a peer for the best fee\textsuperscript{31}. One developer said, “Selecting a developer so early

\textsuperscript{29} Presentation, May 27, 2009, AMV, LLC, Government Leasing News Conference.

\textsuperscript{30} Presentation, May 27, 2009, Patrick Keogh, Government Leasing News Conference.

\textsuperscript{31} Interview, May 29, 2009, Consultant, JBG Companies.
in the process makes it easy for the developer to be disinclined to find the best deal for the GSA because its fee is typically a percentage of the total project hard costs." 

In summary, there is no comprehensive solution to fixing the GSA’s lease construction procurement process. As the executive director said, the process works 80% of the time currently and it is set up so that government employees cannot commit fraudulent acts. While it may not be the most ideal process for developers, adopting a new process may take a long time and a lot of lobbying by developers. For now, the suggestions are merely “provocative” to the GSA.

The GSA’s new lease construction procurement process is seen as a different process than the typical private sector procurement process. It has been put in place to prevent fraudulent acts on behalf of the GSA. In order to facilitate a more streamlined process industry professionals recommend disaggregating the financial aspect of the procurement. The GSA is concerned with making the process attractive enough to keep developer competition high. One way it can do this is to minimize the upfront costs paid out by developers to compete for procurements. It may be able to help developers keep upfront competition costs down by only requiring developers to present a development budget instead of requiring a fully designed building.

The next chapter looks at the growth in the GSA new lease construction sector. It looks closer at where the bulk of the procurements will be constructed in 2009 and 2010.

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33 Interview, May 28, 2009, Executive Director, CB Richard Ellis.

CHAPTER 3: GSA NEW LEASE CONSTRUCTION GROWTH

The GSA’s leasing program is a flexible alternative if there is no available federally owned space and construction is not a viable option. Leasing from the private sector offers the GSA the ability to meet its agency customers’ space requirements in situations where space needs cannot be met by the existing federally owned or leased portfolio. The goal of the leasing program is to meet the needs of GSA’s agency customers at or below market prices. Leases are an attractive option for many agencies because they can provide flexibility in space acquisition and can accommodate short-term requirements. While the number of leased assets declined slightly in 2008, the overall number of leases increased to 8,596. More representative, the rentable square footage continued its annual upward trend, increasing to 177.5 million\(^35\).

2008 was a bell weather year for the GSA because it was the first time that the square footage in the leased inventory was larger than the square footage in the owned inventory. Without the injection of capital, to fund major new construction projects, the GSA expects this trend to continue\(^36\). This bodes well for private developers that are providing space to the GSA.

The GSA sees the crisis in the U.S. financial markets as an opportunity. The downturn in the overall economy is creating greater opportunities in GSA’s leasing program. Rent growth estimates have trended downward over the past seven quarters. In fact, the amount of cities with projected flat-to-declining rent growth has more than doubled\(^37\).


All of this creates opportunities where the GSA can enter into long-term leases at rental rates that are depressed, giving the taxpayers good value for their dollars. Further, with the financial markets still reluctant to lend and little private sector growth in new construction, GSA has a strong negotiating position in the market. GSA is bullish about exploiting these opportunities to lock in at lower lease rates throughout its portfolio and receive lower construction pricing\(^{38}\).

Over 39.1% or 71.8 million square feet of the portfolio consists of leases that are for 100,001 square feet or larger. Leases for space of up to 10,000 square feet only make up 11.6% of GSA’s overall leased portfolio. This indicates that the majority of GSA’s leases are for larger blocks of space\(^{39}\). This correlates well with the Managing Director at CB Richard Ellis who said that the GSA is increasingly looking to lease larger and larger blocks of space in the interest of being able to secure the building and have full control of building ingress and egress. GSA likes to be able to take full control of the security operations for its leased buildings.

Leases that are for 10,001 square feet up to 100,000 square feet consist of approximately 49.2% of GSA’s lease portfolio or 84.8 million square feet. The GSA encourages landlords from across the country to sign up for its online service, fedbizopps.com, allowing them to stay apprised of GSA growth in case they may be able to accommodate a space requirement.

The nation’s capital has the highest concentration of GSA leased facilities with over 29.8% or 52.9 million square feet of the overall leased portfolio. The next region, the southeast Sunbelt, is at 13.6% and 24.1 million square feet of the overall portfolio. The southeast Sunbelt consists of

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\(^{39}\) State of the Portfolio, fy2008, GSA, Portfolio Appendices, page a.17
such states as Florida, Georgia, North and South Caroline, Louisiana, and West Virginia. The smallest concentration of lease assets is found in the New England region where only 4.5 million square feet or 2.5% of the leased portfolio exists.

GSA’s leasing of private landlord facilities provides a good opportunity for growth and consistent demand. With its nearly 180 million lease square feet, it employs an average lease term of 7 to 8 years. Each year approximately 20-25 million square feet of leases roll. The GSA renews its leases 85-90% of the time. If the leases are stratified, a 5-10 year lease has a higher likelihood of being renewed. A 30 year-lease has a much lower likelihood of being renewed by the GSA. Over 20 million square feet of leases are up for renewal each year and 85% of them are renewed. That implies that 3 million square feet of leases will not be renewing; the GSA will be looking to absorb new space providing new demand in the market. Approximately 40% of those leases will be in the Washington D.C. market. Private landlords compete to attract the 3 million square feet of leased space into their buildings. This represents a constant demand pipeline in GSA leasing for brokers, developers, and financiers. All of this does not take into account new growth that occurs.

The main drivers of new lease construction growth are GSA’s security concerns and overall government reorganization. The main reason the GSA is making more new lease construction deals with developers is that it cannot find existing buildings that match its criteria for security. GSA’s number one concern is security. Many agencies in this post 9/11 period, such as the Federal Bureau of Investigation (FBI), are calling for more and more stringent and tough to

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40 State of the Portfolio, fy2008, GSA, Portfolio Appendices, pg. a.16.

