COUNCIL AGENDA: 11/6/18
FILE: 18-1515
ITEM: 4.4

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Kim Walesh
Julia H. Cooper

SUBJECT: **ADDENDUM TO THE PURCHASE AND SALE AGREEMENT FOR HAYES MANSION**

DATE: November 5, 2018

Approved D. D. Sykes Date 11/5/18

COUNCIL DISTRICT: 2

REASON FOR ADDENDUM

Staff requests consideration of this recommendation by the City Council outside of normal Administrative Process Timeline in order to continue the in-process sale of the Hayes Mansion and help to ensure that the bond redemption and transfer of ownership occur without further delay.

RECOMMENDATION

Adopt a resolution authorizing the City Manager to negotiate and execute an amendment to the Purchase and Sale Agreement with JMA Ventures for the sale of the Hayes Mansion to:

(a) Include sharing a portion of the Furniture, Fixtures, and Equipment Reserve Account balance, not to exceed $2,400,000;
(b) Require that JMA deposit an additional $1,000,000 into escrow within two business days of the property approval instead of the $500,000 required by the Purchase and Sale Agreement. The total deposit would be $1,500,000, which the City would retain in an event of Purchaser default; and
(c) Include a provision such that the completion of the parking lease agreement is a condition to closing, rather than an issue precluding the property approval.

OUTCOME

City Council's adoption of the resolution will allow staff to continue toward completing the sale of the Hayes Mansion to JMA Ventures ("Purchaser") for $30,000,000. More specifically, this action is important for the Purchaser's "property approval" under the Purchase and Sale Agreement to move forward to the close of escrow and, whereby the Purchaser's total deposit of $1,500,000 will become non-refundable after the approval, and the City would retain the deposit should the Purchaser default.

Ultimately, completing the proposed sale will allow the City to eliminate all outstanding long-term bond debt against the property and eliminate the ongoing General Fund subsidy for debt service, which ranged from $2,000,000 to $6,000,000 per year since 2003, and is budgeted at $4,900,000 in 2018-2019.

BACKGROUND

On June 26, 2018, City Council adopted Resolution No. 78713, approving a purchase and sale agreement with JMA Ventures, LLC for the sale of the Hayes Mansion for the amount of $30,000,000, along with related actions. The staff memorandum dated June 8, 2018 provides a complete background of the property, renovation phases and bond issuances, financial difficulties of the City's ownership, and efforts to sell the property. The June 8, 2018 memo also contains a complete analysis of the current buyer and Purchase and Sale Agreement.

ANALYSIS

The City and JMA Ventures executed the Purchase and Sale Agreement on August 7, 2018, and JMA Ventures wired its initial deposit of $500,000 to the escrow account held by First American Title Company.

Since executing the Agreement three months ago, JMA Ventures has worked diligently and in good faith toward the purchase of the property, achieving several milestones and investing a considerable amount of time and funds into vetting the property and its investment suitability. These milestones include: negotiating a Memorandum of Agreement with the local Unite Here! labor union; signing a Letter of Intent with Hilton and submitting an application for the Hilton Curio brand; filing a liquor license application with the Department of Alcoholic Beverage Control; and completing thorough inspections and investigations related to the property, detailed in the subsequent sections.

Due Diligence Period

The first phase of the Purchase and Sale Agreement is the "due diligence" period, which is the standard practice in a real estate transaction and allows a potential purchaser of a property to conduct inspections and determine whether or not the purchaser wishes to complete a transaction. During this period, a buyer's deposit is typically refundable, though the purchaser takes on the financial burden of investigating the property and conducting appropriate due diligence. Due to the considerable time and expense involved with inspecting a large commercial property, it is not the standard practice for a purchaser to conduct extensive due diligence activities prior to entering into a purchase contract with a seller.

In addition, sellers usually provide information known to them about the conditions of the property without undertaking any additional investigations. Accordingly, it is in the interest of a potential purchaser to conduct its own investigations during a due diligence period.

The Purchase and Sale Agreement between the City and JMA Ventures states:

> *Seller has requested Purchaser to inspect fully the Property and investigate all matters relevant thereto and to rely solely on the results of Purchaser's own inspections or other information obtained or otherwise available to Purchaser, rather than any information that may have been provided by Seller to Purchaser.*

The Agreement further provides that:

> *Purchaser shall have 45 business days from the Date of this Agreement to review all information relating to the Property and to conduct such inspections, tests, and investigations regarding the Property, including, without limitation, engineering, environmental, and ADA studies, as Purchaser may elect, at Purchaser's sole cost and expense. If Purchaser is satisfied with the results of its inspections and investigations and desires to proceed with the purchase of the Property, then Purchaser shall deliver written notice to Seller.*

Findings Related to Property Condition: Deferred Maintenance and Renovation Scope

During the due diligence period, JMA Ventures conducted its own inspections and investigations with several third-party inspectors and consultants.

