The State Bar of California

Preliminary Plans for Southern California Facilities

Report to the Legislature
April 1, 2010

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INTRODUCTION

Assembly Bill No. 3049 (July 21, 2008) (Bus. & Prof. Code §6140.3) authorized a $10 increase in the State Bar's membership fee beginning in 2009, to be used for the construction, purchase or lease of a facility in southern California, upon the expiration in January 2014 of the State Bar's existing lease of its facility in Los Angeles. AB 3049 instructed the State Bar to make annual reports to the Legislature on its preliminary plans for determining whether to construct, purchase or lease a southern California facility. This report is submitted pursuant to that instruction.

BACKGROUND: THE STATE BAR'S FACILITIES

To effectively serve the public and its members throughout California, the State Bar maintains operations in San Francisco and Los Angeles.

In San Francisco, the State Bar owns 180 Howard Street, a 13-story office building in the downtown financial district. Purchased in 1997 and occupied since 1998, the building also houses several retail and office tenants.

In Los Angeles, the State Bar previously owned a building in downtown, at 1230 West Third Street. When that building was badly damaged by fire in 1986, the Bar relocated to temporary leased space at 333 South Beaudry Street. In January 1994 the Bar took occupancy of 167,000 square feet of leased space at 1149 South Hill Street in the South Park section of downtown. Three connected buildings, 1149 South Hill, 1149 South Broadway and 1150 South Olive, were then known as the Transamerica Center. In 2008 the Bar consolidated operations and relinquished one floor; it now leases 143,000 square feet.

As part of its original lease negotiations with Transamerica, the Bar and Transamerica agreed to a property exchange whereby Transamerica took ownership of the Bar's building at 1230 West Third Street, and the Bar took ownership of a 117,000 square foot surface parking lot one block away from 1149 South Hill Street (bounded by Olive Street, Pico Boulevard, Grand Avenue and Twelfth Street).

The Transamerica Center was sold several times. The Broadway building is now owned by the City of Los Angeles; the Hill and Olive buildings are now owned and operated by LBA Realty. Transamerica vacated much of the premises and the new major tenant, AT&T, was given naming rights. The two buildings are now known as the AT&T Center.

The Bar's lease in the AT&T Center expires in January 2014. The Bar is now faced with the decision of extending its lease in the AT&T Center, leasing space elsewhere, or acquiring space of its own.

THE PROJECT PARAMETERS

The State Bar has identified a number of strategic issues which will serve as a framework for subsequent in-depth analysis and decision-making. The three broad classes of issues to be evaluated are: occupancy alternatives (lease versus ownership; sole occupancy versus joint occupancy; new or existing building, etc.); location (most likely between seven L.A. sub-markets); and cost.

a. Occupancy Alternatives

Subject to further refinement, there are generally eight alternative occupancy structures, divided into three categories, which will be evaluated. They are:

Pure Leasing Options:

- Release current space
- Lease new space in an existing building
- Lease new space in a building coming to market

Ownership Options in Existing Buildings:

- Use leasing leverage to own all or part of a building coming to market
- Acquire interest in existing building for a mix of lease leverage and current lot value
- Buy building as sole owner

Build a New Building:

- Build on current Olive Street parking lot as a sole owner
- Build on current lot or other lot in selected market area as occupant and joint or partial owner

The major distinctions are between lease and ownership; and between whether or not the building in question already exists as a fully functional office building, or is "coming to market," i.e., a new building being constructed, or an existing building slated for major rehabilitation/ renovation.

A number of cost and efficiency factors will influence the choice between these eight options, including:

- Current near term cost
- Full life cycle cost and control of future cost changes
- Cost and stress of relocation
- Potential for expansion
- Transportation and parking efficiency
- Energy efficiency and other "green" items

There are also several relevant, though less quantifiable, factors, having to do with the "image" of the neighborhood and/or building, and of the building's unique identification with the State Bar.