41 Interview, May 28, 2009, Executive Director, CB Richard Ellis.
accommodate requirements. Building setbacks of 100 feet, protected, defended perimeters with anti-climb walls, blast resistant glass, and barriers that can stop a 5000 pound vehicle coming at 50 miles per hour all make it hard for the GSA to lease existing facilities in urban areas. Instead of leasing an existing building and retrofitting the asset, it is finding it more cost effective to lease newly constructed build-to-suit facilities for its agencies\textsuperscript{42}.

The assistant commissioner at the GSA thinks that in the future the OMB will push for less lease construction. Law enforcement buildings that are highly specialized will be funded through federal construction. A vice president at Jones Lang LaSalle argues that ever since 1980 the Government Accountability Office has warned that the GSA should lease less space and own more. The GSA consistently pushes to go in that direction but continually faces pushback from Congress where it cannot get full appropriations for its projects. Funding oftentimes limits GSA’s ability to finance federal construction and so it turns to leasing instead for growth. The pressure is consistently on GSA to lease less because of perceived higher costs of occupancy compared to ownership.

In fact, in the February 2008, Government Accountability Office (GAO) report, the GAO recommends to the GSA:

“OMB, in conjunction with the Federal Real Property Council (established by the administration to help support reform efforts in real property), and in consultation with key stakeholders, should develop a strategy to reduce agencies’ reliance on leased space for long-term needs when ownership would be less costly. OMB generally agreed with the report and GAO’s recommendation\textsuperscript{43}.”

\textsuperscript{42} Interview, May 29, 2009, Assistant Commissioner, General Services Administration.

This further confirms the sentiment that the GSA is getting pressure to slow down the growth of its new lease construction projects. The pressure is coming from OMB and indirectly from the GAO.

The GAO’s report further detailed what it found as it examined ten leases and compared them to what it would cost the federal government to own the buildings instead of lease over a 30-year period:

In the 10 leases we examined, decisions to lease space for long-term needs that would have been more cost-effective to own were driven by the limited availability of capital for ownership and other considerations, such as security and operational efficiency. For four of the seven GSA leases we analyzed, leasing was more costly over the long term than construction—by an estimated $83.3 million over 30 years. For example, GSA executed leases for the Federal Bureau of Investigation's (FBI) field offices in Chicago in 2006 and in Tampa in 2005. These leases were estimated to cost $40 million and about $7 million more, respectively, than federal construction over 30 years. GSA officials said they entered into these leases because GSA lacked up-front capital at that time and there were security considerations. For GSA, limited funding for construction is exacerbated by federal budget scorekeeping rules, which require, for ownership and capital leases, that the full cost of the government's commitment be recorded in the budget in the first year. In contrast, for operating leases, only the amount needed to cover yearly lease payments plus cancellation costs is required to be recorded in the annual budget, thereby making operating leases "look cheaper" in any given year. This is a long-standing challenge, and overreliance on leasing is one of the major reasons we designated federal real property management as a high-risk area.

This report highlights the fact that FBI buildings would be less costly in the long term through using federal construction instead of leasing the buildings, to the tune of $40 and $7 million, respectively. It is important to note that OMB’s pressure on the GSA is not a new dynamic.

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45 Interview, May 27, 2009, Vice President, Jones Lang LaSalle.
OMB has been concerned about the continual growth in GSA new lease construction, especially as it relates to the FBI projects since 1980\textsuperscript{46}.

The GSA Assistant Commissioner points to courthouses in Billings, Montana and Bakersfield, California; they were recently changed from new lease construction projects to federal construction, owned by the federal government. Procurements for FBI projects in Yuma, Arizona, San Juan, Puerto Rico, Detroit, Michigan and Miami, Florida all have stalled due to budget problems. It remains unknown whether these will end up being funded by Congress as federal construction or whether they will stay as new lease construction projects\textsuperscript{47}.

Overall government reorganization and expansion is driving growth of leased facilities as well. For example, the Department of Homeland Security (HLS), formed in 2001, consisted of over 100 different entities. HLS’ creation has created a re-alignment and consolidation within the government. HLS is poised to build a new headquarters building soon so its agencies are not so fragmented. This is likely to be a GSA new lease construction project, which provides growth to the GSA leased portfolio\textsuperscript{48}.

Government expansion is occurring very rapidly. The new administration is creating new jobs. In response to 2009’s economic crisis, the federal government’s stimulus bill is growing government in order to curb job loss. Agencies are expanding. Demand for new buildings is coming from government’s need to house employees overseeing federal government bailout

\textsuperscript{46} GAO Report, February 2008, Federal Real Property.

\textsuperscript{47} Interview, May 29, 2009, Assistant Commissioner, General Services Administration.

\textsuperscript{48} Interview, May 28, 2009, Executive Director, CB Richard Ellis.
programs. An Executive Director at CB Richard Ellis recently completed a 200,000 square foot project providing new space to Troubled Asset Relief Program (TARP). More demand for office space will continue as other agencies are formed and more hiring occurs within the federal government\textsuperscript{49}.

As the federal government becomes part owners in car companies, banks, and other businesses, the plumping up of the Treasury will likely occur. The agency having the responsibility to oversee these public-private organizations will need more office space. The federal government does not have excess space to house these people\textsuperscript{50}.

Analogous to GSA lease procurement growth and the scarce funding sources for federal construction, the consultant at JBG Companies asked, “If you have 28 kids and they all need a place to live, what do you do? If you have the money then go ahead and build you a house. If not, then use private developers to build it and just pay rent.” This simulates the dilemma the GSA runs into each day because it is forced to lease instead of federally construct because it is short on appropriations\textsuperscript{51}.

