Comments by Pam Varni August 8, 2013

1. Page 2 of 22 – Rental Property and Rental Rate.

   The latest version for cost per square foot went from rentable to gross. As I have stated before, all of the Legislature's leases are usable square feet, as are the Executive Branch leases. Basing the rate on gross is not a benefit to the Legislature and increases the overall lease costs. Calculating on rentable is more easily justified since we will be occupying the entire building. What is the justification for using gross square feet? If we had done an RFP, we would be asking for usable office space with windows; we would also not be requesting over 9,000 square feet of basement space. We currently have 811 square feet of basement space at 716 W. 4th Avenue and we rent an additional 480 square feet offsite for $1.20 per square foot. We used to have a conference room in the basement but it was rarely used so we gave up that space. I believe basement space will be undesirable and therefore underutilized. We should not be paying the same per square foot rate for it. The Chris Stephens Commercial Brokerage Opinion of Lease Rate (dated May 5, 2013) for our existing lease at 716 W. 4th Avenue valued the basement rate at $1.00 per square foot. Under the terms of this proposal, we will be paying four times the amount for basement space as we are currently and even more compared to his valuation.

   Under this proposal, 712 and 716 will not be retail space but rather an office building; again, we should not be calculating the lease on gross square feet. As I have stated above, we are already paying additional per square foot costs switching from usable to rentable. Total Gross Building Area is computed by measuring to the outside finished surface of permanent outer building walls without any deductions. All enclosed floors of the building including basements, mechanical equipment floors, penthouses, and the like are included in the measurement. We should not be leasing the penthouse, vertical penetrations, mechanical equipment, etc., which amounts to paying for space we don't occupy.

   The landlords proposal is to renovate the entire building from basement to penthouse and from wall to wall and then lease it to the legislature based on the cost of those improvements amortized over a 25 year period at AIDEA rates. The lease rate IS NOT and has never been based on a "per Square Foot" rate weather Useable or Rentable or Gross square feet.

   The legislature is not "paying more" because the lease is based on Gross. The legislature is paying a lease rate for a completed facility who's cost has been verified by an independent evaluation..

   The total cost of the lease payments are required to be less than the cost of a new building as certified by AHFC **and** an Appraisal and/or Broker Opinion of Value.

By way of comparison if the legislature were to build its own building and pay cash the cost would be "the cost" and would not necessarily based on a lease rate per square foot. Or alternatively if AHFC were to build a new building for the Legisalture and lease it to them the lease payments would be based on the cost as amortized over the course of a financing and those payments would be the lease rate. Again not necessarily based on square footage.

The above describe proposed amendment and renewal is not the result of an RFP because it has been determined that an RFP for 40,000 +/- SF of space, in downtown Anchorage, with 100+/- parking spaces dedicated and on site does not existing. Thus the proposal has been to renew at the existing location, determine the lease rate on the cost/finance basis and verify that the cost is less than a comparable new construction solution.

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Also by way of comparison there are numerous examples of buildings leased on a "gross" SF simply due to the fact the entire building is occupied by one tenant. Buildings that come to mind are: the AHFC building (I think? Pre-purchase), the Atwood building, Anchorage City Hall, the Anchorage Permit Center, the NANA building.

2. Page 3 of 22 – The Base Monthly Rental is $230,630 (this number needs to be grossed up to include the cost of Property Taxes and Insurance)

   Why is there a comment about grossing up the number for property taxes and insurance? When will there be firm numbers? Before the lease is signed The monthly rental rate of $230,630 comes to $3.60 sq. ft. Yes it does if you are calculating it based on Gross BUT NOT accounting anything toward the costs toward dedicated parking. In addition the rate does include $41.94 per GSF for a TI's ($2,7685,000) But does not include any accounting for the $5.0m of funds contributed by the tenant for TI's with an additional proposal to do a partial triple net with an estimated cost of over $600,000 per year on top of that rate. With the figures presented so far, I estimate our cost to be over $5.00 per square foot for a ten year lease. Probably closer to $4.43 full service unless you include the $5.0m then its more. AND this is what it costs for a like new building downtown with dedicated parking. It is worth noting that this Anchorage lease as proposed will be the most expensive Anchorage lease for the State of Alaska (see attached exhibit of Anchorage leases by the Executive Branch). Also, for comparison purposes, I had Research run the numbers comparing the other proposals for Anchorage legislative office space that have been before Legislative Council and this proposal. As you can see, this proposal is by far the most expensive of any previous proposals over a 30-year period (see attached). Let's please see the calculations and assumptions for these other comparable's.

