CALSTRS

Regular Meeting

Item Number 2 – Open Session

Subject: Chief Executive Officer Report

Presenter(s): Cassandra Lichnock

Item Type: Information

Date & Time: May 4, 2022 – 20 minutes

Attachment(s): None

PowerPoint(s): None

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1. **Headquarters Expansion (HQE) Construction Update**

The construction is approximately 59% complete with the latest project schedule indicating a revised Substantial Completion Date (SCD) of late March to early April 2023. Presently, the hard cost contingency budget, approved by the board at the January 2022 board meeting, is sufficient to cover this schedule shift.

On the exterior, the installation of the curtain wall continues, and the main roof is complete this month. Exterior garage metal panel structural framing is nearing completion with the actual panel installation scheduled to begin next month. Interior framing/drywall and rough MEP continues on all levels, as well as sprinkler and vertical mechanical shafts and stair installation. The project schedule update remains in process.

Construction Activities

Construction activities continue and the work completed this month is below:

- Curtain wall installation complete at 03-05
- Curtainwall installation ongoing at 06-07
- Roofing complete at main roof
- P2 Boardroom Interior modifications complete
- Framed Mechanical Shafts (center and south) through 07
- Electrical rough in, equipment installation and drywall continue at office levels 03–07
- Spray applied fireproofing complete at elevator 27 shaft through 07
- First round of water testing of the Curtain Wall System completed and passed

- Completed Fire Sprinkler piping and seismic at P1
- Poured treads and landings at stair 21 parking levels through 04
- Startup of Garage Transfer & Exhaust Fans
- Completed framing and build out of boiler room
- Pads poured for the fire and jockey pump at fire pump room

Schedule Status

The December 2021 Project report included a published schedule with a SCD of January 31, 2023, including 12 weather days. The project's latest projections indicate a late March, early April 2023 targeted SCD, and excludes the weather day contingency since the building exterior is complete.

When the change order was fully approved updating the project budget at the January board meeting, DPR began the official process of finalizing the contracts with the necessary subcontractors. DPR had assumed in the development of the January 31, 2023, schedule, the availability of the trades to complete the project within that timeframe. Unfortunately, they did not predict a labor shortage of skilled workers in certain construction trades, which is the reason the schedule has been pushed out. DPR is developing a recovery schedule that includes accelerating construction activities to 6-day workweeks and or 10-hour workdays and utilizing any means necessary to bring the SCD date back to January 31, 2023.

Budget Status

The budget status for the month ended March 31, 2022 is summarized below:

Summary Period: 3/31/22

Budget Categories	Total Project Budget	Costs to Date	Balance to Complete
Hard Costs	$ 253,358,792	$ 150,534,270	$ 102,824,523
Hard Cost Contingency	$ 4,557,216	$ -	$ 4,557,216
Soft Costs	$ 50,870,198	$ 30,109,648	$ 20,760,550
Project Contingency	$ 9,713,794	$ -	$ 9,713,794
Totals	**$ 318,500,000**	**$ 180,643,917**	**$ 137,856,083**

Risk Status

On-going risks associated with the project are:

<u>OSFM Field Inspections</u>. The OSFM field inspector embraces a narrow interpretation of Underwriter's Laboratory (UL) listings and design which in many instances requires further UL research, and/or an Engineering Judgment on behalf of the design team. Mitigation efforts include weekly meetings between the OSFM and the project team with one week look ahead updates to

ensure that DPR is ready for upcoming inspections. The OSFM is also increasing their days on site from 3 days to 4 days per week to accommodate expediting the schedule.

