STAFF REPORT
ACTION REQUIRED

Hummingbird Centre Redevelopment – Commercial Component Lease

Date:	June 11, 2007
To:	Executive Committee
From:	Deputy City Manager and Chief Financial Officer Chief Executive Officer, Hummingbird Centre for the Performing Arts and
Wards:	28
Reference Number:	P:\2007\Internal Services\SP\Ec07006Sp – wo (AFS #5167)

SUMMARY

This report provides an update on the negotiation of a long-term lease (the "Lease") with Castlepoint Realty Partners Limited ("Castlepoint") for the commercial component of the proposed redevelopment of the Hummingbird Centre for the Performing Arts ("HC").

Legal staff have advised that specific Council authorization is required for the approach recommended by HC and Finance staff in this report for resolving the principal outstanding issue with respect to the Lease. This issue involves the terms under which the City may exercise its right to terminate the Lease in future and re-take possession of the City lands.

RECOMMENDATIONS

The Chief Executive Officer of the Hummingbird Centre for the Performing Arts and Deputy City Manager and Chief Financial Officer recommend that Council approve the embodiment within the Lease of the early termination clause providing in substance the following:

"(i) should the City (or any third party assignee of the City's interest in the land on which the Commercial Component is situated) terminate the Commercial Component Lease pursuant to any of the early lease termination options contained in the Lease, then the use made of the Commercial Component by the City (or the assignee of the City's interest) shall be limited for a period of three years from the effective termination date to any public use that is cultural or charitable in nature that Council shall then determine;

(ii) should such termination occur during the second termination period (i.e., during years 26 to 30 of the Lease term) then the use restriction as described above shall be for the period of 3 years if the option is exercised in years 26 or 27, reducing to 2 years if exercised in year 28 and one year if exercised in year 29. No use restriction would apply if exercised in year 30; and

(iii) for the purpose of determining the payment to be made by the City to Castlepoint pursuant to the provisions of the second termination option of the lease, the appraiser in determining fair market value shall take into account the applicability of the use restriction to the extent that the Commercial Component is not tenanted at the effective point of lease termination."

Financial Impact

The recommendations in this report will not result in any financial impact.

DECISION HISTORY

At its meeting of September 28, 29 and 30, 2005, Council considered Clause No. 1 of Report No. 8 of its Policy and Finance Committee (the "2005 Report") regarding the updated Business Plan for the HC and the detailed redevelopment proposal from Castlepoint Realty Partners ("Castlepoint").

Council directed that the City and the Board of Directors of the Hummingbird Centre (the "Board") pursue the Board's preferred Business Plan option, which contemplated construction of CityCentre and the sale of a portion of the HC site for a proposed condominium tower, in order to help fund the cost of constructing CityCentre. Council further directed that the parties consider a default option wherein Castlepoint would build the CityCentre space (the "Commercial Component") and enter into a long-term lease with the City to use it for commercial purposes, if the Board is unable to raise funds necessary to build CityCentre by a predetermined date. The City would have the option to terminate the Lease early if the Board is successful in raising the funds at a later date. Council directed that a Working Committee of City staff and Board members be established to review alternative "civic uses" for the Commercial Component, should this lease termination option be exercised by the City in the future. This review was to include civic options including, but not limited to:

1. A Humanitas project;
2. A facility to examine environmental advancements, innovation and sustainability; and

3. A sports complex

At its meeting of July, 25, 26 & 27, 2006, Council adopted Clause No. 59 of Report No. 6 of the Policy and Finance Committee (the “2006 Report”) with a number of recommendations, including the following:

- the City enter into an Umbrella Agreement with Castlepoint providing for the sale of a strata portion of the HC site for the amount of Fifteen Million Dollars ($15,000,000.00), in accordance with the terms and conditions summarized in the Executive Summary attached to the report, and substantially in the form of the agreement attached to the report;
- if the parties proceed with the Commercial Component, that the parties enter into a long term lease for a term of 89 years, for a one-time payment of Three Million and Five Hundred Thousand Dollars ($3,500,000.00) for basic rent; and
- the City enter into such other agreements as may be, in the opinion of the City Solicitor, be necessary to give effect to the Umbrella Agreement.

The 2006 Report indicated that the Working Committee had met and determined that it was premature to recommend any specific future civic use for the retail/commercial component of the redevelopment should the CityCentre concept not proceed immediately. The Working Committee determined that all potential civic uses should be considered in due course at the appropriate time.

ISSUE BACKGROUND

As part of the development of the HC Business Plan, it was determined by HC staff that a fallback option would be necessary in the event that sufficient funds could not be raised to construct CityCentre. As this structure would form the base of the proposed condominium tower, it could not be added at a later date if funds were not available at the time the condominium tower is constructed.

As a solution, Castlepoint proposed that if the Board had not raised sufficient funds by a specific date (currently set at December 31, 2007), Castlepoint would enter into a long term lease with the City, build the structure (the Commercial Component) and use it for commercial purposes. If the Board could later raise sufficient funds, the City would have the opportunity to terminate the lease at two specific points in time.