The $787 billion stimulus act signed into law by President Obama in 2009 is not expected to provide large direct growth in the GSA new lease construction sector. The bill provides over $5 billion to the GSA for the “greening” of existing federally owned buildings. In the bill, there is little more than $100 million allocated for “swing space,” in order to house agencies that must

\textsuperscript{49} Interview, May 28, 2009, Executive Director, CB Richard Ellis.

\textsuperscript{50} Interview, May 29, 2009, Consultant, JBG Companies.

\textsuperscript{51} Interview, May 29, 2009, Consultant, JBG Companies.
move out while their buildings are being retrofitted. This will provide a short-term opportunity for landlords to provide space for the respective agencies.

Under the Obama administration’s 2009 budget, funding will increase for government agencies such as the National Institute of Health (NIH), part of the Federal Drug Administration (FDA) and decrease for the military. This is likely to fuel more new growth in the GSA new lease construction sector. During the Bush administration, the NIH stopped growing as its budget was only increasing 2-3% per year. Compare that growth to the NIH’s budget growth under the Clinton administration at 15% per year. Over four years, NIH grew 100%. The NIH is expanding and it does not have room to grow. This will likely provide new lease construction growth. This growth is not specific to the Washington D.C. area. These agencies are growing throughout the country.

Figure 7 shows the immense amount of growth in the GSA lease construction project space.

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52 Interview, May 28, 2009, Vice President, LCOR.
Forty-five projects are in some stage of proposal and planning. The projects with AA next to them indicate that the GSA has authorization to award the projects to a private developer for construction. Thirty of the projects the GSA plans to construct are FBI projects.

Figure 7: Major GSA Lease Construction Projects

Figure 7 illustrates the GSA’s effort to make leasing to the federal government a countrywide opportunity. There is no concentrated geographic area that benefits substantially over the next. California is the beneficiary of 5 of the 45 projects. Of the five projects in California, four of them are FBI field offices. The chart highlights the delay in the procurement process. Honolulu’s FBI office was approved for the 2008 budget. The Solicitation for Offers was released in June 2009. It is likely that the process will spill into 2010.

Lease terms are shorter than 20 years for some procurements. However, the FBI field office procurements are 20-year lease terms. These longer lease terms help mitigate developers’ worries about the extremely high costs of construction especially in light of the asset’s extremely specialized architecture.

These projects have the development community buzzing and ready to compete in a market that does not have many build to suit growth opportunities. A typical procurement attracts 15 to 25 developers who are vying for the chance to lease to the GSA. For the most recent Phoenix, Arizona FBI response to the Solicitation for Offers, the GSA received 25 responses from willing developers. Many developers are interested in doing business with the GSA. Completing build-to-suits for the GSA is a flight to safety and quality for developers who seek growth in a down economy.

This chapter explored the growth of the GSA’s new lease construction program. FBI field offices are in high demand. 2009’s stimulus act does not provide direct growth opportunities for private developers. Indirectly private developers will see demand for new procurements to house

\[54 \text{Interview, May 27, 2009, Vice President, Jones Lang LaSalle.}\]
new agencies created, such as TARP, and people in “swing space” while buildings are being “greened.”

With all of this growth in the GSA new lease construction sector, the question remains—will private developers be able to obtain financing in 2009 to facilitate the construction of the needed space? The next chapter explores tactics developers and the GSA can use to finance these new projects in 2009’s credit crunch.
CHAPTER 4: THE FINANCING PROCESS

The current 2008-2009 credit crunch is causing many new lease construction GSA projects to stall, go through protracted litigation, or simply not get built. The credit crunch refers to the unwillingness of lenders to lend money to real estate developers. The tough current market for financing is considered a market disruption and many hope that the old ways of financing projects will return. Financing for government leasing deals (where leases are backed by the full faith and credit of the United States) has always been lower than that for more risky ventures. Lessors of government-leased building have typically obtained financing more easily and on less costly terms than other borrowers.

As of February, 2009, GSA identified 21 lease projects that it believes have been impacted by the lessor’s inability to secure funding resulting in delayed delivery of space or a need to re-compete the procurement. Several lessors have experienced difficulty obtaining financing for the tenant improvements. Others have withdrawn from procurements due to their inability to obtain financing. These delays can add cost to the overall project and impact GSA’s client agencies ability to fulfill their mission.

Financiers and developers are looking for creative ways to accommodate the GSA’s needs and sidestep the current risk-averse position of real estate lenders. One of the ways developers are

55 Interview, June 15, 2009, Managing Partner, Bostonia Partners.


getting the deals financed is by using the Credit Tenant Lease (CTL). A CTL is a method of financing real estate. The landlord borrows money to finance the property and pledges as security the rents to be received from the tenant. Usually, the financing is structured as nonrecourse debt, and the lease is structured as a triple net lease\(^58\). In this case the federal government is the credit tenant and the landlord is the developer who wins the procurement.

In the past CTL’s have been used on larger, more complex projects in order to obtain more favorable financing. A CTL signed between a developer and the GSA allows the real estate transaction to be stripped into both a real estate piece and a credit piece. The idea is to take advantage of the superb credit rating of the federal government in hopes of getting the developer lower cost financing for the project. After all, there is no piece of real estate that has quite the same intrinsic value as a piece of real estate occupied by the federal government with its unparalleled promise to pay\(^59\).

The lease rental payments associated with the CTL amortize down the majority of the project cost for the borrower. However, oftentimes there is a remaining amount owed to the lender that is not amortized down at the end of the lease term. The only way to handle financing the remaining residual value of the building that goes unamortized is to sell the note to a mortgage buyer who will assign a higher spread to the loan than the initial securitized loan proceeds. The


\(^{59}\) Interview, June 15, 2009, Managing Partner, Bostonia Partners.
real estate desk of commercial banks understands the real estate aspects of these deals. However, bond traders, in the end, are the buyers of the rental stream of payments\(^{60}\).

