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BGR RELEASE

January 15, 2009

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Rethinking the World Trade Center Building Transaction

The World Trade Center, rising high above the Mississippi River with spectacular views of the city, is commonly perceived as one of the most valuable redevelopment sites in New Orleans. It consists of a 33-story tower building and parking garage, owned by the city's New Orleans Building Corporation (NOBC) and built on city-owned land at the foot of Canal Street. The building, about 40 years old, has passed its prime as an office tower and is in need of redevelopment.

But despite the property's location, redevelopment efforts that began more than 10 years ago have been unsuccessful. An eight-year effort by the developer originally selected for the project terminated in 2006. A new developer was chosen in 2007, but withdrew in August 2008. In October, NOBC gave the runners-up in the 2007 round of developer proposals 120 days to seek financing and close a deal. NOBC indicated that it would seek a new round of proposals if the developers could not meet the deadline. In November, both runners-up declined the opportunity to pursue the deal.

Although past efforts have suffered from a variety of economic, financial, legal and political problems, the long delay raises questions about continuing the city's underlying approach to redevelopment. Since the 1990s, the city has pursued redevelopment of the property in partnership with the master tenant of the tower and garage, the World Trade Center of New Orleans, Inc. (WTC), a private nonprofit civic organization dedicated to international trade development.

This report reviews the current approach and suggests an alternative strategy – an outright sale of the buildings.

Background

In 1963, the city, acting through NOBC's predecessor, leased a site at the foot of Canal Street, and all improvements to be built on it, to the master tenant's predecessor for 56 years. The master tenant's predecessor built an office tower and garage on the site. The construction was financed through revenue bonds issued by NOBC's predecessor. The lease, which expires in

2019 (Current Lease), obligated the master tenant to pay rent in an amount sufficient to retire the bonds. That obligation ended in 1993, when the bonds were retired. The master tenant currently pays no rent for its use of the building and garage. It receives rents from other building tenants and the garage and pays the costs of operating, maintaining, insuring and repairing the property. All net income flows to the master tenant for its own purposes.

In the 1990s, the master tenant approached the city with a proposal to convert a portion of the tower building into a hotel. Since then, NOBC and the master tenant have been jointly pursuing redevelopment of the World Trade Center property.

Both NOBC and the master tenant have cited the limited term remaining on the Current Lease, about 11 years, as a practical hindrance to long-term redevelopment of the property. NOBC proposed dealing with that problem by entering into a new 99-year lease and development agreement with the master tenant. Under that arrangement, the master tenant would assign its rights under the Proposed Lease to a private developer. In exchange, the master tenant would receive payments and rights worth approximately $15 million.[1]

NOBC would receive an up-front payment of rent. Based on the 2007 Request for Proposals, this payment would be at least $19 million.[2] In addition, NOBC would receive annual payments equal to 60% of the property taxes that would be due on the existing improvements if they were not tax-exempt.[3] It plans to use the proceeds for riverfront redevelopment.

Together, the up-front payment to NOBC and the compensation to the master tenant total approximately $34 million. This total exceeds NOBC's most recent market value estimate for the buildings of approximately $24 million, and may make it difficult to do a deal without tax abatements and other public subsidies to offset the premium paid above fair market value. To the extent that such subsidies are granted, the public ends up giving back over the long term what it receives up front. We note that the transaction as it was most recently structured protected the developer from paying taxes on 40% of the value of the existing improvements.[4]

Alternative Strategy

The city established NOBC, a nonprofit, public benefit corporation, for the purpose of owning, leasing, developing and operating city properties. As the city's agent, NOBC has an obligation to maximize the return on those assets.

Unfortunately, the current redevelopment strategy for the World Trade Center buildings unnecessarily limits the city's ability to maximize its return on the asset and should be abandoned. Instead of entering into a new lease with the current master tenant, NOBC should seek to buy out the master tenant's remaining 11-year leasehold interest in the tower and garage buildings and then sell them outright.[5]

Buying out the master tenant and selling the buildings free and clear of its interest is preferable to the Proposed Lease for several reasons. First, a sale to a private developer would return the World Trade Center buildings to commerce and place them on the tax rolls. Second, it would allow NOBC to maximize the return to the public by delivering an unencumbered property. Third, it would eliminate needless complexity and result in more transparent, market-based pricing for both NOBC's and the master tenant's respective interests. Fourth, it would fairly compensate the WTC organization for its remaining leasehold interest and allow it to pursue its civic objectives as it deems fit. The risk of the property languishing undeveloped could be reduced by imposing a development timeline with penalties for nonperformance.

While the master tenant cannot be forced to sell its leasehold interest, there are good reasons for it to consider a fairly priced buy-out.[6] The short remaining life of the Current Lease makes it difficult to generate revenue. Floors 4 to 17 of the office tower are currently gutted, and returning them to commerce would require a significant investment that could not be easily recouped over the remaining term of the lease. Attracting office tenants will become more difficult, and income from the tower will decline, as the lease termination date approaches. A buy-out would provide a funding source for recouping a portion of the pre-development expenses that the master tenant is currently carrying.

What is a reasonable price? One approach would be to pay the present value of the master tenant's projected net income from the World Trade Center property over the remaining 11-year lease term, compensation for the two floors it occupies, and reimbursement for a portion of legitimate pre-development expenses that benefited the redevelopment process. Compensation for the two floors, worth an estimated $1.2 million, could come in the form of a cash payment for surrendering them, or a condominium or leasehold interest. A condominium or leasehold interest would allow WTC to continue to occupy its current space.

