GSA Public Buildings Service

April 20, 2016

MEMORANDUM TO: REGIONAL COMMISSIONERS, PBS
REGIONAL LEASING AND PORTFOLIO DIRECTORS
REGIONAL LEASING ACQUISITION OFFICERS

4/20/2016

X James C. Wisner

James C. Wisner

Signed by: General Services Administration

FROM: JAMES C. WISNER
Assistant Commissioner for the Office of Leasing – PR

4/20/2016

X J. Stuart Burns

Stuart Burns

Signed by: General Services Administration

STUART BURNS
Assistant Commissioner for the Office of Real Property Asset Management – PT

SUBJECT: LEASING ALERT – Lease Term Strategy

1. Purpose. This Leasing Alert implements policy designed to:

a. Obtain lower rental rates by better leveraging GSA's financial strength and its 20 year lease acquisition authority by entering into longer leases where appropriate;

U.S. General Services Administration
1800 F Street, NW
Washington, DC 20405-0002
www.gsa.gov

b. Reduce the number of lease procurements and the resulting workload burden on regions through the use of longer lease term strategies; and
c. Implement these strategies in a manner that does not result in a material increase in vacant leased space.

2. Background.

a. GSA tenant agencies stay in the same location for an average of 23.3 years (when weighted by size). Despite this fact, the most common lease term entered into by GSA is a 10 year lease with termination rights any time after the fifth year (10/5 firm lease term). Although the Government has a high probability of remaining in a lease for a period well beyond the five years, GSA lessors receive no credit from their lenders for a lease term where the tenant has ongoing termination rights after the fifth year and, therefore, are unable to pass along more favorable rental pricing to the Government.

   GSA may experience reduced competition in its lease procurements since some potential offerors will choose not to make their space available if the tenant is seeking the ability to cancel on short notice, even if not applicable until after five years of occupancy. Additionally, since GSA has statutory authority to enter into 20 year lease terms, GSA may be foregoing the benefits of more favorable rental pricing when it seeks lease terms for only a 10 year period.

b. The Office of Leasing recognizes three opportunities to add value to the leasing program when considering lease term strategy. These are:

   1) GSA's unique long-term presence in the market;

   2) GSA's 20 year lease procurement statutory authority; and

   3) GSA's use of renewal options, including in some instances using unevaluated renewal options, to control the space beyond the 20 year statutory authority as explained below.

3. Effective Date. This Leasing Alert is effective on the date of signature unless modified, cancelled, or reissued.

4. Cancellation. None.

5. Applicability. This Leasing Alert and its attachments apply to all General Services Administration (GSA) real property leasing activities.

6. Instructions and Procedures. Instructions and procedures are provided in Attachment 1.

Attachment 1: Instructions and Procedures for Lease Term Strategy

Attachment 2: Suggested Edits to RLP Language for Longer Lease Terms

Attachment 3: OA Internal Concurrence Memorandum

COVER PAGE FOR ATTACHMENTS 1 THROUGH 3

Attachment 1: Instructions and Procedures for Lease Term Strategy

1. Introduction.

   a. In many instances, GSA has used a 10 year, 5 year firm lease strategy to allow the Government flexibility with its housing requirements, and to minimize the amount of vacant Government-controlled space since the Government can terminate the lease if it no longer needs the space. While the Government maintains flexibility with its housing requirements with such lease termination rights, GSA may be foregoing more favorable rental pricing in markets where there is a high potential for backfill of vacant Government-controlled space. For all lease requirements, the Government should consider the benefits of favorable rental pricing associated with longer firm terms against the costs associated with the risk of the inability to backfill vacant Government-controlled space.

   b. Except as indicated otherwise in this Leasing Alert, the firm term of all new lease solicitations should more closely match the expected need for the space by the Government, and not necessarily match the length of a particular agency's Occupancy Agreement (OA). In order to benefit from more favorable rental pricing, when feasible and appropriate, GSA should strive to increase the length of its firm term lease terms, with specific exceptions noted below:

      - Projects where capital lease scoring is triggered;
      - A specific alternative housing solution for the long term has been identified (i.e., an imminent relocation to a federal building or consolidation with another lease);
      - Lease construct projects where the Lease and OA terms must be coterminous and the OA is non-cancelable;
      - Where the risk of sustained vacancy is much greater due to limited or smaller market locations which are other than major metropolitan areas that are reflective of more vibrant markets;
      - AAAP actions that do not allow for term durations of 20 years; and
      - Other individual actions as determined on a case-by-case basis.

   c. In March 2016, Office of Leasing introduced a new feature in Bullseye that provides for a recommendation in the Bullseye report as to whether a project is a good candidate for a longer lease term. GSA regions should consider the lease term recommendations in the Bullseye report.