The CTL is a special lease that has atypical lease clauses allowing it to look more like a triple-net lease than the typical gross lease used by the government. It is an exchange of limited risk, yielding better financing and more competitive rental rates. The GSA likes it because if the risk is properly assessed and managed through the use of standardized modifications to certain clauses in the lease, the GSA can access increased benefits through lower rent. Financial institutions can better collateralize the base rent at the GSA’s high credit rating\(^{61}\). The more the lease looks like a triple net lease, which is a clean stream of payments from the federal government, the more the spread over the 10-year treasury can be minimized in financing the transaction. The stream of payments can be sold to hedge funds and insurance companies with much lower spreads than a traditional real estate loan. This is because the loans are seen to be similar to a bond issued by any other American corporation such as Nabisco or Johnson and Johnson, only with better credit behind the payments\(^{62}\).

A triple net lease is an agreement that designates the lessee (the tenant) as being solely responsible for all of the costs relating to the asset being leased in addition to the rent fee applied under the lease. The structure of this type of lease requires the lessee to pay for net real estate taxes on the leased asset, net building insurance and net common area maintenance. The lessee


\(^{61}\) Presentation, June 11, 2008, GSA Lease Construct Industry Roundtable at the Madison Loews Hotel, Washington, DC.

\(^{62}\) Interview, June 15, 2009, Managing Partner, Bostonia Partners.
has to pay the net amount of three types of costs, which how this term got its name. The net rent is lower than a gross rental rate. The GSA uses gross leases. A gross lease is all-inclusive. The tenant pays rent only; the owner pays all expenses related to the property.

CTL’s can attract capital at rates between 125-175 basis points over the Ten Year U.S. Treasury. The bond market has the most efficient execution for procuring financing because it is accurate and good at assessing risk.

The pink stars on Figure 8 show where GSA leased bonds based on a CTL with the GSA have been financed historically. As the chart shows, the use of the CTL has made it possible for offerors to receive financing rates below where public corporate bonds are priced. Efficiencies of the public corporate bond market make it possible for developers to receive similarly low rates when financing GSA transactions. The market is struggling to really know where these financeable bonds should be priced in 2009:

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65 Interview, May 28, 2009, Executive Director, CB Richard Ellis.

66 Interview, May 28, 2009, Executive Director, CB Richard Ellis.
Clauses in a CTL allow it to look more like a bond than a traditional real estate transaction. Effectively, the CTL defines its default provisions more thoroughly. Its rent payments service the financial obligations along with the operating, insurance, repair and maintenance responsibilities all in one payment. The three components of the CTL are outlined more clearly in Figure 9 showing how the rental stream is categorized into three different areas: the space lease, the service agreement, and the service agreement reserve.

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68 Presentation, June 11, 2008, GSA Lease Construct Industry Roundtable at the Madison Loews Hotel, Washington, DC.
Figure 9: Credit Tenant Lease Components

The space lease encompasses the actual rent for the space. Rental payments can only be reduced or terminated for casualty or fire or if the space is not delivered on time and to specifications.

The service agreement encompasses the service agreement that is separate from the space lease. The service agreement provides the landlord with service rent for the operating expenses, taxes, insurance, repairs, maintenance, and management fees. Payments for the service agreement may be terminated partially or fully if service are unsatisfactory.

Finally, the service agreement reserve is put in place to act as additional security for the government. It is comprised of an amount representing up to 10% of the annual base rent, funded through the service agreement rent. The service agreement reserve is the place the GSA looks when it wants to offset rent beyond the notice or cure period in the lease.

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69 Presentation, June 8, 2008, General Services Administration, Lease Construct Industry Roundtable.

70 Presentation, June 8, 2008, General Services Administration, Lease Construct Industry Roundtable.
Some of the specific differences with the CTL include a lower requirement for reserves. The Failure of Performance Clause in most GSA leases allows the GSA to self-help and make necessary repairs to its premises as it sees fit and, in turn, pass the cost to the landlord. This leaves the lender exposed to a liability that it does not want. However, the CTL allows for a smaller reserve account that limits the amount of self-help the GSA can do in its lease to the amount of money in the reserve account. It also gives the lessor and lessee (the GSA) the rights to cure and give notice to each other in the event of a default.\textsuperscript{71}

Essentially, the base rent is more secure by the GSA agreeing to take on more risk than previously. The general counsel at the GSA agrees that in order to continue to get GSA new lease construction transactions done, the GSA has already and will continue to take on slightly more risk in order to make it possible for developers to finance new construction lease deals with the GSA\textsuperscript{72}.

Another clause where GSA takes on more risk in the CTL is the Development and Delivery Clause. This means that should the developer not deliver the premises in an acceptable condition, according to the GSA’s opinion, the agency no longer holds a provision that allows it to walk away from its lease obligation, as it does in most of its leases. Where the GSA would traditionally be able to withhold all rent and walk away from the lease, the CTL limits its ability

\textsuperscript{71} Interview, May 29, 2009, Legal Counsel, General Services Administration.

\textsuperscript{72} Interview, May 29, 2009, Legal Counsel, General Services Administration.
to withhold rental payment to the Service Agreement Rent, or reserve account, and provides for a cure period before the GSA can pursue additional remedies against the lessor\textsuperscript{73}.

The last clause that is different in the CTL is the fire and casualty clause. In a traditional lease with the GSA, repairs or reconstruction of the premises are not addressed. However, the CTL allows the lessor to provide repairs and a reconstruction period while still allowing the GSA to stop paying rent. Gap insurance is purchased as part of the bond issuance behind the CTL to payback the bondholders in the event of a total loss of the real estate asset during construction\textsuperscript{74}.

As noted in Samuel Morris’ testimony\textsuperscript{75} before the Transportation and Infrastructure Subcommittee on March 20, 2009, the CTL provides a way to make the GSA lease construction transaction more attractive to lenders to finance in a frozen credit market. JBG Companies used the CTL to finance the Department of Transportation’s 1.35 million square foot headquarters.