JMA hired building system specialists to perform detailed inspections and analyses of the building components that are not readily accessible, nor apparent from a walk-through or visual assessment. Those specialists identified extensive deferred maintenance and needed repairs to major building systems and components. These items include: HVAC equipment replacement; roof replacement in several areas; elevator system repair and replacement; safety issues to comply with egress, sprinkler, and other building codes; leaks and plumbing related items; and structural improvements for water intrusion on the slab foundation of Building 1. JMA Ventures has disclosed that the deferred maintenance items are estimated to cost approximately $7,000,000.

It is important to note that this figure does not include the capital repairs that the Purchaser would perform to the City's parking garage on the adjacent parcel as consideration of the lease of the subterranean portion of the parking garage.

In a separate, but parallel set of investigations, JMA Ventures hired designers and consultants to develop a renovation scope and budget to renovate the 214 guest rooms and expansive common spaces, and to develop the large on-site restaurant. Renovation items include: new flooring, wall coverings, furniture, window coverings, artwork, bathroom finishes and fixtures, and audiovisual equipment, among other items. The total renovation scope is estimated to cost $19,100,000. The industry-standard way to state hotel renovation costs is on a per room or "per key" basis, even though the renovation includes common areas and amenities outside of the rooms. In this case, the per-key renovation budget (for 214 rooms) is estimated at $89,374.

The total capital budget (deferred maintenance plus renovation scope) is estimated to be $26,100,000, exclusive of the capital repairs to the subterranean portion of the parking garage on the adjacent parcel.

JMA's Plan Prior to Entering into the PSA

During the City's bid selection process, which began in fall 2017, JMA Ventures provided to staff its "going-in" assumption that it would need to invest a total of $15,000,000 of capital into the property. The $15,000,000 budget included approximately $12,840,000 in renovations ($60,000 per key in renovations), and the remaining $2,160,000 for deferred maintenance. The deferred maintenance portion of the initial budget was informed by several walk-throughs of the property by JMA's investment team, but did not include detailed inspections by building specialists and experts, which are routinely performed during the due diligence period of a Purchase and Sale Agreement. The renovation portion of the budget was informed by the industry experience of the JMA team, who benchmarked the visual condition of the Hayes Mansion against other properties it had recently acquired and renovated. The JMA team ultimately assumed that $15,000,000 would be sufficient to cover deferred maintenance and the renovation.

During the bid selection process, JMA made clear to staff that it budgeted $15,000,000 for capital investment and that its target hotel brand was Hilton Curio or Marriott Autograph. These factors (proposed capital investment budget and hotel brand) were part of staff's evaluation criteria, and accounted for a total of 15 out of 100 available points. For perspective, the second place finalist assumed a capital investment of $8,000,000 to $10,000,000 and proposed the same two prospective brands. Given the general knowledge of the evaluation team that the City had not invested heavily into the property over the years, staff concluded that JMA's $15,000,000 capital budget was more realistic.

The table below shows the difference between JMA's capital budget prior to entering into the PSA, and the Hayes Mansion's actual capital needs after completing due diligence.

	Budgeted Capital Needs Prior to PSA	Actual Capital Needs After Due Diligence
Deferred Maintenance	$2,160,000	$7,000,000
Renovations	$12,849,000 or $60,000 per key	$19,126,000 or $89,374 per key
Total Capital Budget	**$15,000,000**	**$26,126,000**
Difference in Capital Budget		**($11,126,00)**

The difference between JMA's capital budget prior to entering into the Purchase and Sale Agreement and after completing its thorough investigations during the due diligence period is $11,126,000. The actual deferred maintenance discovered through the due diligence investigations is significantly greater than the assumption JMA made prior to entering into contract; the specialists who performed the thorough inspections uncovered many defects that were not apparent from the earlier walk-throughs. Likewise, the renovation budget, driven significantly by increasing material and labor costs, and the Hilton Curio requirements, surpassed the earlier expectations. (It is worthwhile to note that the other proposed brand, Marriott Autograph, provided a costlier set of requirements and had concerns about the property's location and lack of foot traffic. As a result, JMA decided to forgo a potential relationship with that brand.)

The "Go" or "No Go" Decision

At this point of any pending real estate transaction, a buyer updates its pro forma model with actual costs, and makes any other adjustments as a result of its findings during the due diligence period. Then, based on a measure of investment return (such as internal rate of return ("IRR") or return on investment ("ROI") a buyer makes a "go" or "no go" decision on the purchase of the property. Unfortunately, the difference in JMA's budgeted capital verses actual capital needs has impacted the pro forma to the point of a potential "no go" decision to complete the purchase of the Hayes Mansion.

