

Office Optimization - Office Swing Space

Date: June 27, 2019
To: Executive Committee
From: Deputy City Manager, Corporate Services
Wards: 10 Spadina-Fort York

SUMMARY

The purpose of this report is to seek approval of the plan to use Union Station East Wing floors 2, 3 and 4 (the "East Wing") as office space for the City and to invest in the base building obligations and fit-up requirements of the facility, allowing for the reduction of City office leases, securing of critical swing space to support future office optimization and modernization, resulting in the realization of operating cost savings.

There is approximately 92,000 square feet of space in the East Wing of Union Station. A small portion of the space is currently being used by Union Station operations staff and as a construction site office for various construction projects active at the station, and is otherwise vacant and in need of base building and fit-up investments to support any type of future occupancy. After a third party review of potential use options for the space, and considering the City's priorities of achieving fiscal sustainability, it was determined that utilization of the East Wing as City office space would realize the highest value from the premises. As a result, in the near term, this report recommends utilizing the East Wing as City office space to achieve the following City benefits:

- Unlocks value by repurposing underutilized, vacant City-owned space.
- Rationalizes external City leases to reduce overall operating costs and improve fiscal sustainability.
- Secures critical swing space in the downtown core, enabling further cost avoidance during office optimization and modernization projects versus leasing third party space.

Corporate Services and CreateTO have identified five (5) locations where the City leases space from third party landlords at a cost to the City of approximately \$2.5 million per year. These five (5) leases are scheduled to expire in 2020. By investing \$20 million in base building and fit up costs, the City will be able to eliminate these five (5) City leases, consolidating them into Union Station East Wing to generate immediate cost savings and provide a significant return on investment. This will maximize the utility of the premises in the near term, and will be critical in enabling a broader office optimization plan, which will be brought forward to City Council in Q3 2019. Beyond the

initial five (5) leases coming to the end of their term in 2020, there are an additional twenty-five (25) City leases that are coming to the end of their terms over the next (eight) 8 years that will be rationalized, which represents additional opportunity to reduce operating costs associated with the City's office portfolio on a long-term and sustainable basis

On a long-term basis, City staff will continue to explore other options for the East Wing, including considerations brought forward by the current head lessee to utilize the space as retail, attraction and/or other commercial and publicly accessible uses.

RECOMMENDATIONS

The Deputy City Manager, Corporate Services, recommends that:

1. City Council amend the 2019 - 2028 Approved Capital Budget and Plan for the Facilities, Real Estate, Environment & Energy program by adding a new capital project "Union Station East Wing" with total project cost of \$20.0 million and cash flows of \$2.5 million in 2019 and \$17.5 million in 2020, to be funded by recoverable debt, repayable over 15 years, to complete base building and office fit-up work associated with Union Station East Wing.
2. City Council approve the plan from the Deputy City Manager, Corporate Services, to utilize Union Station East Wing on an interim basis to rationalize spaces leased by the City from third party landlords which expire in 2020 and serve as swing space for office modernization projects.
3. City Council, in accordance with Section 71-11.1C of the City of Toronto Municipal Code Chapter 71 (Financial Control By-law), grant authority to amend Purchase Order Number 6030175 with NORR Limited, Architects and Engineers and increase the value of the contract by \$850,000, net of all taxes and applicable charges, revising the current contract authority from \$44,473,000, net of all taxes and applicable charges, up to a maximum value of \$45,323,000, net of all taxes and applicable charges, to provide required additional base building architecture and engineering services for the East Wing Project.

FINANCIAL IMPACT

The current condition of the East Wing requires both base building and fit-up expenditures in order to make the full 92,000 square feet of space safe and suitable for occupancy. The City is required to maintain the base building needs of the premises regardless of internal or third party use.

It is estimated that the current base building requires \$10 million in expenditures for upgrades and repairs to electrical, mechanical and architectural systems. An additional

\$10 million is required to out-fit the premises for office uses, including workstations, furniture and interior construction. This makes up the \$20 million investment required (including contingencies and allowances) in order to utilize the space for City office use. Of this amount, up to \$4 million will be invested in workstations and furniture that will have an estimated lifespan of 15 years and can be reused or relocated to another City office facility if and when required.

Council approval is required to amend the 2019 - 2028 Approved Capital Plan for the Facilities, Real Estate & Environment and Energy program by adding a new capital project "Union Station East Wing" in the amount of \$20.0 million to carry out the work outlined above, with 2019 cash flows of \$2.5 million and 2020 cash flows of \$17.5 million funded through 15 year debt requiring annual payments of \$1.7 million that will be recovered through lease savings.

