london moeder
advisors

Evaluation of Proposed Costco Lease

for

Protect Our Community Now

Rebuttal Report of
Gary H. London, *Senior Principal*
Nathan Moeder, *Principal*

October 26 , 2020

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To: Protect Our Community Now

RE: Proposed Costco Ground Lease for NWC of Camino del Sur & Carmel Valley Ranch Road

London Moeder Advisors ("LMA") has completed an analysis of the proposed Costco ground lease for the property located at the northwest corner of Camino del Sur and Carmel Valley Ranch Road in San Diego, CA. The property is owned by the Poway Unified School District ("PUSD") and comprises approximately 27.22 acres of land.

LMA is not taking any position on the ultimate use of this property. The purpose of this analysis is to provide financial context to the proposed Costco lease so it or any other offer is understood on a comparable financial basis.

The following summarizes our financial conclusions:

- PUSD agreed to the Costco lease which undervalues the property by 50 to 60% compared to alternative bid from Brookfield ($47 million closing 24 to 36 months).
- The Costco lease also locks PUSD into an up-to 60-year lease that yields 1.17% compound average growth rate, which is significantly under market.
- The net present value of the Costco lease is estimated to be $22 million which is $25 million lower than the Brookfield bid and comparable to the Cambridge school bid.
- Both the Costco and Brookfield bids require a complete set of approvals including rezoning and voter approval, which represents additional risks to those bids.

We recommend the following approaches:

- Because there was an incomplete analysis of the RFP responses, and information regarding the approval process for the property was incorrect, we recommend reopening the process for new proposals from developers to determine the true market value.
- If no new offers present themselves (or even if they do), the school district should conduct a thorough analysis of all offers that appropriately considers all relevant factors, including the time value of money and other risks.
- It would also be appropriate for PUSD to counter the Cambridge proposal closer to the potential value of the Costco lease (approximately $25 million). In doing so, PUSD could achieve the value of the Costco lease today, rather than having to wait for approvals and be subject to delayed lease payments.

Proposed Costco Ground Lease

When considering proposals for either leasing or selling a property, it is imperative that offers are evaluated with special attention to the underlying value of the property. While offers for purchase clearly state a value for the property, ground leases are not as straight forward. Therefore, ground leases must use the *net present value* calculation to determine the price of the property in today's dollars to compare with offers for purchase. This is known as the Leased Fee Interest valuation, which discounts to present value of both the annual rent payments and the reversionary value of the land.

Discussion of Ground Lease Cap Rates

The value of a long-term ground lease is determined by dividing the annual net income by a capitalization rate ("cap rate"). Ground lease cap rates generally range from 7% to 11%, which ultimately represents the annual percentage return on land value.

It is important to note that the cap rate and value is an inverse relationship. Meaning, the higher the value, the lower the return (or profit). Conversely, the higher the cap rate, the lower the value of the investment.

Properties that are well located with market driven rents (such as participation or revenue sharing rents) can achieve a lower cap rate. This results in a higher value for the property because investors are willing to pay more for the property and accept a lower return initially because they understand that revenue will increase in the future according to the market. An example of this would be hotels in Downtown San Diego where the ground rent is based on a percentage of hotel revenue, or sales. Investors know that they will receive a market rent each year.

The appropriate cap rate, or return on land value, under the terms of the Costco ground lease would likely range from 8% to 9%. However, a case can be argued for a higher cap rate because the lease locks PUSD into a perpetually under market lease rate for up to 60 years.

The proposed ground lease payments by Costco is outlined as follows:

Initial Term:		
Years 1-10	$2,114,690	annually
Years 11-20	$2,431,894	annually
Years 21-30	$2,796,678	annually
Years 31-40	$3,216,179	annually
Renewals:		
Years 41-50	$3,698,605	annually
Years 51-60	$4,253,396	annually

While this schedule increases the total rent by 15% every 10 years, this is not a good deal. Basic financial concepts consider the overall growth rate of the income. When that is calculated, the 60-year compounded average growth rate is only 1.17%. Stated differently, if you start with the lease payment of $2,114,690 (Year 1) and grow it by 1.17% compounded annually, at total lease payment of $4,253,396 is achieved in Year 60.

Instead of agreeing to flat percentage increases every ten years, prudent owners of real estate assets put mechanisms in the lease to allow for market adjustments. For example, the lease may stipulate that every ten years the land is re-appraised to establish an updated fair market value for the land.

Because there are no protective measures to ensure that the landowner receives market-based rent over 60 years, the cap rate for this property is higher - likely in the 8% to 9% range. This has the impact of lowering the value because the income stream is fixed at 1.17% compounded annually, without the ability to adjust to market over the 60-year period.