The first of the early lease termination options would occur ten (10) to fifteen (15) years after substantial completion of the Commercial Component, and after it is 95% leased and occupied (the “Stabilization Date”). The City would have the option to terminate the Lease by making a payment to Castlepoint that would result in Castlepoint recouping its capital expenditures and earning a 10% return on its investment. The second lease termination option would be available twenty-six (26) to thirty (30) years after the Stabilization Date, upon payment by the City to Castlepoint of the fair market value of the Commercial Component. Castlepoint, City and HC staff reached agreement on this approach and these early termination options were incorporated in the Umbrella Agreement attached to the 2006 Report.

As the purpose of the termination options has been to provide the City with the future opportunity to create CityCentre or some other facility with a public use, Castlepoint has requested that the early lease termination provisions in the Lease permanently restrict the City to a public use of this property. However, following further negotiations, Castlepoint has proposed the following more limited restrictions:

- In the event that the first lease termination option is exercised (ie. at years 10 to 15), the City may only use the property for public uses for the three years thereafter (i.e. during the first three years after terminating the Lease, the City cannot use it for commercial purposes or sell it to another party that will use it for commercial purposes)

- In the event that the City exercises the second termination option (ie. at years 26 to 30), the City may only use the property for public uses for three years thereafter if the termination option is exercised in years 26 or 27, reducing to 2 years if exercised in year 28 and one year if exercised in year 29. No use restriction would apply if exercised in year 30.

- In the event the City sells the property to another party, the purchaser must also be bound by the above restrictions in exercising the early lease termination options

Although the staff reports to Council discussed the purpose of the termination options in terms of possible civic use, as did the Council motion establishing the Working Committee, the recommendations in the 2006 Report do not refer to any use restriction on the Commercial Component in the event the Lease is terminated. Accordingly, Legal staff have advised that Council authority is required if such future restrictions on the City's use of its land are to be included in the Lease.

COMMENTS

The HC's objective for the early lease termination options has always been to hold open the possibility of creating CityCentre or some other facility in the structure at the base of the proposed condominium tower on the HC site. According to Castlepoint's representatives, Castlepoint agreed to the termination options in order to help HC achieve this objective. It was not Castlepoint's intention to agree to termination options that might act instead as a means by which a hard cap would be placed on their returns from investment in the CityCentre structure.

In agreeing to undertake construction of the Commercial Component, Castlepoint will be facing the risk, common to any commercial real estate venture, that the projected returns may be lower than anticipated. If adverse market conditions are experienced, and the City does not exercise the termination options, Castlepoint may experience a financial loss on its investment. In Castlepoint's view, this risk would be offset by the potential of generating a significant profit in the event that favourable market conditions exist, and the City does not exercise the termination option.

Without Castlepoint's proposed use restrictions, a hypothetical possibility exists for the City to use the termination option to cap Castlepoint's returns and to generate an additional profit for the City. For example, if Castlepoint's use of the Commercial Component is very successful over the first fifteen years, the amount that the City would have to pay Castlepoint to exercise the first termination option will be very low because the amount by which Castlepoint's revenues will need to be topped up to reach the minimum ten (10%) percent return on investment will be relatively small. The City could then sell or lease the property to another party. The value of this space to another owner or tenant would be high if the space has recently been highly successful in generating rental revenue. In this manner, the City could theoretically realize a substantial windfall by paying a low termination price and immediately selling the space at a much higher price if there is no use restriction.

For the second termination option, Castlepoint has raised the hypothetical possibility that it could also be manipulated to reduce its returns. Although the price for terminating the Lease will be established by an appraisal of fair market value, the City will have a five year time period over which it can choose to exercise the option. In Castlepoint's view, it would be possible for the City to choose a specific year in which the appraised value is low in anticipation that values will rise and that the property can be leased or sold at a profit for another commercial venture.

Such approaches to using the termination options were not envisioned by HC and Finance staff. The financial assessment of the proposed transaction in the 2005 Report did not incorporate the potential for additional profit through the use of the early termination options to achieve purely financial objectives for the City. Finance staff are of the view that such approaches would represent a departure from the original objectives and would be inconsistent with the original principles established with Castlepoint. Therefore, HC and Finance staff support Castlepoint's proposal to restrict the City's use of the Commercial Component, in the event that the early termination options are exercised.

It has been agreed with Castlepoint that the City must not be permanently restricted in its use of the property, should one of the early termination options be exercised. The possibility exists that the City will exercise the lease termination but determine at a later date that limiting the property to public uses is no longer necessary. Staff in conjunction with outside counsel, have prepared a proposed lease termination clause which restricts the use of the structure for the first three years after the first termination option. For the second termination option, the use restriction will be for 3 years if the option is exercised in years 26 or 27, reducing to 2 years if exercised in year 28 and one year if exercised in year 29. No use restriction would apply if exercised in year 30. HC and Finance staff recommend that Council approve this clause in order to resolve this remaining issue so that the proposed redevelopment may proceed.

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