Project Schedule

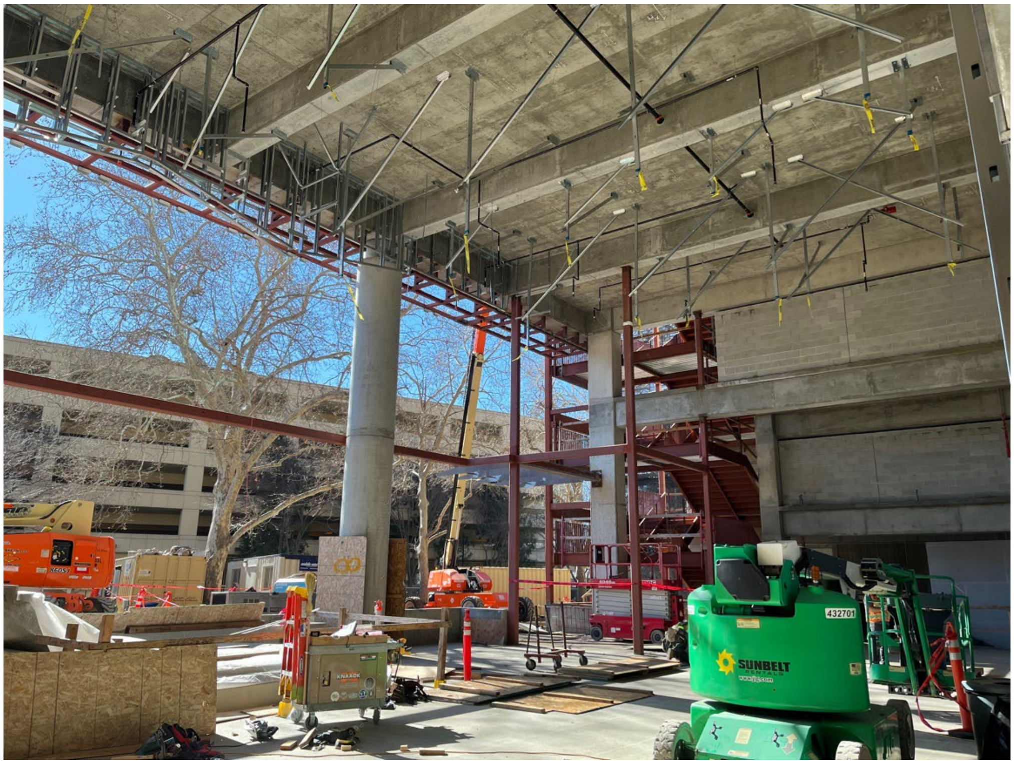
The Subcontractors predict impacts from labor shortages across all trades and supply chain impacts. DPR's efforts to accelerate construction activities to 6-day workweeks and or 10-hour workdays will help mitigate the effects on the project. DPR is managing procurement of all outstanding items and will inform us of issues from any supply chain impacts.

Project Photos

Building View West Side (E Street)

Building View – West and North Sides

West Side



Lobby

2. Leasing and Occupancy Update

There has been an increase in tenant activity as companies are trying to bring their employees back to the office. Currently in the Sacramento Downtown area, Jones Lang Lasalle (JLL) is tracking 14 active tenants looking for office space. They range in size from 5,000 SF up to 48,500 SF. Two of these are recently advertised State requirements: Victims Compensation and Government Claims Board for 34,700 sf and Dept of Managed Care for 48,500 sf. 100 Waterfront Place has been submitted and the final date for submittals was March 31, 2022.

Over the last two years, tenants have taken a wait and see approach, postponing any significant investments in relocations. There are currently 9 prospects on the activity report. Most of these tenants have been using short term renewals to plan the timing of when they return to the office.

JLL's preliminary first quarter office statistics is complete. Absorption for the first quarter for the Sacramento Metropolitan area is -549,711 SF. Statistically this is the largest negative net absorption in a single quarter since the onset of the Pandemic. This is the result of the State of CA consolidations and downsizes and have been anticipated. In the Downtown market, the State of California Managed Healthcare moved out of 48,000 SF at 980 9th Street and California Department of Parks and Recreation moved out of 58,500 SF at One Capitol Mall. Wells Fargo Center also had -31,851 SF of private sector tenants vacate their building during the last quarter. Many of these vacancies have been expected for some time and they are just hitting these statistics now. The overall office market has already anticipated much of this news and any reduction of rents have already occurred.