Conventional wisdom suggests that, for organizations like the State Bar, whose size and function remain relatively stable for the long-term, ownership often yields lower long-term costs than leasing equivalent space. For the State Bar, this would mean acquiring ownership interest in an existing building or a building coming to market. While construction of a new building remains a possibility to be analyzed, the rationale for building from the ground up is usually the desire for showcase space or the need for highly specialized space; because these are not considerations for the Bar, new construction initiated solely by the Bar is unlikely. It is possible, however, that an attractive opportunity may present itself for a joint venture with a developer, where the State Bar would commit to a long term lease and participate in the equity contribution and appreciation. At the same time, the State Bar enjoys substantial leasing leverage as an "anchor" tenant, owing to its size, stability and creditworthiness. This leverage could be used to obtain substantial rent concessions and other favorable terms that translate into lower long-term costs via leasing.

Attached is a matrix of the occupancy alternatives and decision factors. The matrix is a quick-reference and does not represent the detailed analysis that will be completed at later phases of the project.

b. Location Alternatives

The State Bar's southern California office must be located so as to 1) maximize access and convenience for employees, members and the public; 2) provide cost-effective and efficient premises; and 3) offer an appropriate professional image.

To evaluate whether a location other than downtown Los Angeles might be feasible or desirable, the State Bar analyzed the distribution of its southern California employees and members. The employee analysis showed that current State Bar employees live in a wide radius extending from downtown. The member analysis (based on member record zip codes) showed that 55% of the Bar's southern California members are located in Los Angeles County, 16% in Orange County, 16% in San Diego County, and 13% in six other counties.

There are seven major office submarkets in Los Angeles County, representing geographic concentrations of Class A and B office buildings which are grouped closely enough to influence each other's pricing. These submarkets are: Tri-Cities (Burbank/Glendale/Pasadena), Downtown, Wilshire Corridor, San Fernando Valley, San Gabriel Valley, South Bay, and West Los Angeles. Each submarket offers a different set of advantages and disadvantages. Most of these areas feature freeway access, and some additionally offer varying degrees of public transit service. Further considerations include the prevailing age and type of office buildings, the range of amenities, the availability and cost of parking, and the safety and image of each area.

Subject to further evaluation, the Downtown Los Angeles submarket (itself a conglomeration of several distinct areas) is most likely the best location to serve members and employees in southern California, based on: 1) current location of members and employees; 2) the area's central location and convenient access to airports, Union Station and other means of public transportation; 3) proximity to courts, government offices, business and amenities; and 4) overall affordability.

c. Cost Analysis

At this early stage, while most options remain hypothetical, it is not possible to provide a detailed, real-life cost analysis for the State Bar's occupancy alternatives. Therefore, in the context of defining the parameters of the Los Angeles real estate project, and understanding the process to follow, the State Bar's real estate consultant selected four ***hypothetical scenarios*** representing various occupancy alternatives, then performed a model cost analysis that ***illustrates the type of analysis*** that will be performed when real-life options are evaluated.

The four scenarios, all located in Downtown Los Angeles, are: (1) re-leasing space in the current building; (2) occupying as sole tenant on a long-term lease a historically renovated building near the current State Bar location; (3) occupying space and becoming a joint owner in a new (to-be-constructed) building not far from the current State Bar location, in which the Bar would occupy approximately 40% of the space and enjoy the revenue benefits of joint ownership of the remaining space; and (4) purchasing an existing building with minimal outside tenancies.

Each model assumes an identical 100,000 square foot office premises; expresses rents on a “triple net” basis; uses identical base building operating expenses; and keeps the remaining assumptions for escalations, 15 year term plus extensions, 290 parking spaces, and out-of-pocket capital expenditures constant across all four scenarios.

Leasing terms defined:

“FSG” = Full Service Gross, a standard leasing format in which the tenant’s base rent is assumed to include initial year operating expenses. The alternative format is “NNN,” Triple Net, in which the rent is stated as exclusive of operating expenses, which the tenant pays in addition to base rent.