Figure 10 outlines the three main clauses that are refined in a CTL differentiating it from other traditional GSA leases.

\textsuperscript{73} Slide 20, Presentation, June 11, 2008, GSA Lease Construct Industry Roundtable at the Madison Loews Hotel, Washington, DC.

\textsuperscript{74} Interview, June 15, 2009, Managing Partner, Bostonia Partners.

Each clause represents a shift of more risk to the GSA. First, with respect to Development and Delivery, the CTL limits withholding rent to the Service Agreement Rent and provides a cure period prior to pursuing any additional remedies. Second, with respect to the Failure to Perform or Default provisions, the CTL limits withholding rent to the Service Agreement Rent and the Service Agreement Reserve. Additionally, the CTL spells out the definitive periods of time to cure. The traditional lease would permit withholding all rent in a failure to perform or default situation. Finally, with respect to the Fire and Casualty clauses, the CTL allows the GSA to withhold all rental payment, but allows for a repair and reconstruction period. Repair and reconstruction periods were not addressed in the traditional lease. These three provisions are detailed in Figure 10.

76 Presentation, June 8, 2008, General Services Administration, Lease Construct Industry Roundtable.
THE EQUITY PROBLEM:

It used to be that a lender would make a construction loan and believe in the future value of the projects and that obtaining a permanent loan would be no problem. Even with a government lease in 2009’s real estate market, it is not easy to finance 70-75% of the cost of the building\textsuperscript{77}. Equity capital is very impatient\textsuperscript{78}.

In 2004, only five years ago, developers could finance new GSA lease construction with 100% debt and leave no equity in the project. In 2009, developers are required by banks to leave up to 30-50% of their equity in the projects\textsuperscript{79}. Lenders have begun to use a Loan to Cost formula as opposed to a Loan to Value formula. These challenges coupled with the fact that construction costs have increased while prospectus rents have not kept up have made it increasingly tough to accomplish GSA new lease construction transactions done.

There is significant equity flowing into these projects. These conditions have created an immense need for equity holders such as USAA, Blackstone, Prudential, and BlackRock\textsuperscript{80}. As more equity is added to the capital stack for these projects, it is becoming harder and harder to entice developers to compete on new lease construction projects. Equity requires returns in the 13% range and debt is still at 6.5%, but the GSA is realizing that the overall cost of funds is

\textsuperscript{77} Interview, May 28, 2009, Executive Director, CB Richard Ellis.

\textsuperscript{78} Interview, May 28, 2009, Vice President, LCOR.

\textsuperscript{79} Interview, May 28, 2009, Executive Vice President, CB Richard Ellis.

\textsuperscript{80} Interview, May 28, 2009, Managing Director, CB Richard Ellis.
going up for developers competing for new lease construction procurements\textsuperscript{81}. GSA is fighting
to get the best deal for the taxpayer.

The GSA saw six deals fall apart in the last twelve months that it was trying to procure on behalf
of the Federal Bureau of Investigation (FBI). Prospectus rent caps were unrealistic in terms of
building a new building. Typically, developers look to achieve a 9.5% to 10% yield on costs, but
many of the current prospectus rents would yield the developer a 6% yield on costs, at best. At
those rates, many developers will go invest their money elsewhere. The GSA wants to attract the
best developers to compete for its new lease construction procurements\textsuperscript{82} in order to preserve
quality and deliver the best product to its customer agencies; however, depressed returns on new
lease construction limit the pool of potential developers.

However, the GSA seemingly does not want to face the reality that equity is more expensive and
is harder to come in 2009. So with the latest lending standards, it is incredibly tough to make
these deals work to a 9.5% return on costs\textsuperscript{83}.

\textbf{THE COST OVER-RUN PROBLEM:}

There is a real lack of sensitivity and awareness by the GSA of what it costs to build new space
in the 2009 market\textsuperscript{84}. The GSA was behind the curve on the construction cost run up. Its

\textsuperscript{81} Interview, May 28, 2009, Managing Director, CB Richard Ellis.

\textsuperscript{82} Interview, May 29, 2009, Assistant Commissioner, General Services Administration.

\textsuperscript{83} Interview, May 28, 2009, Executive Director, CB Richard Ellis.

\textsuperscript{84} Interview, May 28, 2009, Vice President, LCOR.
prospectus rent schedules were going up at 3-4% a year during years when construction costs were growing at 12% per year. This has made it tight and sometimes impossible to make the numbers work for developers to attain financing. FBI projects have been a prime example. Many developers put in bids at the prospectus limit in order to please the GSA; however, they went in with a major caveat. The developer asks the GSA for extra funds to pay for such extraordinary improvements as security barriers that withstand a 5,000 pound vehicle coming at 50 miles per hour, blast resistant glass, an anti-climb K-12 fence, or a protected defended perimeter—all required components of the latest FBI security program.

Berry Corporation was in the process of delivering an FBI building to the GSA but the project stalled because of cost overruns and financing problems. The GSA’s proposed rent threshold did not work to get the project built and financed. Similarly, a FBI project in Portland, Oregon, is experiencing financial distress. The GSA is now turning to the FBI to buy-down the lease because the rate per square foot in the rent prospectus will not allow the GSA to deliver the building that the FBI wants. Buying down the lease means that the GSA would actually contribute money directly to the construction of the building in order to make it so the developer finances less building and in turn charges less rent to the GSA. Buying down the lease happens when the approved rent limitation makes the project unfeasible to build.

A developer constructing a $59 million hospital for the federal government in Texas was not able to finance building the hospital through its construction lender until the agency was able to

85 Interview, May 27, 2009, Vice President, Jones Lang LaSalle.

86 Interview, May 27, 2009, Vice President, Jones Lang LaSalle.
receive an appropriation of $39 million to pay for the building tenant improvements\textsuperscript{87}. In this case, the government will pay its lease payments based on a $20 million construction package.