   Our calculations and assumptions regarding the other solutions to follow at the end. However, keep in mind that none of those solutions got advanced past the "idea" phase so they are not really comparable solutions.

3. Page 3 of 22 – CPI Removed, 3% yearly increase in rent

The percentage of change in CPI-U needs to be back in the lease. Automatically adding a 3% increase to the total monthly rent is excessive. The calculation for the CPI-U is 35% x base monthly rent x % change in CPI-U, not 100% over the previous month's rent every July 1. As proposed, our costs will increase 3 times as much as the State of Alaska pays for CPI-U increases in rent. For example, our normal CPI-U increase on the $230,630 (35% x base monthly rental rate x % of change in CPI-U (we will use 3% as an example) would be an increase of $2,421.62/month versus $6,918.90/month ($230,630 x 3%). Also, the CPI-U calculations are meant to compensate the Lessor for the increase in utilities. Under the proposal, the Legislature pays the utilities, etc., under a partial triple net. What is the justification for a 3% yearly increase of rent under those terms?

As stated above the concept behind this solution is to provide a comprehensive solution to the legislature at a fair cost. If the solution wants to be less than a comprehensive rehabilitation of a single use building then say so and the cost will be less. The range is from as-is where-is to full renovation. But in any case the cost will be less than a new building.

As stated above the lease rate is derived by amortizing the validated project costs over a term of finance. In this case 25 years even though the commitment from the Legislature is only 10 years.

Under any commercial real estate financing transaction (which can be verified by AHFC and/AIDEA) there are two components that "pay for" the project costs; debt and equity. The lender AIDEA (or any other lender) **will require** that the loan be based on approximately 75% of value, or cost, whichever is less AND **will require** a Debt Service Coverage Ratio ("DSCR") typically about 1.30.

By way of example is the following sample calculation: a project which costs $1,000,000 would be qualified for a $750,000 loan. That loan calculated based on a 5.76% interest rate (the current AIDEA rate) and on a 25 year amortization would require a debt service payment of $4,722.83 per month.

AIDEA (or any other lender) would then require lease income of 1.30 times that amount or $6,139.68. The difference between the lease amount and the debt service payment of $1,416.85 represents the portion of the lease payment retained by the borrower (landlord) as his return on the equity portion of the cost of the project. $1,416.85/Mo. x 12 Mo. = $17,002.19/yr. That amount $17,002.19 ÷ $250,000 (the equity portion or non-debt portion of the total cost) = 6.8% return on equity.

Thus a lease based on a cost basis is calculated by taking cost (as validated as fair and reasonable costs) amortized to achieve a debt service with coverage ratio and a "fair and

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reasonable" rate of return to the investor on the investor's equity; this is the ROI ("Return on Investment"). That fair and reasonable ROI in real estate is generally in the range of 10-15%.

In order to achieve a 10% rate of return on this transaction the lease rate has been escalated at 3% per year such that the average ROI over 10 years is 10%. The lease escalation could be reduced to 0% if the starting lease rate were increased such that the ROI after debt service were 10% at the beginning.

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Even given the above the landlord is at risk after year 10 that the tenant does not renew and there are 15 years of loan service remaining which would be an argument that the ROI should be higher than 10% to allow reserves against that eventuality.

In a typical state lease the concept of 35% of the lease escalating at CPI is meant to allow the landlord to recoup increases in operating costs. The idea being that operating costs are roughly 35% of the total lease costs (which may or may not be the case) and those costs are escalating. When a landlord agrees to these terms he would/should price his lease rate bid such that he is protected against operating costs actually turning out to be higher. So he should consider his bid such that the "35%" is roughly equivalent to his true anticipated O&M costs PLUS a margin to protect against costs which increase more rapidly. This is a balance of risks between landlord and tenant over the life of the lease. In a "bid" response environment each bidder balances these risks against his desire to win the bid against competing bidders.

