TORONTO TRANSIT COMMISSION
REPORT NO.

MEETING DATE: November 17, 2009

SUBJECT: TTC GROUND LEASE RENEWALS – RENT DETERMINATION PROCESS

INFORMATION ITEM

REASON FOR CONFIDENTIAL INFORMATION:

This report contains advice or communications that are subject to solicitor-client privilege.

RECOMMENDATION

It is recommended that:

1) The Commission receives the information set out in the confidential attachment;

2) The contents of the confidential attachment remain confidential in their entirety as it contains advice which is subject to solicitor – client privilege.

FUNDING

There are no direct funding impacts arising from this report.

BACKGROUND

At the August 26, 2009 meeting of the Committee of the Whole, staff was requested to report back on "an ongoing process to be used for any new or extended long-term property renewals or leases to ensure that the TTC is receiving best value."

Concern has been raised regarding the fixing of an amount of rent into the distant future when inflation can be expected to erode the value of the rent payment.

TTC is the registered owner of most of the lands used for the construction of the original Yonge Subway line between Union Station and Eglinton, outside of the road allowance. Consequently where surplus lands were leased in the 1960's, TTC is the landlord and handles lease renewals.

With the expansion of the subway system, property was acquired on TTC's behalf by the former Municipality of Metropolitan Toronto. With amalgamation, the City of Toronto became the owner of these transit lands, as an example those above the Bloor Danforth subway line, and the City administers a number of ground leases where TTC is not a party to the agreement. City of Toronto (Facilities & Real Estate) negotiates these ground lease renewals, usually with limited TTC participation unless TTC have new property requirements.

DISCUSSION

TTC has not entered into any new ground leases over the last 20 years excepting the Parliament Loop (as part of the City's acquisition of the First Parliament Building site). Most leasing activity is associated with existing ground leases that grant renewal terms at the option of the tenant. The majority of TTC ground leases were executed in the late 1960's / early 1970's and contain similar wording regarding renewal terms:

> "Execute and deliver another lease for a term of thirty three years of the demised premises with covenants in all respects similar to those in this indenture, excluding the provisions as to the quantum of rental"

The "quantum of rental" is typically defined as "a fair and proper sum to be paid as yearly rent for the demised land excluding buildings". This is intended to ensure that the tenant is paying rent only on the value of the land and not on the improvements to the land that are typically paid for entirely by the tenant.

The basic formula for determination of renewal rent at the date of renewal (or other time as defined in the lease) is:

Annual Rent ($) = Land Value ($) x Fair Market Rate of Return on Leases (%)

The typical challenge is assessing the Land Value which is a function of location, size, configuration, permitted uses, zoning, encumbrances and existing conditions. While many of these factors are common to all real estate transactions, long term ground leases over subway lines are a very limited subset of all property transactions and there are relatively few relevant comparables in the marketplace. Land Value estimates frequently have a very large range between lowest value estimates proposed by the tenant and the highest value estimates suggested by the landlord.

The fair market rate of return on ground leases is typically tied to interest rates / long term bond yields and lies between a more easily defined range.

To achieve best value for TTC's assets, as the landlord, the amount of annual rent should ideally include:

1) A guaranteed minimum net rent
2) An escalation mechanism for the minimum rent such as CPI
3) A participation rent component that allows TTC to share in the profits

There are two alternative approaches commonly employed, the 'objective' and the 'subjective', and care should be taken to choose the appropriate treatment at the time depending on the lease. Land value should ideally be based on the highest and best use and TTC should not be under compensated if the tenant elects to under develop a site.

Frequently surplus transit lands under lease are encumbered by the existence of adjacent transit operations. While convenient access to a subway station is an asset that enhances property value, there are also circumstances where allowances must be made for certain costs the tenant must incur that are not typically encountered on land that does not contain transit facilities. In addition to the original incremental development costs, over the long term the cost of maintaining supporting structures that separate the development from the transit facilities can become very large and requires adjustment to a rental amount that would be appropriate for a building constructed on land without a subway.

As time has passed and new transit projects such as the Fire Ventilation Upgrades, Second Exits, and Easier Access Improvements have been created, the ability to recapture surplus land from the leased use is becoming increasingly important. In addition to an amount of rent, TTC obtains value when we are able to operate with as little interference as possible from our tenant's activities. To confirm TTC is receiving fair value in rent renewals, an external real estate consultant can be engaged to participate in the process, including performance of a peer review.

JUSTIFICATION

TTC is bound by the terms of the agreement which was agreed to in the distant past. Every attempt is made to negotiate fair rents at market value which reflect the specific circumstances and TTC current and future operating requirements.

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October 29, 2009
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