JMA explained the property condition and cost challenges to staff. Considering the circumstances, JMA proposed that in order to complete the transaction, it would need to retain the Furniture, Fixtures, and Equipment ("FF&E") reserve fund to ease the capital funding gap. The City had originally negotiated to retain this reserve fund prior to Council's approval of the sale on June 26, 2018.

This reserve fund acts as a savings account for the property manager to use to replace furniture, fixtures, and equipment as needed. Funds accrue into this account at a rate of 4% of gross revenues per month. At the time of City Council's approval of the sale on June 8, 2018, the

FF&E reserve account contained approximately $2,308,000. As of September 2018, the account contained $2,468,434. By the end of 2018, it could grow to approximately $2,600,000.

Staff's Recommendation

JMA Ventures has worked diligently and in good faith toward the completion of the sale of the Hayes Mansion. The firm has developed partnerships to facilitate a smooth transition in ownership, including negotiating an agreement to retain the local Unite Here! labor union. Based upon its track record as a reputable and responsible hotel owner, staff are confident that JMA will be a good steward of this historic and important San Jose asset.

From a financial perspective, selling the Hayes Mansion will allow the City to eliminate all outstanding long-term bond debt against the property and eliminate the ongoing General Fund subsidy for debt service, which ranged from $2,000,000 to $6,000,000 per year since 2003. In addition, by completing the transaction in the short-term, the City can minimize the debt service owed between now and June 1, 2019. Specifically, for the Series 2008C Bonds, monthly interest payments of $31,333 through June 1, 2019 amount to $219,330 (principal due for the Series 2008C begins on June 1, 2024). For the Series 2008D Bonds, monthly interest payment of $47,000 through June 1, 2019 amount to $329,000. The June 1, 2019 principal payment for the Series 2008D Bonds is $3,295,000. Together, total interest and principal due on for the Series 2008 C and 2008D Bonds on June 1, 2019 is approximately $3,800,000.

Staff recommends amending the Purchase and Sale Agreement with the following terms:

- Agree to share a portion of the FF&E reserve account (to be negotiated), but capped at $2,400,000. The City would retain the balance as net proceeds of the sale. Contribution of a portion of the FF&E reserve will reduce the City's total net proceeds by the negotiated amount, but will still allow for full repayment of all of the outstanding bonds.
- Require that JMA sign the "property approval" in conjunction with amended Agreement to share a portion of the FF&E reserve funds, thereby ending the due diligence period and converting the refundable deposit to non-refundable status.
- Require that JMA deposit an additional $1,000,000 into escrow within 3 business days of the property approval (instead of the $500,000 required by the Purchase and Sale Agreement). The total deposit would be $1,500,000, which the City would retain in an event of Purchaser default.

Staff's recommendation to share a portion of the FF&E reserve fund will allow for the sale of the Hayes Mansion with <u>positive net proceeds,</u> estimated to be at least $3,105,668, depending upon the actual share negotiated. The table below shows the financial implications of staff's recommendation:

Estimated Source and Use of Funds
(Preliminary, subject to change)

	As of June 2018	As of Dec. 2018	Recommendation
Source of Funds			
Sale of Hayes Mansion Proceeds	$30,000,000	$30,000,000	30,000,000
Debt Service Reserve Release – CSJFA 2008C	1,091,500	1,102,056	1,102,056
Debt Service Reserve Release – CSJFA 2008D	4,739,000	4,787,171	4,787,171
Cash Released from Hayes Operations [a]	990,000	990,258	990,258
Furniture, Fixture & Equipment Reserve [b]	2,308,000	2,468,434	2,468,434
Total Sources	**$ 39,128,500**	**$39,347,919**	**$39,347,919**
Use of Funds			
CSJFA 2008C Bonds Retirement	$10,915,000	$10,915,000	$10,915,000
CSJFA 2008C Accrued Interest	31,333	62,667	62,667
CSJFA 2008D Bonds Retirement	17,545,000	17,545,000	17,545,000
CSJFA 2008D Accrued Interest	47,000	94,000	94,000
Permanently-Affixed Public Art [c]	150,000	150,000	150,000
Devcon Loan Repayment [d]	1,200,000	1,200,000	1,200,000
Other Related Obligations	3,875,600	3,875,584	3,875,584
FF&E Reserve Contribution (not to exceed)	-	-	2,400,000
Excess Funds	5,364,567	5,505,668	3,105,668
Total Uses	**$ 39,128,500**	**$39,347,919**	**$39,347,919**