In the case of the proposed lease there is no bid environment because there are no solutions that can meet the desired specifications. So the "balance" between Landlord and Tenant are "negotiated" based on actual costs. Both for the original cost of the project AND the ongoing Operating costs. The concept behind a NNN lease essentially says that neither party can accurately predict the actual future operating costs thus in order to avoid estimating and the applying "margins" against the risk the parties simply agree that the tenant will simply pay the actual costs as they occur. In some cases some of those costs are in the control of the tenant such as the lighting bill or the number of janitorial efforts per week. In other cases the costs are not in the control of the tenant such as the cost per kilowatt hour.

At any rate the NNN lease is the most balanced approach for all parties' interests which is why virtually every lease completed by corporate tenants that lease nationally are based on NNN leases.

4. Page 3 of 22 – Monthly Rental Payments Sent by Wire Transfer

The State of Alaska does not at this time pay by wire transfer unless it is to a foreign entity or a payment over a million dollars. Our $230,630 a month would not qualify. Our Accounting Section has all our leases on "Scheduled Payments" and the Department of Administration issues payment before the first of the month.

Okay.

5. Page 5 of 22 – Tenant Improvements

The State of Alaska separates the leasehold improvement costs from the base lease cost. Contrast that standard with this proposal which includes in the base lease cost rental rate a portion of the leasehold improvement costs in the amount of $2,685,760. No problem to change it back the way it was but I don't think it's a good solution for the state. See below. When the State of Alaska goes out to bid, they have the leasehold improvement portion of construction distinct from the primary structure so that it is limited to the construction needs specific to the requirement of the Agency's solicitation and does not include the basic structure of the building or construction in common areas. The complete new construction of a facility is not considered leasehold improvements. Only a percentage as deemed directly connected with the Agency's needs are identified as leasehold improvements, i.e., partition walls and electrical and data outlets required to meet specific needs of the Agency. Where are the figures to show we are only paying for normal tenant improvements, (i.e. partition walls, electrical, etc.) not for the structure, etc.?

We have prepared a budget for the base building and can prepare a lease rate based on that base building. Then the tenant needs to pay for its tenant improvements. We have estimated those at $120/Gross SF. We are prepared to provide a complete turnkey tenant improvement solution for that amount price guaranteed so that you know up front what the number is.

Our Fairbanks Class A rental space cost $62.50 per square foot for leasehold improvements; and these leasehold improvements were not included in the base rent. This proposal requests a leasehold improvement rate of $120 per square foot, twice that amount. What is the justification for the disparity?

We would have to see what the Fairbanks deal was in order to understand what that $62.50 got you. Was it carpet and paint? Were the ceiling systems already in? Were the mechanical systems already distributed? Were the light fixtures already in?

The reason we have structured the lease the way we have is because the base lease costs for core and shell gets the building to a "like new" construction core and shell space which is raw unfinished space. To get from that to completed tenant improvements can run from $100 - $150 and in some cases as high as $200. We have estimated the TI's as drawn at $120 and are willing to commit to that number up front.

In the end we can finance all of them or we can finance none of them. The lease rate would be adjusted accordingly

6. Page 6 of 22 – Utilities and Services

   I strongly recommend we have a full service lease and know exactly what our price per square foot is minus 10% to show the savings required under a lease extension. It seems we are assuming too much risk and unknown costs for a ten year period without a substantial reduction in rent to accommodate our maintaining the building and parking areas for maintenance, utilities, janitorial, elevators, fire alarm, HVAC, plumbing repairs, etc.

   These costs are going to be whatever they are. If the Landlord is asked to pay for them then they will first be estimated then secondly a "margin" will be added to the estimate and then that will be added to the proposed NNN rent. Under this scenario the Legislature will be paying "costs" PLUS a "margin" instead of just costs.

   Other legislative leases require the Lessor at least every five years to renovate the space for worn walls, ceilings, floors and replace damaged or worn wall, floor, or window coverings or paint. This proposal has the Legislature assuming that cost and responsibility.

   If the legislature wants us to factor that into the cost of the lease we can. But why do so and pay for it until you know for sure that you need it? When the improvements are worn pay to replace them at actual costs. Do the work but only when needed.