Scenario 1: Continued Occupancy at 1149 S. Hill Street
This scenario assumes that the Bar modifies its existing lease at the AT&T Center to rent 100,000 square feet. This would require the reconfiguration of the Bar’s premises to give up approximately two floors currently being rented. Reflecting the State Bar’s significant leasing leverage in a declining office market, yet offset by the reduction of two floors and the landlord capital expense for tenant improvement construction, a $15.00/sf annual NNN rent is used (roughly equivalent to $25.30/sf on an FSG basis).

Scenario 2: Lease Entire Herald Examiner Building, 1111 S. Broadway
The Hearst Corporation owns the Herald Examiner Building, a historic landmark structure. This building totals nearly 100,000 square feet and could afford the State Bar an opportunity to capture significant goodwill by serving as the anchor for the rehabilitation of this landmark structure. Any renovation project would be structured to explicitly insulate the Bar from any risk associated with building rehabilitation. Such a transaction would involve a fiscally strong landlord who can utilize the major tax benefits afforded by historic renovation, equal to approximately 25% of assumed project costs, and would offer the State Bar the opportunity to reduce expenses through a property tax exemption. In this scenario, the required development yield is set at 9.5% of total costs (net of tax credits) to illustrate the relatively more encumbered value of the landmark structure, generating a $17.59/sf NNN rent (roughly equivalent to $23.77 on an FSG basis).

Scenario 3: Acquire an Interest in a New Building, Olympic/Grand
This scenario assumes that the State Bar uses its leasing leverage to anchor a new 250,000 square foot Class B office development project. The hypothetical site is the southeast corner of Olympic/Grand, a site slated for residential development that is currently in bankruptcy. Land value is based on the December 2005 purchase of the Metropolis site at 8th/Francisco for $255/sf, which was reduced 25% for the subject site to adjust for the residentially-oriented valuation in that transaction. Hard cost was set at $150/sf for a market Class B structure, with above-grade structured parking at $20,000 per space and a soft cost factor of 30%. The required development yield was set at 8.5% of total project costs, generating a $31.38/sf NNN rent (roughly equivalent to $41.68/sf on an FSG basis).

Scenario 4: Acquire an Existing Building, 737 S. Broadway
This scenario depicts the purchase of an existing building in downtown Los Angeles. The hypothetical building is a 166,000 square foot, eight-story building with basement on a 19,828 square foot lot, built in the early 1900’s. The location is on Lower Broadway at the edge of the

Jewelry District. The asking price for the property is $16.0M, and renovation costs were set at $175/sf for a renovated Class B structure with a soft cost factor of 30%, comparable to Scenario 2 costs. The basement is to be converted to guest parking for the Bar's visitors at a cost of $25,000 per space, plus the cost of attendants for security. In this scenario, it is assumed the State Bar or another state entity issues tax-exempt municipal bonds equal to the total project cost less equity available from sale of the Olive Street parking lot. The Bar's occupancy cost, as a building owner, is set at the minimum level required to generate a Net Operating Income sufficient for a 1.20 Debt Service Coverage Ratio over proposed tax-exempt financing debt service. This DSC ratio is higher than traditional tax-exempt financing coverage ratios to account for the uncertainty associated with the State's credit rating. This scenario results in a $22.59/sf NNN occupancy cost (roughly equivalent to $28.79/sf on an FSG basis). Including offsite parking lease costs for the Bar's occupancy cost will be $28.68/sf NNN annually ($34.88/sf FSG).

<u>Approach to Measurement</u>
The appropriate metric to use in comparing the results of these strategic alternatives is the Net Present Value of the 30-year cash flows (NPV), which discounts a future cash flow stream at a constant annual discount rate to arrive at the equivalent lump sum value today. In each scenario, the consultant first calculated the State Bar's future occupancy costs over the 15 year initial term plus 15 year renewal term, and discounted these outflows back to an NPV using a 6.0% discount rate.