To justify and offset the investment proposed, CreateTO and City Staff have identified five (5) locations where the City leases office space from third party landlords which are set to expire in 2020. The City can relocate operations from these leased premises and utilize the East Wing space on an interim basis allowing the City to not have to incur the costs related to these third party leases. The current annual gross expenditure of these third party leases is approximately \$2.5 million, which does not consider rent increases and/or leasehold improvements that would be expected should the City have to renew these leases. The East Wing has the capacity to accommodate these five (5) leases and the existing East Wing occupants, approximately 330 staff, in approximately 30,000 square feet. The remaining 62,000 square feet of space in the East Wing can accommodate an additional 750 staff from leases expiring in 2021 and beyond and/or can be utilized as swing space to support a broader office optimization plan. Leveraging the East Wing as swing space will lead to further cost avoidance by providing City-owned space to accommodate staff during renovations rather than leasing third party spaces.

In analyzing the options for use of the East Wing, City staff recognized that the \$10 million required to address base building requirements would be incurred in any scenario, regardless of City or third party use. Therefore, in determining the annual rate of return of the investment in the East Wing the base building costs were excluded. Over a 10 year period the lease savings generate sufficient benefits to cover all operating costs and the incremental \$10 million investment in office-fit up costs, as shown in Table 1 below.

Table 1: Financial Analysis (excluding Base Building Costs) over a 10 Year Period

Item	Financial Cost / Benefit over 10 Years
Capital Required - Office Fit-Up	\$10 million
Operating Required - Total Operating Costs (\$0.45M/yr)*	\$4 million
Estimated Annual Savings - Lease Savings (\$2.5M/yr)	\$22 million
Annual Rate of Return **	18%

* Assumes initial occupancy of approximately 30,000 sf. Operating costs estimated at \$15 per square foot for maintenance, custodial, security and utilities.

** Assumes \$22 million in lease savings over 10 years (\$2.5 million per year) / \$14 million in incremental costs over 10 years (\$10m office fit-up + \$4m operating costs).

Additional benefits and savings will be identified, that go beyond the five (5) leases and financial analysis above, in the Q3 2019 report to City Council on the office optimization strategy which will maximize the use of the East Wing and improve the rate of return and payback period. Overall, the recommended approach to use the East Wing for City office use provides the greatest return to the City in the near-term, as downtown office space is currently being leased at historically high prices and lease costs for the City are expected to increase significantly if third party leases are renewed in 2020.

CreateTO and City staff also explored the potential to utilize the East Wing for commercial use (via the Head Lessee), using generic assumptions related to potential financial returns provided by a consultant. The consultants assumed net revenue (i.e. revenues excluding operation costs and taxes) for the East Wing space estimated at \$40 per square foot under a commercial use scenario. Under the terms of the Head Lease the City and the Head Lessee would share equally in the net proceeds. Based on the above assumptions, the commercial use of the East Wing would not generate sufficient financial benefits for the City as compared to the proposed use which will allow the City to collapse existing third party leases and fully leveraging the premises as swing space, thus avoiding future costs to lease swing space should this space be required.

DECISION HISTORY

At its meeting on May 14, 2018, Executive Committee adopted a staff report entitled "Optimizing the City-Wide Office Portfolio" and endorsed key directions to modernize and find efficiencies in the City-wide office portfolio:

<http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2018.EX34.4>

At its meeting on July 4, 2017, City Council directed the Chief Corporate Officer to provide City Council with plans for the East Wing of Union Station to avoid opportunity cost of vacancy, including a financial analysis of the capital funding requirements and potential revenues or savings:

<http://app.toronto.ca/tmmis/viewAgendaItemHistory.do?item=2017.AU9.9>

COMMENTS

The City owns approximately 92,000 square feet of usable space in the East Wing of Union Station, spanning the 2nd, 3rd, and 4th floor. The majority of the space is currently vacant and in need of base building investments to support full occupancy. The premises were previously tenanted to a major bank for office uses, which was vacated in July 2016. Since that time, only small portions of the space have been used to accommodate on-site construction project teams and Union Station operations staff. City Council directed staff to report on the potential use of the East Wing, following an Auditor General report identifying the underutilization of the premises. An investment is required across the entire 92,000 square feet so that the City can occupy the space to

capitalize on the opportunity cost of vacancy and further rationalize leases to reduce operating expenses.