Value of Leased Fee and Net Present Value

One approach to value is to divide the annual net income by a cap rate. The annual income of the Costco lease is $2,114,690. Dividing by a cap rate range of 8% to 9% results in a value of $23.5 million and $26.4 million, respectively. This essentially represents the "potential" value of the Leased Fee interest assuming that a lease is signed today and the project is already approved. In reality, PUSD will have to work with Costco's timeline to seek project approvals.

An alternative calculation for establishing value is to apply a discount rate to the entire stream of lease payments and the reversionary value at the end of the lease. For the rent payments, the discount rate is the same as the cap rate (8% to 9%) because both represent the annual return on land value. The discount rate accounts for all real estate risks associated with the lease for 60 years, such as creditworthiness of the tenant, default risk, and inflation risk.

For the reversion value at the end of the lease, we have assumed a value of $25 million in today's dollars. Assuming a land appreciation rate of 2% annually, we discounted back to present value by 10%. The slightly higher discount rate reflects the uncertainty regarding market conditions, the political environment and the condition of the site in 60 years, all of which will affect the future land value.

We have prepared a table in the Appendix that demonstrates the net present value of the lease payments and reversion at the end of the lease. Based on this analysis, the Lease Fee value is estimated to be $20.3 million to $23.8 million (average of $22 million).

It is important to note that there is an added layer of risk to the Costco proposal because the site requires approvals to change the use of the property. It could take up three years or longer to achieve approvals, which would then be subject to potential litigation that could further delay the project. In addition, the lease is unsigned and the LOI is not a binding agreement. Therefore, a higher discount rate could be used which would have the effect of lowering the net present value of the Lease Fee value.

Incomplete Analysis of the Proposals

Based on our analysis, the value of the Leased Fee ranges from $20.3 million to $23.8 million, or an average of $22 million. Compared to the Brookfield proposed purchase price of $47 million, this

represents a valuation difference of nearly 35% to 42%.[1] In other words, these two proposals are not close. As a result, more analysis and due diligence of the proposals is not only necessary but required.

By way of example, even if Brookfield hypothetically overestimated its offer by 25%, the school district would come out ahead at $35.25 million - $13 million more than the value of the Costco lease.

In addition, the "restriction" on the use of funds is a non-issue as it relates to the economic value of the proposals. It is our understanding that the lease payments can be used by PUSD; whereas the sale would have to have to be allocated toward capital improvement projects. Either way, it is revenue for PUSD to either pay for ongoing operations, or to pay for future projects that require funding.

The biggest factor is whether PUSD wants to lock itself into a 60-year lease that is significantly under market based on a compound average growth rate of 1.17%.

Should you have any questions regarding this analysis, please contact us.

Sincerely,

Gary H. London

Nathan Moeder

[1] For consistency, we assumed a $47 million sale price discounted for 36 months by a discount rate of 10%.

Appendix

NPV/Cap Rate/CAGR Calculations

Period	Annual Rent		NPV @ Growth Rate of 8.0%	NPV @ Growth Rate of 9.0%	Reversion	NPV of Reversion at 10.0%
1						
2						
3						
4	$2,114,690		$1,554,360	$1,498,100		
5	$2,114,690		$1,439,222	$1,374,403		
6	$2,114,690		$1,332,613	$1,260,921		
7	$2,114,690		$1,233,901	$1,156,808		
8	$2,114,690		$1,142,501	$1,061,292		
9	$2,114,690		$1,057,871	$973,662		
10	$2,114,690		$979,511	$893,268		
11	$2,114,690		$906,954	$819,512		
12	$2,114,690		$839,772	$751,846		
13	$2,114,690		$777,567	$689,767		
14	$2,431,894	15%	$827,965	$727,736		
15	$2,431,894		$766,634	$667,647		
16	$2,431,894		$709,847	$612,521		
17	$2,431,894		$657,265	$561,945		
18	$2,431,894		$608,579	$515,546		
19	$2,431,894		$563,499	$472,978		
20	$2,431,894		$521,758	$433,925		
21	$2,431,894		$483,110	$398,096		
22	$2,431,894		$447,324	$365,226		
23	$2,431,894		$414,189	$335,070		
24	$2,796,678	15%	$441,034	$353,514		
25	$2,796,678		$408,365	$324,325		
26	$2,796,678		$378,116	$297,546		
27	$2,796,678		$350,107	$272,978		
28	$2,796,678		$324,173	$250,438		
29	$2,796,678		$300,161	$229,760		
30	$2,796,678		$277,926	$210,789		
31	$2,796,678		$257,339	$193,384		
32	$2,796,678		$238,277	$177,417		
33	$2,796,678		$220,627	$162,768		
34	$3,216,179	15%	$234,927	$171,727		
35	$3,216,179		$217,525	$157,548		
36	$3,216,179		$201,412	$144,539		
37	$3,216,179		$186,492	$132,605		
38	$3,216,179		$172,678	$121,656		
39	$3,216,179		$159,887	$111,611		
40	$3,216,179		$148,044	$102,395		