<u>Summary of Occupancy Cost – Hypothetical Scenarios</u>

	Scenario 1 Re-lease at current site	**Scenario 2** Lease renovated historic building	**Scenario 3** Acquire new building	**Scenario 4** Acquire existing building
Total Yr. 1 Occupancy Cost	$2,878,000	$2,725,000	$4,516,000	$3,488,000
Full Service Gross Rent Equivalent per SF (Income & Expenses, not including Parking)	*$25.30*	*$23.77*	*$41.68*	*$28.79*
30-Year Total Occupancy Cost	$122,100,000	$115,300,00	$185,200,000	$127,800,00
Discount Rate	6%	6%	6%	6%
30-Year NPV	$45,300,000	$42,800,000	$69,100,000	$49,300,000

The State Bar owns a 117,000 square foot surface parking lot, currently valued at approximately $12 million. Any financial assessment of alternatives must also consider the financial impact of this asset on the costs of office occupancy, whether this property is used as part of a future office solution or, alternatively, the potential asset revenues are used to offset building rent. These revenues could come from operation of the property as a commercial parking lot, or from the sale of the property and reinvestment of the proceeds.

STATUS & NEXT STEPS

The Bar conducted its preliminary assessment of Southern California facilities needs from late 2008 through mid 2009, well in advance of a January 2014 occupancy deadline. Further action was limited for the rest of 2009. This was due in part to the Governor's October 2009 veto of the Bar's fee bill, which placed a hold on all major projects. It was also due to the continuing softness in the office real estate market, which has significantly prolonged the window of opportunity during which the Bar, as a creditworthy and respected tenant, can expect to achieve concessions or benefits in acquiring new space or re-renting existing space.

The next significant step, about to be launched, is a space planning exercise. A very preliminary analysis of the Bar's square footage requirements showed that a more efficient floor plan could possibly reduce the Bar's space requirements by 20% to 30%, from its current 143,000 rentable square feet to 100,000 – 115,000 square feet. The more comprehensive space planning effort will consider:

- Current and future functions and programs, and current and projected headcount.
- Modern standards for space utilization, design and workflow (the Bar's current Los Angeles office was designed 20 years ago)
- A more integrated use of office technology to improve communications and workflow, reduce hard copy materials, etc.
- The possible expansion of meeting/conference space to accommodate educational programs usually conducted off-site; options for "virtual" meetings; etc.

Following the space planning activity, the Bar will empanel a Real Property Steering Committee, which was originally planned for late 2009 but was deferred. The steering committee will be comprised of Board of Governors members and others with expertise in the southern California real estate market, in addition to key State Bar staff members. The committee will be a practical working group that will oversee the further development and implementation of the southern California real estate plan, coordinate with constituents as appropriate, and ensure adherence to the policies and parameters set forth by the Board of Governors. The Real Property Steering Committee model was used successfully by the State Bar in the past, culminating in the lease of the Bar's current space in Los Angeles and the purchase of 180 Howard Street in San Francisco. The steering committee will likely be formed by approximately October 2010.

The Real Property Steering Committee will engage outside experts as appropriate for a project of this size and complexity. This will include a real estate consultant who will first provide strategic advice and in-depth economic analyses of alternatives; and will then assist the State Bar in the competitive bidding process to select brokers, architects, contractors and other required vendors (by identifying reputable vendors, drafting requests for proposals, interviewing responding vendors, etc). The firms invited to submit proposals to provide real estate consulting services are independent of brokers, contractors or other vendors; compensation for their services is strictly on a time and materials basis, with no contingent compensation for any proposed outcome.

Cox, Castle & Nicholson, one of the major real estate law firms in the United States, has been the State Bar's outside special real estate legal counsel for many years, successfully representing the Bar in all of its major real estate transactions, including the negotiation of the complex lease for 1149 South Hill Street in Los Angeles and the purchase of 180 Howard Street in San Francisco. Cox, Castle will continue to provide legal advice and assistance for the Bar's current southern California project.