Highest and Best Use of Union Station East Wing

CreateTO staff commissioned a consultant to complete a highest and best use study for the East Wing premises. The study included an objective evaluation of different use types, with a focus on office and retail, to determine optimal use. The study concluded that the best utilization of the space in the near term is for office use due to the location of the premises (i.e. upper floors vs. ground floor space), market demand, implementation risk, building layout, building conditions, elevator access and expected financial returns.

In the long term, the future uses of the East Wing will consider principles previous set out by Council around the restoration and revitalization of the station, as well as broader City priorities and objectives, to determine the most appropriate use for the East Wing space. In the short term, the East Wing will be used as City office space to allow for the rationalization of external leased space, provision of critical swing space, and to reduce overall operating costs in the City's real estate portfolio.

The initial Union Station Revitalization Project scope of work intentionally did not include the interior base building elements of the East Wing, as this space was currently tenanted and was expected to be tenanted until the end of the project, initially scheduled for 2016.

Head Lease Agreement and Union Station East Wing

In 2009, the City entered into a 75 year Head Lease Agreement with a third party, Osmington (Union Station) Inc. ("Osmington" or "Head Lessee"), providing them with the exclusive right to carry out commercial uses at Union Station within pre-defined spaces. Commercial activities performed by Osmington include, but are not limited to, administering the lease out of retail spaces, commercial advertising, and special events. The Head Lease Agreement provides that the City and Osmington share in the net operating income generated from all commercial activities. The Head Lease Agreement states that if the City chooses to lease any portion of the East Wing for commercial use, it must first offer this space to the Head Lessee, Osmington.

Union Station East Wing for City Use

This report recommends utilizing the East Wing of Union Station to rationalize the space occupied under a number of leases with third party landlords which expire in 2020. The rent and operating costs under these leases amount to approximately \$2.5 million annually.

The East Wing will also serve as swing space to accommodate staff during office renovations at Metro Hall and City Hall, which are receiving investments in office

modernization (as approved by City Council). A plan to scale office optimization across the larger City-wide office portfolio will be reported to City Council in Q3 2019. Securing swing space in the downtown area is a critical component of the office modernization plan, as staff need to be relocated while office space is renovated and made more efficient. Construction on the East Wing may take 12-16 months to complete, which necessitates starting construction as soon as possible so that swing space is available and prepared for occupancy once Council approves a broader office optimization plan and to ensure the City is able to leverage its asset to the fullest extent to minimize and manage costs.

Leveraging City-owned space in the East Wing to provide swing accommodation is financially prudent, as Toronto's leasing market becomes increasingly expensive and in short supply. Toronto's downtown office vacancy is one of the lowest in North America, dropping to a record low of 2.6% in Q1 2019. The current leasing environment puts pressure on space availability, lease terms (i.e. landlords require longer term commitments) and asking prices. It is estimated that leasing swing space of 92,000 square feet could cost up to \$40 million for a 5-year term (based on \$65 per square foot gross - estimated average downtown rent), including \$30 million in gross rent plus \$10 million in fit-up costs. Furthermore, City-wide, the annual cost of space per individual occupant (including all operating and capital costs associated with the premises) is approximately \$8,900 per occupant in leased office space versus \$6,700 per occupant in City-owned office buildings. The cost savings support the rationale to leverage City-owned assets to the fullest extent possible and reduce leasehold interests. Investing in the East Wing office space will provide a total occupancy load of 1,071 persons (357 per floor) based on a building engineer assessment.

Contract Amendments

As NORR is the architecture and engineering firm of record for the Union Station Revitalization Project, their knowledge and experience working in the building is required to support the interior design of the renovated office space. As part of the East Wing office renovation project, NORR will provide services to the interior design consultant including engineering design requirements, integration between the East Wing office renovation project and the Union Station Revitalization Project, integration with building systems and commissioning. Based on industry benchmarks and current market conditions, staff estimate that an additional contract amendment up to \$850,000, inclusive of contingencies and allowances, is required to provide the required services to complete this project.

Next Steps and Deliverables

As a next step, Facilities Management and Purchasing and Materials Management will procure a third-party Project Management Services firm through a competitive process. The Project Management Services Firm will be responsible for all design, construction and furniture fixtures and equipment associated with the Union Station East Wing improvements. Concurrently, Real Estate Services and Facilities Management will work with affected leasehold interests to determine appropriate scheduling and logistics for

relocation and lease expirations. A broader report on office optimization and how to fully leverage the East Wing (for the City's interim use) within the context of a modernized office portfolio will be recommended to Council in Q3 2019.

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SIGNATURE

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ATTACHMENTS