The master tenant's net income from the buildings was negative in 2007, the last year for which information is publicly available.[7] The master tenant claims that projected net income should not be based on that year, since the master tenant intends to resume leasing the gutted floors. However, it is unlikely that the master tenant will be able to generate income at a level sufficient to justify the compensation under the Proposed Lease.

The master tenant claims that it is entitled to additional compensation for a number of other factors, such as the intangible value of its name on the building and revenues foregone when it ceased leasing many of the floors in anticipation of a redevelopment transaction that never occurred. While it is unfortunate that the prior redevelopment failed, the citizens of New Orleans should not be held responsible for this outcome. As for the name, the WTC organization would always be free to negotiate with any future owner of the building for the use of its name.

Leases for the redevelopments proposed over the last 10 years would have provided WTC with a 99-year payment stream. WTC and NOBC have indicated that the payment stream was intended to provide the WTC organization with a steady revenue stream to support its future economic development efforts. WTC has also argued that treating the redevelopment of the property strictly as a real estate transaction undervalues WTC's history and its role as an institution for the promotion of international trade. While WTC's trade efforts may merit some type of government support, the redevelopment of the World Trade Center buildings should be approached strictly as a real estate transaction. Other considerations, including the WTC's past contributions to economic development and its future role in this regard, should not affect the price paid to the WTC for its leasehold interest. They should be addressed separately by the city and WTC.

During the 65 years that it has pursued its international trade mission, the WTC has made significant contributions to the economic life of the city. City support of the WTC or any other nonprofit providing beneficial economic development services should come through a cooperative endeavor agreement that clearly spells out responsibilities and compensation – not through an indirect 99-year commitment in a lease.

Conclusion

NOBC, as the city's agent, has an obligation to maximize the return on the city's assets. The Proposed Lease transaction, which extends the WTC organization's leasehold interest by 88 years, fails to deliver on that obligation. It compensates the WTC for more than its leasehold value, and unnecessarily limits the amount of taxes payable to the city, the Orleans Parish School Board and other tax recipient bodies. It also limits the property's development potential by introducing unnecessary complications and continuing obligations.

It is time to try a different approach, namely a buy-out of WTC's interest and a clean sale of the buildings. The city should set a minimum price that approximates their market value and sell them to the highest bidder willing to accept a redevelopment timeline with penalties for nonperformance. Issues related to WTC's role as an economic development entity should be addressed separately from those relating to the real estate.

As noted above, WTC has a long history of promoting international trade in New Orleans, largely through the efforts of dedicated volunteers. If the city wants to support the organization's work, it should provide funding directly, as it does in other cases, pursuant to a cooperative endeavor agreement.

ENDNOTES

[1] They include: a guaranteed minimum revenue stream of $350,000 per year, adjusted for inflation every five years; a condominium interest in, or beneficial use of, the 29th and 30th floors, where WTC has its offices and dining club; and $5 million to cover a portion of interior demolition, legal and other pre-development expenses incurred by WTC in connection with the first aborted transaction. BGR estimates the present value of the guaranteed revenue stream at $8.6 million and two floors at $1.2 million.
To value the guaranteed revenue stream, BGR assumed an inflation adjustment of 10% at the end of every five-year period. This rate approximates the average, five-year change in inflation since 1998. BGR then discounted the 99-year stream of payments at a rate of 6%. To value the two floors, BGR attributed to the tower $14 million of the up-front lease payment and 60% of the present value of WTC's guaranteed revenue stream. These totaled approximately $19 million, or $30 per square foot for the 635,000 square feet that would be available to the developer. It multiplied the square footage of the floors retained by WTC by $30. For the reimbursable pre-development expenses, BGR used the number stipulated for such expenses in a memorandum of understanding between NOBC and WTC, dated January 31, 2007. WTC claims that the amount due now exceeds $6 million.
[2] The request for proposals called for up-front rent totaling at least $24 million. The $5 million payment for WTC's predevelopment expenses would be deducted from the proceeds. New Orleans Building Corporation and World Trade Center of New Orleans, Inc., Request for Developer Qualifications and Lease Proposals, released January 31, 2007.
[3] The tower and garage structures are currently tax-exempt. According to NOBC, the improvements made by the developer would be fully taxable.
[4] We are advised by NOBC that the discount was provided because WTC and the developer are giving up their rights to build on part of the land. NOBC sought the no-build area to protect the line of sight to the river. The no-build area consists of an 8,409-square-foot strip, about 70 feet wide, running along the left side of the tower building from Canal Street toward Spanish Plaza. Approximately half of the area appears to be subject to a Public Belt Railroad right-of-way, which would limit (if not prevent) the tenant's ability to build there.
[5] As an alternative to an outright sale, NOBC could enter into an effective sale of the buildings through a 99-year lease directly with a developer. However, to provide the same benefits as an outright sale, the lease should require a full payment in lieu of taxes to the tax recipient bodies. The sale or lease of the improvements would be coupled with a new lease of the underlying city-owned land.
[6] WTC claims that it has the right, since the original development deal collapsed in 2006, to select a new developer and enter into a new lease, provided that the rental payments and economic benefits to NOBC are not "materially different" from the original deal. As the source of that right, it cites Section B (10.02) of a lease that was signed in 2003 in connection with the original deal. However, the effective date for that lease never occurred. Section D of that lease declares the lease, other than Section C (which addresses reimbursement expenses), is null and void *ab initio* in those circumstances. Thus, Section B is deemed never to have gone into effect.
[7] Based on information in World Trade Center of New Orleans, Inc., Internal Revenue Service Form 990: Return of Organization Exempt from Income Tax, 2007.

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