Developers are being forced to be creative with financing these projects. Especially as they are tasked with rent caps that seem unfeasible. Rents should be reflective of the cost of equity and debt\textsuperscript{88}. The GSA does not have a lack of work and new lease construction that they need constructed. Approximately $4-6 billion of aggregate value in projects is in some phase of the new lease construction procurement process representing a significant backlog of projects. Meanwhile, approximately $2-3 billion of new construction is being delivered for the GSA’s new lease construction requirements\textsuperscript{89}.

Figure 11 shows the increasing costs of GSA buildings delivered on behalf of the FBI.

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\textsuperscript{87} Interview, May 27, 2009, Vice President, Jones Lang LaSalle.

\textsuperscript{88} Interview, May 29, 2009, Consultant, JBG companies.

\textsuperscript{89} Presentation, May 27, 2009, Dennis Eisen, Government Leasing News Conference.
The total soft and hard costs excluding financing are sizably more than a traditional office building. GSA rent thresholds do not match up with the increasing costs\textsuperscript{91}. For example, in June 2008, a $400 per square foot FBI-type building was constructed while a $270 per square foot general office building was constructed. Similarly, in January 2007, a FBI building was constructed for $275 per square foot while a general office building was constructed for $175 per square foot. In some cases, a 48% premium is paid to construct a GSA building versus building a general office building.

\textsuperscript{90} Presentation, May 27, 2009, CTL Capital, Government Leasing News Conference.

\textsuperscript{91} Presentation, May 27, 2009, Paul Penney, Government Leasing News Conference.
THE SCORING ISSUE:

Scoring is a major factor developers must consider when seeking financing for a GSA new lease construction project. If the GSA lease violates any one of the scoring rules in Figure 12 as part of the OMB Circular A-11, then it must score or record the entire value of the lease in the first year.

GSA Scoring Rules

The GSA is required to submit to its OMB representatives the following types of leasing and other non-routine financing proposals for review of the scoring impact. This is to determine if the lease is to be scored as an operating lease or a capital lease.

An operating lease meets the following criteria:

- Ownership of the asset remains with the lessor during the term of the lease and is not transferred to the Government at or shortly after the end of the lease term.

- The lease does not contain a bargain-price purchase option.

- The lease term does not exceed 75 percent of the estimated economic life of the asset.

- The present value of the minimum lease payments over the life of the lease does not exceed 90 percent of the fair market value of the asset at the beginning of the lease term.

- The asset is a general purpose asset rather than being for a special purpose of the Government and is not built to the unique specification of the Government as lessee.

- There is a private sector market for the asset.

Figure 12: GSA Scoring Rules
This negates the whole reasoning behind the GSA leasing. The GSA tailors its leases in order to meet the thresholds to avoid having to score the full lease value upfront in the lease. (See Figure 12 for thresholds.) These restrictions affect the likelihood of receiving financing for the project. Oftentimes, the scoring rules force the GSA to ask for a shorter lease term to avoid amortizing the full building value over the term of the lease. In effect, the GSA does not want it to appear that it is paying for the building in full—setting up an operating lease is the objective, not a capital lease.

For example, one of the most problematic scorekeeping rules stipulates that the present value of the rental payments does not exceed 90% of the fair market value of the asset at the beginning of the lease term. If an asset was deemed to be worth $100 million upon completion and occupancy and it had a 20-year lease that had a $8.5 million annual rental stream in place, the present value discounted at 6.5% would be $93.6 million. Because the $93.6 million present value exceeds 90% of the fair market value of the asset, this project would break scoring rules and not be lawful to build. However, if the lease term is shortened to 18 years, the same $8.5 million annual payment provides a present value of $88.6 million making it so the project complies with scorekeeping rules and comes in under the 90% threshold.

For GSA, limited funding for construction is exacerbated by federal budget scorekeeping rules, which require, for ownership and capital leases, that the full cost of the government’s commitment be recorded in the budget in the first year. In contrast, for operating leases, only the

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92 Interview, May 29, 2009, Assistant Commissioner, General Services Administration.
The single biggest hurdle to financing a project while abiding by these scoring guidelines is the requirement to keep the present value of the minimum lease payments over the life of the lease from exceeding 90 percent of the fair market value of the asset at the beginning of the lease term\textsuperscript{94}. Lenders often resist these shorter lease terms on projects. Even though statistics show the GSA renews between 85-90\% of its leases,\textsuperscript{95} lenders still worry about lending on a highly specialized project like a FBI field office when the lease term is only 12-15 years. The lender worries that the borrower will not be able to fully payoff the loan if the GSA is to vacate the space. The residual value gives lenders trouble and has stopped them from financing new

\textsuperscript{93} GAO-08-197 Report, Federal Real Property.

\textsuperscript{94} Interview, May 29, 2009, Assistant Commissioner, General Services Administration.

\textsuperscript{95} Interview, May 28, 2009, Executive Director, CB Richard Ellis.
projects. Without the scoring rules, the GSA could extend its lease terms and help the developer have a higher chance of getting financing. However, by extending its lease terms to help the developer, it would also be committing itself to longer payment schedules, thereby reducing flexibility to move or grow in its current facility.

Residual value insurance (RVI) has traditionally been available to borrowers to get around the problem lenders have with the short lease terms on such a specialized government asset. Developers were previously available to purchase these plans from insurance companies like MBIA, AIG, AMBAC, and Chubb. Industry professionals interviewed for this thesis do not see RVI available in 2009’s market. If available, RVI will be very expensive. Formerly, RVI typically cost 5 percent of the total residual value after the end of the lease term. This effectively became a reverse form of equity. By way of example, instead of a developer having to go out and raise $30 million to fund the leftover amount after an expired lease term, it could pay 5 percent of the $30 million for an insurance policy upfront as a project cost. The $1.5 million cost for the policy would guarantee the lender that if the GSA did not renew its lease at the end of the lease term, the insurance company could cover the remaining $30 million owed the lender.