Period	Annual Rent		NPV @ Growth Rate of 8.0%	NPV @ Growth Rate of 9.0%	Reversion	NPV of Reversion at 10.0%
41	$3,216,179		$137,078	$93,941		
42	$3,216,179		$126,924	$86,184		
43	$3,216,179		$117,522	$79,068		
44	$3,698,605	15%	$125,139	$83,420		
45	$3,698,605		$115,869	$76,532		
46	$3,698,605		$107,287	$70,213		
47	$3,698,605		$99,339	$64,416		
48	$3,698,605		$91,981	$59,097		
49	$3,698,605		$85,168	$54,218		
50	$3,698,605		$78,859	$49,741		
51	$3,698,605		$73,017	$45,634		
52	$3,698,605		$67,609	$41,866		
53	$3,698,605		$62,601	$38,409		
54	$4,253,396	15%	$66,658	$40,523		
55	$4,253,396		$61,720	$37,177		
56	$4,253,396		$57,149	$34,108		
57	$4,253,396		$52,915	$31,291		
58	$4,253,396		$48,996	$28,708		
59	$4,253,396		$45,366	$26,337		
60	$4,253,396		$42,006	$24,163		
61	$4,253,396		$38,894	$22,168		
62	$4,253,396		$36,013	$20,337		
63	$3,216,179		$25,214	$14,108	$87,046,403	$214,789
Total			$23,544,860	$20,106,927		$214,789
	Add: Reversion NPV		$214,789	$214,789		
	Leased Fee Valuation		$23,759,649	$20,321,715		

Cap Rate Value

Initial Annual Rent	$2,114,690	$2,114,690
Cap Rate on Ground Lease	8.00%	9.00%
Valuation	$26,433,625	$23,496,556

Compound Average Growth Rate (CAGR)

Year 1 Annual Rent	$2,114,690
Year 60 Annual Rent	$4,253,396
Compounded Growth Rate	1.17%

CORPORATE PROFILE
London Moeder Advisors

REPRESENTATIVE SERVICES

Market and Feasibility Studies	Development Services	Litigation Consulting
Financial Structuring	Fiscal Impact	Workout Projects
Asset Disposition	Strategic Planning	MAI Valuation
Government Processing	Capital Access	Economic Analysis

London Moeder Advisors (formerly The London Group) was formed in 1991 to provide real estate advisory services to a broad range of clientele. **The firm principals, Gary London and Nathan Moeder, combine for over 60 years of experience. We have analyzed, packaged and achieved capital for a wide variety of real estate projects. Clients who are actively pursuing, developing and investing in projects have regularly sought our advice and financial analysis capabilities. Our experience ranges from large scale, master planned communities to urban redevelopment projects, spanning all land uses and development issues of all sizes and types. These engagements have been undertaken principally throughout North America and Mexico.**

A snapshot of a few of the services we render for both the residential and commercial sectors:

- **Market Analysis** for mixed use, urban and suburban properties. Studies concentrate on market depth for specific products, detailed recommendations for product type, absorption and future competition. It also includes economic overviews and forecasts of the relevant communities.

- **Financial Feasibility Studies** for new projects of multiple types, including condominium, apartment, office, and master-planned communities. Studies incorporate debt and equity needs, sensitivity analyses, rates of return and land valuations.

- **Litigation support/expert witness services** for real estate and financial related issues, including economic damages/losses, valuations, historic market conditions and due diligence. We have extensive deposition, trial, mediation and arbitration experience.

- **Investment studies for firms acquiring or disposing of real estate.** Studies include valuation, repositioning projects and portfolios, economic/real estate forecasts and valuation of partnerships. Often, the commercial studies include the valuation of businesses.

- **Estate Planning services** including valuation of portfolios, development of strategies for disposition or repositioning portfolios, succession planning and advisory services for high net worth individuals. We have also been involved in numerous marriage dissolution assignments where real estate is involved.

- **Fiscal Impact, Job Generation and Economic Multiplier Effect Reports**, traditionally prepared for larger commercial projects and in support of Environmental Impact Reports. We have been retained by both developers and municipalities for these reports. The studies typically relate to the tax revenues and employment impacts of new projects.

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