STATE BAR OFFICE SPACE OPTIONS IN LOS ANGELES

MATRIX OF ALTERNATIVES AND QUALITATIVE OBSERVATIONS ON MEASUREMENT PARAMETERS

PRELIMINARY AND ILLUSTRATIVE DRAFT. SUBJECT TO CHANGE

	LEASING OPTIONS			OWNERSHIP OPTIONS IN EXISTING BUILDINGS			BUILDING A NEW BUILDING	
	Re-Lease Current Space	**Lease new space in existing building**	**Lease new space in building coming to market**	**Use leasing leverage to own part of building coming to market**	**Acquire interest in existing building for mix of lease and lot**	**Buy building as sole owner**	**Build on Current Lot as Sole Owner**	**Build on Current Lot or Adjacent as Occupant/Joint Owner**
COLUMN REFERENCE	**C**	**D**	**E**	**F**	**G**	**H**	**I**	**J**
Current, Near Term Cost	Likely lower than most, some leverage	Average or somewhat lower, some leverage	Considerable leverage, "effective" probably lower than average	Average or higher since rent schedule key to value; returns as owner	Average or higher since rent schedule key to value; returns as owner	Should be lower but opportunities are limited	Initially possibly higher due to construction costs	Opportunity to lower cost OR pay full market but participate more in profit
Life Cycle Cost, e.g. control of future cost	Unknown, but potentially higher if location fades	Some opportunity through extension options	Leverage should permit attractive extension options	Again, face rent likely to be at or over market, but more than fully offset	Again, face rent likely to be at or over market, but more than fully offset	Best control available except for normal expense risk	At least as good as buying building since should have better systems	Best of all worlds, modern systems plus leverage and control
Cost and stress of relocation	May be significant if upgrades done in place	Minimal since all work done elsewhere; move when all is ready	Minimal since all work done elsewhere; move when all is ready	Minimal since all work done elsewhere; move when all is ready	Minimal since all work done elsewhere; move when all is ready	Some headaches both in transction and t.i.'s	Major headaches in mgmt, control, and changes	Materially less stress. Some transaction issues but otherwise "turnkey"
Potential for Expansion	Probably can be negotiated	Uncertain	Uncertain	Should be good as to knowledge and control of upcoming vacant space	Should be good as to knowledge and control of upcoming vacant space	Cuts two ways; either too big at start or constrned	Cuts two ways; either too big at start or constrained	Should be excellent
Transportation and parking efficiency	Unchanged from current: Expo line could enhance	Same or better if in Downtown	Same or better if in Downtown	Same or better if in Downtown	Same or better if in Downtown	Same or better if in Downtown	Same or better if in Downtown	Same or better if in Downtown
Energy efficiency and other "green" items	Very limited	Uncertain but probably limited unless building new or retro-fitted	Should be better than average with newer systems	Should be better than average with newer systems	Uncertain but probably limited unless building new or retro-fitted	As good as you want it to be	As good as you want it to be	As good as you AND your co-owner want it to be

Location image	Fair to good Unchanged	Variable but unlikely to be too much better in currently available	Variable but unlikely to be too much better in currently available	Variable but unlikely to be too much better in currently available	Variable but unlikely to be too much better in currently available	Not likely to be better due to supply location	No change	No change
Building image	Fair to good Unchanged	Variable but unlikely to be too much better in currently available	Could well be better or certainly more distinctive	Could well be better or certainly more distinctive	Variable but unlikely to be too much better in currently available	Variable but unlikely to be too much better	Opportunity for significant image enhancement	Opportunity for significant image enhancement
Unique identification with CSB	Limited	Uncertain but likely to be limited in larger bldg	Possible, depending on size	Possible, depending on size	Real opportunity for naming if desired	Manifest opportunity	Manifest opportunity	Manifest opportunity tempered by value of naming rights