In summary, developers and the GSA are seeking new ways to be able to finance much needed new lease construction in this tough credit climate. Developers are using such tactics as implementing the Credit Tenant Lease, seeking out new equity sources, asking for additional

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96 Interview, May 29, 2009, Consultant, JBG Companies.

97 Interview, May 28, 2009, Executive Director, CB Richard Ellis.

capital appropriations from the GSA to pay for improvements and buy down lease rates, and using all these innovative tactics while complying with the OMB scorekeeping rules.

The next chapter concludes the thesis. It provides a summary of the findings and includes recommendations for how the GSA new lease construction procurement process can be improved. The chapter also discusses the growth in this sector and what it means for developers. Finally, the conclusion outlines financing structures that work best and how they can be implemented in 2009’s credit strained market.
Developers in 2009’s turbulent real estate market are looking for areas of real estate to invest capital, and many are turning to the General Services Administration (GSA) for portfolio growth. Commercial developers face a dismal year in 2009—financing evaporated for new construction, demand fell, and projects struggle to come on line and lease up, falling short of forecasts. As of early 2009, construction and development in the commercial real estate sector is decreasing. The GSA is not slowing its growth. Its inventory of over 7,100 separate leased properties housing more than 1 million federal workers put GSA’s leased portfolio at 181 million square feet, thereby surpassing the inventory of federally owned space.

For GSA, the current 2009 environment presents both opportunities and problems. GSA is certainly a strong credit tenant for any proposed development deal. However, because of the lack of financing, it will be more difficult for developers to construct new buildings to meet specific GSA standards and requirements. Moreover, the lack of new speculative buildings in the market will inhibit GSA’s ability to find space in existing facilities.

GSA’s advantage is twofold: the availability and choice in office space markets is increasing, and construction costs are due for a decrease. The 2009-2010 period will certainly be a tenant’s market. Rents and occupancy costs will decline or stabilize at attractive levels for several

99 *Recommendations are bolded in this chapter.

100 Testimony before the Subcommittee on Economic Development, Public Buildings, and Emergency Management, March 20, 2009, Dean A. Schwanke, Senior Vice President, Urban Land Institute.

Thus, the next two years should be a good time for leasing new space at attractive terms for the GSA.

**Another opportunity to come out of the 2009 market is that in place of building several new lease construction facilities, the GSA could acquire new buildings to meet its growth needs.** Attractive acquisition opportunities present themselves in 2009’s transaction market where there are distressed sellers and few buyers. GSA can find attractive buying opportunities and can potentially acquire quality, well-located office buildings for its own use at greatly reduced prices, instead of pursuing the new lease construction process. However, this seems unlikely because the GSA is becoming more and more dependent on build-to-suit new lease construction and cannot get appropriations for new federal construction. Instead of seeking an appropriation for $15 million for a border patrol station, the GSA receives $1.5 million annually to lease the facility.

Financing is another major challenge for offerors and the GSA. In the credit crunch of 2008-2009, successful GSA offerors have been unable to obtain lease project financing and, as a result, have not been able to proceed with lease construction projects. Offerors have attributed this problem to the tighter credit market. For example, the 266,200 square foot FBI new lease construction project in Detroit, Michigan was awarded to a developer in February 2007. In October 2007, the developer faced a tight credit market and could not secure financing for the project at a rate that would support its expected return. The developer asked to withdraw. GSA

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and the developer completed a no-cost settlement agreement and GSA rescinded the contract in February 2008. This type of occurrence is not widespread for the GSA, but these types of stories do not go unnoticed.\(^{104}\)

**When financing is tough to obtain for an offeror, the GSA should use its credit tenant lease (CTL)\(^{105}\).** In the past it was used mostly in larger lease transactions in order to gain better lease rates through the most effective financing available. The U.S. Government Accountability Office has put out reports encouraging the GSA to adopt a more businesslike leasing approach.\(^{106}\) The GSA should make its lease more lender-friendly by modifying the General Clauses in the CTL to enable better lessor financing. If the GSA made 2009’s projects financeable it could avoid what happened to the FBI procurement in Detroit, Michigan.

The financial markets in the earlier part of the 2000’s supported the inefficiencies built into the GSA’s process for procuring new lease construction projects. This is no longer the case. **Risk adverse credit markets have an appetite for new lease construction financings but they must be efficiently structured. Lease clauses need to be favorable to the developer’s lender and not give the GSA easy outs to stop paying rent.** These clauses include the Casualty and Assignment clauses. Also, the GSA has been able to take advantage of low and declining financing rates in the past. **In 2009, with spreads at historically high rates, the GSA should**

\(^{104}\)http://159.142.162.71/Portal/gsa/ep/contentView.do?programId=16090&channelId=-24821&ooid=0&contentId=24771&pageTypeld=8199&contentType=GSA_BASIC&programPage=%2Fep%2Fprogram%2FgsaBasic.jsp&P=S, The Impact of the Credit Crisis on GSA’s Capital Program, July 29, 2008

\(^{105}\)As outlined in Chapter 4.

\(^{106}\)http://159.142.162.71/Portal/gsa/ep/contentView.do?programId=16090&channelId=-24821&ooid=0&contentId=24771&pageTypeld=8199&contentType=GSA_BASIC&programPage=%2Fep%2Fprogram%2FgsaBasic.jsp&P=S, The Impact of the Credit Crisis on GSA’s Capital Program, July 29, 2008

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do everything it can to avoid procurement failures because of the inability to finance. To this end, the CTL allows the offeror to get the best financing possible. For new lease construction procurement it can greatly increase the appetite of lenders to loan dollars on a GSA transaction\textsuperscript{107}.