[a] *Estimate – Final amount to be determined at the closing of the sale*
[b] *FF&E reserve fund accrues monthly; $2,468,434 balance as of September 2018. This figure may increase to approximately $2,600,000 by December 2018*
[c] *Public Art that cannot be removed from the Hayes Mansion, permanently affixed; Final amount to be determined by the Office of Cultural Affairs and will be subject to a future appropriation action of Council to transfer to a CIP Public Arts Fund.*
[d] *Prior to November 2013, the Mansion was operated under a lease agreement between the City and Hayes Renaissance, L.P. ("HRLP") and it was terminated due to HRLP's inability to meet the terms and conditions of the agreement. Upon termination, the City agreed to assume HRLP's liability to Devcon Construction Incorporated ("Devcon") in the amount of $1,200,000 and the City entered into a repayment agreement with Devcon, with no payment of interest, no maturity date, and subordinate to the Center's net revenues. Since 2003, there has been insufficient net revenues to make payments on the Devcon loan and the full amount remains outstanding. With the sale of the property, sales proceeds along with other funds will be sufficient to repay the Devcon loan in full.*

Additional Considerations

Edenvale Garage Parking Lease

On June 26, 2018, in a separate but related action, City Council approved the award of the 50-year lease of the subterranean portion of the Edenvale Garden Park parking garage to JMA Ventures. Staff and JMA are working to complete the lease agreement, but have discovered certain issues that may require future City Council action. For example, the survey of the property shows that the roadway providing access to the Hayes Mansion (perpendicular to Edenvale Avenue) lies on City parkland – not the Hayes Mansion parcel - and is not part of the public right of way. This means that the City must create an easement across the roadway in order to provide JMA (or any future owner of the Hayes Mansion) with access to the property.

Given this new information and other issues related to the parking lease it will take more time for staff to complete the parking lease, staff recommend that the proposed Amendment to the Purchase and Sale Agreement also include a provision such that the completion of the parking lease agreement is a condition to closing (rather than an issue precluding the "property approval"). Shifting this item toward close will allow for JMA to formally issue the "property approval," and for the deposit to become non-refundable.

EVALUATION AND FOLLOW-UP

Below is a summary of key milestones and estimate completion time:

Redemption of Authority's 2008C and 2008D bonds	Winter 2019
Close of escrow and transfer of ownership	Winter 2019
Council approval of budget and appropriation actions	Spring 2019

PUBLIC OUTREACH

Extensive public outreach was performed to develop the City Manager's 2008 General Fund Structural Deficit Elimination Plan. This Plan identified the Hayes Mansion as an under-performing City-owned asset that should be repositioned and returned to private ownership.

Staff contacted approximately 400 real estate brokers to notify the real estate community of the City's intent to sell the Hayes Mansion and invite offers to purchase the property. The bid solicitation was posted to two leading commercial real estate websites, reaching thousands of potential bidders, including brokers and developers.

COORDINATION

This memorandum was developed in coordination with the City Manager's Budget Office and the City Attorney's Office.

COMMISSION RECOMMENDATION/INPUT

The sale of the Hayes Mansion was not considered by a Commission.

FISCAL/POLICY ALIGNMENT

The sale of the Hayes Mansion aligns with previous City Council direction to dispose of under-performing City-owned assets. In addition, the retained use of the property as a hotel allows the City to continue to receive hotel-related tax revenue, and the sale to a private entity adds the Hayes Mansion to the property tax roll.

COST SUMMARY/IMPLICATIONS

As described above, the sale of Hayes Mansion would generate a positive net impact in 2018-2019 of approximately $3,100,000 in net sale proceeds and $3,800,000 in avoided debt service payments in 2018-2019 for a total of $6,900,000. On an ongoing basis, the City would eliminate the General Fund transfer to the Community Facilities Revenue Fund, which is currently budgeted at $4,900,000. Staff will return to the City Council during a future budget process for a final accounting after the transaction's close and recommend budget adjustments necessary to recognize the net impact. As described in the June 8, 2018 memorandum, a likely candidate for the net proceeds would be the accelerated pay down of golf course-related debt, which is in alignment with City Council Policy 1-18 that seeks to redirect one-time savings from debt restructurings and refundings toward paying down the outstanding principal of other existing City debt."

CEQA

Not a Project, File No. PP17-003, Agreements/Contracts (New or Amended) resulting in no physical changes to the environment.

/s/
KIM WALESH
Deputy City Manager
Director of Economic Development

/s/
JULIA H. COOPER
Director of Finance

For questions related to the sale of the property, please contact Nanci Klein, Assistant Director of Economic Development, at (408) 535-8184; for questions related to the outstanding bonds, please contact Julia H. Cooper, Director of Finance at (408) 535-7011.