



## M E M O R A N D U M

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**Date:** June 29, 2011

**To:** California State Lottery Commission

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**Subject:** Item 9(a) – Second Phase of Headquarters Campus Plan

### **ISSUE**

Should the California State Lottery Commission (Commission) demolish the existing headquarters and move forward with completing the campus project as identified in the approved Mitigated Negative Declaration (MND)?

### **RECOMMENDATION**

California State Lottery (Lottery) staff recommends that the Commission approve the demolition of the existing headquarters building at 600 North 10<sup>th</sup> Street once the Lottery is complete with the move to the new headquarters building. Further, it is recommended that Lottery staff investigate if there is a potential tenant that could commit to a lease agreement for new office space were the Lottery to build it, or if there is an opportune time to sell the excess property.

### **BACKGROUND**

In 2006 the Lottery began evaluating the headquarters complex to determine if it should rehabilitate the existing aging facilities or consider other options. In June of 2007 it was reported to the Commission that the recommendation was not to rehabilitate but to purchase something new. In October of 2007 the Lottery Commission approved funding for planning and preliminary design of a new headquarters facility on the site of the current one. The planning consisted of what to do with the 13 acres that the Lottery owned, what is the highest and best use, and what is the most advantageous to the Lottery, both from an operational efficiency standpoint as well as a financial standpoint.

Early in 2009 Richards Blvd. Joint Venture completed the California State Lottery Office Development Analysis. The campus plan analyzed various development alternatives to determine what would provide the best financial advantage on the property that the Lottery owns. The alternatives included:

1. Renovate and reuse the existing headquarters building
2. Construct a new headquarters building on-site and lease the existing headquarters complex without renovation
3. Construct a new headquarters building on-site, and then renovate and lease the existing headquarters complex
4. Construct a new headquarters building on-site, and then demolish the existing building and construct one, six-story office building of approximately 165,000 square feet (SF) and lease it out
5. Construct a new headquarters building on-site, and then demolish the existing building and construct two, six-story office buildings of approximately 165,000 SF each (330,000 SF total) for leasing and a parking structure to support them

The recommendation leading from the analysis was that the Lottery should pursue a phased development approach to the headquarters campus as shown in number 5 above. The first phase was to construct a new Lottery headquarters building which is nearly complete. For the second phase additional office space could be developed. These additional buildings could provide an ongoing source of revenue that could offset the cost of the new Lottery building and provide a cash flow stream to offset the cost of Lottery operations. The report suggested that from a purely financial standpoint, "The more the property is developed, the better the financial contribution to the Lottery's bottom line."

At the January 2009 meeting the Commission adopted the Mitigated Negative Declaration (MND) prepared for the California State Lottery complex which was consistent with the planning that had been done. While the MND indicated support for the campus plan it did not commit the Lottery to it. It was understood that with the phased approach the additional Lottery campus development was optional and would be considered in the future. With the new headquarters nearing completion the time has arrived that a decision needs to be made on how to proceed with the balance of the campus.

## **DISCUSSION**

The campus plan that was developed for the Lottery focused on leveraging assets for financial gain. If the original plan were followed in its entirety, it would mean that

the Lottery should move forward with the development of the additional office buildings and a parking structure. The construction market continues to be depressed, which would provide the Lottery with highly competitive pricing on other development, just as it received on the new headquarters building. Both the plan and subsequent staff analysis show that additional development can provide additional income for the Lottery, provided that the space is substantially occupied. The risk of vacancy is an important consideration. The Lottery would need either a high level of confidence that once completed a tenant would be found, or that the Lottery had an advanced agreement in place with a tenant. Clearly the latter would be preferred since the risk of finding a tenant is then eliminated. The pursuit of a tenant for new office space has not been undertaken.

The campus plan did have additional alternatives to leverage assets that were considered again by staff with current market conditions. Most notable were alternatives 2 and 3 above that included leasing out the existing headquarters building which, on the surface, sounds reasonable. Unfortunately, both of these alternatives continue to have challenges with return on investment for the Lottery. First and foremost, reutilizing the existing headquarters building brings with it risk of major repairs with the aging facility, which drove the original decision to replace the building. In discussions with State and private real estate professionals another major concern would be a lack of on-site parking for tenants which would have a significant affect on rental rates. The campus plan also cited, "This relative lack of parking would affect the marketability of the space under both alternatives." Alternative 2 included no renovation, which would mean no additional initial investment for the Lottery; however, it would also be difficult to generate enough income to cover the expenses of the property given the low quality of the space. While Alternative 3 would improve the quality of the space it would also include a large initial investment on renovation. These improvements would commit the Lottery to the building for several years in order to recover the investment. Again, it would be challenging to generate enough income to cover expenses. For the reasons cited here it is not recommended that the Lottery pursue leasing out the existing building.

One alternative not considered as part of the campus plan was selling off excess property once the new headquarters building was complete including necessary parking. Lottery staff briefly investigated this alternative; however, given the depressed real estate market, the common recommendation by real estate professionals was to postpone any sale until the market improved. Regardless of timing it was suggested that the property would be more marketable without any improvements on it.

**Demolition of the existing headquarters building**

Regardless of if or when the Lottery moves forward with additional campus development the next step would be the removal of the existing headquarters building at 600 North 10<sup>th</sup> Street in Sacramento. Timing of the removal is important since even empty, with very minimal maintenance, the building costs the Lottery approximately \$180,000 per year in maintenance and operations. Because the Lottery anticipated the demolition of the building the asset has been fully drawn down and there is no annual capitalization expense. Cost to demolish the building, including removal of a fuel oil storage tank, can be achieved within the existing new headquarters construction contract and budget.