The GSA should seek to exploit the benefits of ownership while leasing space from developers. GSA’s perpetual ownership value should not conflict with scoring rules. Currently, the GSA signs a 15 to 20 year lease on many new lease construction procurements. Many times, the total building cost will be amortized over the term of the lease, making the GSA pay for the whole building during its initial lease term. The GSA should take advantage of its negotiating position by including lease options in its standard lease. By including lease options, the GSA would avoid renewing at fair market value. GSA could gain the benefits of ownership while not actually owning the asset; it could use its leverage over the lessor by seeking lower rent at the end of its lease term. This could also save the GSA headaches from dealing with a hard-to-negotiate-with lessor because the renewal rental rate would be pre-determined.

The GSA should form a task force made up of developers, architects, financiers, and contracting officers to revise and comment on the current new lease construction procurement process. While industry professionals appreciate the organization the current procurement process brings to a behemoth real estate operation, many professionals have comments and recommendations to improve the process. Recommendations may include better communication throughout the procurement process, more upfront information on the procurement’s requirements, and more immediate feedback on proposals.

The GSA should re-evaluate its push to build new FBI field offices. The proposed rents should be recalibrated based on the intense security requirements. The 30+ new FBI field office buildings are providing a flurry of new procurement business for developers. However, developers are having a hard time making the projects feasible with the proposed rent thresholds. Developers cannot make a reasonable return given the final construction cost of the security requirements. The GSA should be realistic about these costs and offer a realistic rent threshold for these projects. Otherwise, it will continue to see fewer developer proposals, busted procurements, and possibly lower quality construction.

The GSA publicizes its desire to construct more projects through federal construction instead of leaning on the private sector for its space needs, however, it should not turn a blind eye to what private sector efficiencies offer. Data continually show that federal construction costs the taxpayer more than 20-40% more than when the private sector constructs the same building. Moreover, the competitive aspects of involving multiple offerors who are competing based on price and design offer great efficiencies for the GSA. Pricing risk in the private financial markets is very efficient. The private sector seeks out the best cost of capital. So, as the GSA talks of a pendulum swing back to constructing more federally owned buildings, it should be aware that the private sector offers efficiencies and lower construction costs. A prime example is the well-known Ronald Reagan Building in Washington, D.C. where the development costs were double what the building would have cost had a developer constructed it108.

108 Interview, June 16, 2009, Managing Director, CTL Capital.
In a more drastic move, the GSA could seek to use the federal government’s borrowing power to assist in financing these new lease construction facilities. This would further securitize its annual lease payments and veil them as bond payments similar to buying a United States Treasury. Treasury Bills in 2009 are yielding very low rates of return, (in the low 1-2% range) and would therefore help to yield very low financing rates for the developer. The GSA could offer a bond proposal through the Treasury where the annual lease payments would cover the pay down of the bonds sold. The developer could then buy these bonds to control the property. This would make it possible for the federal government to use its borrowing power and receive lower lease rates, while still not owning the facility.

GSA’s new lease construction procurement process has developers complaining about the tendency of GSA to drag procurements on for years and years before making an award. All the while developers are spending money and time wondering if they will be awarded the procurement. The current procurement process involves bundling all design, construction, financing, and operations into a single procurement.

Sections of the Federal Acquisition Regulations (FAR), which is the principal set of rules in the Federal Acquisition Regulation System with regard to government acquisitions, encourage innovation and specifically encourage procurement officials to use the industry’s best practices\(^\text{109}\). This directive coupled with developers’ desire to see the process change could be the impetus for sweeping reform.

The process between developer selection and funding should be a collaborative effort, a public-private partnership allowing more disaggregation of the development’s components. The current process inefficiently assigns project risks. As offerors submit their bids, they are loading the pricing with premiums to cover the risks, making it more expensive for the federal government. Rate risk inherent in the process can be better managed, and increases and decreases in financing rates can be reflected in scope revisions instead of causing the deal to implode.

Choose the developer earlier in the process. Then other developers would not be forced to design a full building and spend $100,000 to over $1,000,000 chasing a procurement. More developers would compete and more competition could result in lower pricing. The GSA would choose a developer based on its credentials, experience and development fee. GSA would then procure the space while working with the developer to manage the needs of the occupying agency. In this process, if financing rates go down during the procurement process, GSA reaps the benefits. If financing rates go up, GSA pays more but still has control of the procurement. GSA can look to cut costs in other places as a result. As in the Detroit, Michigan FBI procurement and many others, when rates go up, developers give up and the procurement falls apart.

With the current process, GSA is paying a premium on all procurements. By selecting the developer earlier, the GSA could reap the benefits if construction pricing or financing costs go down during the procurement. It will not have this chance with the current method because the developer’s price will include a premium for risk and upfront capital outlay.

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The GSA is backed by the full faith and credit of the United States federal government. From a credit rating perspective, there is no better tenant. Though there are many challenges in developing new lease construction projects for the federal government, the benefits seem to outweigh the challenges. Developers accept a lower return (9.5 to 10.5%) on costs. The risk associated with these transactions is minimal once the GSA actually occupies the building and is paying rent. In 2009’s credit crunch the typical return demanded for equity capital is 20% and debt capital is demanding 7%, a 9.5-10.5% return on costs for a new real estate project. This is aggressive, indicating that these projects are appetizing in a down market111.

With GSA’s increasing dependence on new lease construction build-to-suits, developers can find growth in providing space to the federal government. Experts think there are over 10 years of new GSA projects in the pipeline as of 2009112. It is very important for developers to be judicious in the procurements they pursue. With over 30 FBI field offices in the pipeline for procurement throughout the nation, developers can grow their portfolios with an AAA+ credit tenant. Developers should not forget the challenges: financing these projects in 2009’s turbulent credit market, possible cost over runs, working with the highly regulated federal government, and drawn out time schedules. GSA new lease construction projects can continue to be successfully developed but all the stakeholders (developers, GSA contracting officers, and financiers) must focus on what can be improved in the procurement process to attract more developers to compete, and to deliver the best build-to-suits to the GSA.

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