2. Strategic Opportunities.

a. *Longer Firm Terms*. Landlords can often offer lower rental rates to tenants entering into longer firm terms, since they offer a stable revenue stream and minimize vacancy and financial risk. Since lenders are able to offer lessors lower lending rates with such lower risk scenarios, lessors can pass these savings onto tenants in the form of lower rental rates. By considering the backfill potential of vacant Government-controlled space within a market, GSA can more closely align the firm term with the estimated period of Government need for the space in the market, regardless of the length of an individual agency's OA. By identifying those locations and markets where there is a high probability of the Government remaining in a building for 10 to 20 years, and optimizing the firm term to better suit that need, the Government is in a better position to capitalize on lower rental rates and reduce future procurement workload.

b. *Size and Type of Space Requirement*. The Government should consider the size and type of space requirement when assessing its backfill or sublease potential. The Government may be able to more easily backfill or sublease space that is in a large, vibrant market, is generic/general purpose in nature, or is of a size or configuration for which there is high demand – such space may offer longer firm term opportunities. Since not all lease acquisitions offer long firm term opportunities, we have identified factors to consider when determining firm term length within this Attachment.

c. *Full Term*. A full term refers to the total duration included in a lease solicitation and contract, including any combination of a firm term and soft term, but not option periods (whether evaluated or unevaluated). For a term that includes termination rights (during the soft term), the Government should consider whether limiting the termination window immediately following the firm term is more beneficial, or whether ongoing termination rights are more beneficial to the Government. A termination window (e.g., a one-time right to terminate after a certain period up to 120-180 days immediately following the firm term), may provide the Government with more favorable lease rates. Use of soft terms (i.e., continuous termination rights at any time) is more appropriate and desirable in smaller markets where little backfill potential exists or when coordinating a consolidation or relocation.

d. *Renewal Options*. Rental rates captured in unevaluated and evaluated options offer the opportunity to be significantly below future market rental rates without creating any risk to the Government, and without exceeding the statutory 20 year limit on lease procurement authority. As part of the original lease procurement, options may be included beyond a 20 year lease term, so long as at the time of exercising the option, the remaining term left on the lease does not exceed 20 years. Multiple successive options can be valuable when future rental rates rise. Conversely, if the lease is awarded at the high-end of a market cycle, renewal options allow the Government the opportunity to forego renewal options at high rates and renegotiate. It should be noted that all pre-priced options for non-prospectus level leases, whether evaluated or unevaluated, must be scored, along with the initial lease term, prior to lease award. As the time approaches for making a determination to exercise an evaluated or unevaluated renewal option, option rates should again be reviewed against the market and protocol followed in accordance with Leasing Desk Guide Chapter 9.

e. *Factors to Consider*. If the tenant agency is relocating and/or downsizing to achieve a more efficient utilization rate and the answer to many of the questions below is "yes," target a firm term greater than 5 years, ideally 10 or more, but also consider using evaluated options up to the maximum firm term allowed under scoring rules to avoid categorization as a capital lease at the time of procurement. There should be a compelling case of an expectant vibrant market demand and strong indications of a long term Government need for the space. There are numerous variables in this decision, thus, LCOs should use discretion. Some of the factors to consider are:

1. Does the Bullseye report identify this project as a potential candidate for a long term lease action based on market conditions? If not, do market conditions suggest a longer term?
2. Is the lease a core location for the customer such as a Regional Headquarters building or Field Office? If so, this would make it more likely that the agency will have a long term need for space in that market.
3. Does the customer have a need for specialized build-out of space (i.e., custom TI tier 3 or higher)?
4. Is this a built-to-suit or lease construction project? A longer lease term may help the lessor with securing better lender financing that may result in lower rental rates. (Note: OA must be coterminous with the lease term and non-cancelable.)
5. Is the customer using substantial RWA funds to customize the space? Will agency invest large sums in their space build-out?
6. Is there a very strong likelihood of another agency quickly backfilling the space should the OA be cancelled?

7. Does the utilization rate meet approved targets?

With careful thought to the above considerations, asserting a longer term perspective, even when our customers may not agree to those terms, can present opportunities. As those opportunities are pursued, the OA Internal Concurrence Memorandum between Office of Leasing and Portfolio should be executed for awareness across business lines (See Attachment 3).

f. *Lease Term Scenarios*. Below are examples, among many, where GSA should consider longer firm terms.