7. Page 7 of 22 – Electrical Outlets

   Our language of electrical outlets every 8 linear feet of wall space is standard RFP language. In fact, the Executive Branch electrical requirements further state, "and one duplex outlet on every wall less than eight linear feet." I do not see a copy of the Approval Plans to ensure we have adequate electrical requirements. I would like to keep our 8 linear feet language and add a section that the Agency will review plans and negotiate with the Lessor to review the electrical requirements.

   Okay fine.

8. Page 12 of 22 – Maintenance and Repair

   The Lessee should keep the building and the areas immediately surrounding, and belonging to the building, free from objectionable tenancy, odors, vermin, rodents, and other features that will in the opinion of the Lessee be detrimental to Lessee's operation. With the Glacier Brewhouse, Orzo, etc. around our existing building, we have had had multiple problems with urine, cigarettes, blood, etc. The Lessor should take responsibility and not have us cleaning up the mess from the surrounding properties.

I suggest we have a full service lease and not substitute Lessor with Lessee.

Adjacent property owner will take care of their own property.

9. Page 19 of 22 – Reimbursement

I don't think the documentation section should come out. Okay fine. I also can see the Agency paying for design, engineering, etc. that was specific to our requirements, but not for items that are for the structure that would then be of benefit to the Lessor or another tenant.

I'm pleased to discuss further at your convenience.

COMPARABLES

With regard to the comparable proposals I can speak to authoritatively to 909, West 9th, the ACDA proposal and the current proposal.

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Of course, all of the comparable proposals are "academic" comparable's since none of them were ever actually advanced to hard dollars. For instance the 909 alternative was "an idea" with a rough estimate but the actual property was never under contract for acquisition for a due diligence period with a scheduled closing and a scheduled scope.

909 WEST 9TH

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The cost of $14,700,000 is approximately correct for construction. However, to that cost must be added the acquisition price of $6,700,000 for a total of $21,400,000. Plus an additional $1,000,000 of tenant supplied TI items (not counting furniture) for a total of $22,400,000. Additionally it is for a 52,000 Gross SF building including the basement or $430 per Gross SF.

Adjusting for size to 64,048 Gross SF the costs would be $27,600,000 (64,048 x $430). Further an adjustment needs to be made for "structured" dedicated parking and a location in the heart of the CBD rather than the periphery. An allocation of 25% results in a total of $34,500,000.

If financed over 25 years at AIDEA rates (based on the above explanation of how real estate financing works) the number would be $34.5 @ 5.76% = $217,250 x 1.3 = $282,425 + (O&M @ $0.83 x 52,000 = $43,160) = $325,585

$325,585 x 12 x 30 = $117,210,000

Block 102

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My recollection was for 45,000 Gross SF on a lot value that was never determined because the lot was never available for sale.

ACDA

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The ACDA proposal was for $4.00 per Rentable SF per month (May 12, 2011 presentation to Leg Council by Ron Pollock) the SF was to be determined.

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If the SF matched the SF for the current proposal then 64,048 Gross SF. Assume a Gross to Rentable efficiency factor of 82% = 52,519 RSF x $4.00 = $210,077 x 12 months x 30 years = $75,600,000. Plus the escalation to 35% of costs at an assumed CPI of 3% over 30 years = $16,800,000 = $92,400,000 Plus tenant improvements assumed to be $120 per Gross SF = $7,685,760 at an amortized cost assuming a tax exempt rate of 4.3% =$38,034/mo. x 12 x 30 = $13,700,000 for a total cost of **$106,100,000.**

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The Current Proposal

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$230,500/mo. x 12 x 30 = $83,000,000. Plus O&M at $0.83 x 64048 = $53,159 x 12 x 30 escalated at 3% per year = $31,900,000. Plus $5,000,000 TI amortized at 4.3% over 30 years = $8,900,000. For a total of $123,800,000

Conclusion

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Every real estate transaction is unique. Making broad generalities about assumptions and what might have been solutions and putting them out there as fact is not really productive.

The Proposal presented to Legislative Council and accepted by them is to renovate the existing building to like new condition and to verify that that the total cost to do so is less than new construction for the same thing.

Above and beyond that in addition to what was required by Legislative Council an additional back check is being imposed by Legislative Legal that the completed product is at a lease rate that is 90% of market for the product delivered.