<u>Example 1</u>: FBI Field Office with 150,000 RSF with adequate utilization rate as a lease construction project in a market where there is potential backfill from other federal tenants, is a good candidate to target a firm term as long as scoring would allow (i.e., a duration of 15 years, with a 5 year evaluated option, or 20 years firm. Additionally, multiple unevaluated options of 5 years each could offer additional strategic advantages that could be sought.)

Note that for lease construct projects, the OA must be coterminous with the lease term and non-cancelable.

<u>Example 2</u>: An IRS requirement with 10,000 RSF in a market like Chicago, where ample backfill and sublease potential exists, is a strong candidate to solicit an initial firm term duration of 10 (or more) years, with two, 5 year evaluated options, for a total of 20 years.

3. <u>Occupancy Agreements</u>.

a. Agency concurrence/signature on an OA is not required for periods that include an evaluated or unevaluated option until the point of exercising that option. Providing evaluated or unevaluated renewal options in a solicitation and contract adds value and strategic choices.

b. For those instances where it is determined that there is an opportunity to optimize the value of the PBS portfolio by pursuing a firm term duration longer than a tenant agency is willing to sign an OA, communication across business lines about the intent of the specific lease is required. Regions should use the template “OA Internal Concurrence Memorandum” provided in Attachment 3 to document the communication between Office of Leasing and Portfolio.

c. *OA Scenarios*: Below are examples, among many, where pursuing a lease term duration longer than an agency is willing to sign an OA might make sense:

Example 1: Agency agrees to an OA reflecting a lease that is a 5 year cancelable term. GSA determines that a lease with a 10 year firm term and two, 5 year evaluated renewal options offers the best value to the taxpayer because of a combination of: a) the agency is likely to remain beyond 5 years; b) a strong backfill demand is anticipated by other Government agencies; c) a vibrant, active market for the type of space being sought; and d) a strong private sector sublet demand is perceived.

Example 2: Agency agrees to a 5 year cancelable OA. GSA determines a 5 year firm term with three, 5 year evaluated renewal options is the best strategy because there is some uncertainty about the length of the agency's need beyond 5 years but there is likely to be strong backfill demand and/or sublet demand.

Example 3: Agency agrees to a 10 year cancelable OA. GSA determines a 15 year firm term with a 5 year evaluated renewal option offers the best value to the taxpayer because of: a) strong likelihood of the agency continued need for the space, and/or a high TI tier, and/or a major RWA investment into the space making relocation expensive; b) challenging market with perceived rising rents; and c) ability to easily backfill or sublease the space.

It should be noted that terms do not need to be 5 or 10 year increments. They can be any duration that creates the most value, complies with scoring guidelines, and provides the best strategic option. Additionally, if GSA pursues a firm term longer than the agency is willing to sign a cancellable OA, the project team should not use this as a reason to pursue a non-cancelable OA to mitigate vacancy risk. The exception is for lease construction projects where the Lease and OA terms must be coterminous, and the OA is non-cancelable.

Attachment 2: Suggested Edits to RLP Language for Longer Lease Terms

Sample language below can be adjusted as needed to best suit strategic opportunities for the project and to align with the market.

1.02 AMOUNT AND TYPE OF SPACE, LEASE TERM, AND OCCUPANCY DATE

F. This lease term shall be for 10 Years Firm. This lease may be renewed at the option of the Government for two (2), five (5) year firm terms. The Government reserves the right in the lease to not include an option, or to reduce the length of an option, if inclusion of the option would cause the lease to score as a capital lease, in accordance with paragraph 3.04 of this RLP. Should the Government make the determination to modify the term or option(s), an amendment to the RLP will be issued.

Attachment 3: OA Internal Concurrence Memorandum

MEMORANDUM TO FILE
Entering into Lease Term Longer than Customer Signed Occupancy Agreement (OA)
Lease Acquisition Project Number ________
Occupancy Agreement (OA) Number __________

This memo acknowledges that GSA is entering into a Lease for PROJECT #_________________ in CITY, STATE, for a period of XX years, which is XX years beyond the Occupancy Agreement (OA) with AGENCY NAME.

It has been determined that the value of extending the lease term beyond the OA term exceeds the risk associated of the potential for vacated Government occupancy by the initial tenant with consideration to several strategic factors.

The primary reason(s) for this determination is(are): __________________________.

Approved:

________________________________ ________
Director, Leasing Division Date

Approved:

________________________________ ________
Director, Portfolio Management Division Date