Overall Sacramento's vacancy is currently 19.3% while the Downtown area is at 18.5%. When looking at the Class A product in both of these areas, the overall vacancy is at 18.2% while Downtown is 15.8%. The average asking rates do remain flat in Downtown at $3.44 per SF on a monthly basis.

Additional Activities

CalSTRS headquarters hosted the Greater Sacramento Economic Council and The Governor's Office of Business and Economic Development (GO-Biz) 2022 Fam Tour event, where they invited top site consultants from around the nation to experience Greater Sacramento's assets and competitiveness for themselves. This even featured speakers from GO-Biz, along with some regional partners that had case studies to share. CalSTRS building was showcased as one of the most compelling Class A real estate options in the region.

Lease Revenue Bonds

Recently, staff was asked: Are the debt service "lease" payments (for the Bonds used to finance the HQE Project), impacted by fluctuations in rental revenue expected from future headquarters building lease(s)?

The short answer is "no, not directly", but first, a reminder for how the decision was made to issue the Bonds and lease portions of CalSTRS' headquarters:

The board undertook a rigorous multi-year evaluation to solve CalSTRS long-term space needs. A critical step in this process was considering CalSTRS' three long-term facility alternatives - expansion, acquisition, or lease. A thorough financial analysis was prepared to compare the net cost of each alternative under consideration. This ultimately led to the board's decision in November 2018 to move forward with the expansion alternative (HQE Project), utilizing tax-exempt lease revenue green bond financing.

The quantitative financial analysis entailed a comparison of the cost of each alternative based on their respective net present values (NPV). Simplistically, an NPV analysis takes a set of future cash flow projections (inflows and outflows) and discounts them at a rate reflective of current funding costs, to arrive at comparable present day value of each alternative. For the HQE Project analysis, the 7.0% assumed investment rate of return was deemed the most relevant discount rate over a 30-year horizon. Note: The primary cash flows for the HQ Expansion alternative, using bond financing, included estimates for facility operating costs, capital improvements, tenant improvements, debt service payments on the bonds, parking income, rental revenues (assuming certain floors of HQ would be leased out until needed by CalSTRS) and an estimated residual value for the HQ Expansion at the end of the 30-year horizon.

As noted, estimated rental revenues for the existing headquarters were included in the NPV analysis, adding to the favorable results of the NPV for the HQE Project using the bond financing alternative. However, it's important to recognize that the NPV analysis was used to support a decision made at a point-in-time. Once the decision was made, the NPV had no subsequent bearing on the actual bond financing transaction.

More specifically, the projected rental revenues from the existing headquarters that was incorporated into the NPV will not have a direct impact on the debt service payments for the bonds. Although the revenues from leasing the headquarters will be remitted to the trust fund and subsequently invested, and in that sense will indirectly offset some of the cost of the HQE Project, they are not a direct source of funding for the debt service payments.

To better explain this, following is an overview of the bond transaction:

In December 2019, CalSTRS successfully secured bond financing for the HQE Project with the issuance of $340.6 million ($272.6 million par and $68.0 million original issue premium) in tax-exempt lease-revenue green bonds through a conduit issuer, the California Infrastructure and Economic Development Bank (IBank).

Legal Structure:

- The bond issuance is facilitated through CalSTRS' lease-leaseback arrangement with the IBank.

- Under this arrangement, CalSTRS leases the HQE Project site to the IBank via the Site Lease and the IBank contemporaneously leases the site and the HQE Project back to CalSTRS via the Facility Lease. The IBank will use the lease revenues received from CalSTRS to pay the debt service on the Bonds. **This is the why the bonds are called "lease-revenue" bonds.**

- The proceeds of the Bonds issued by the IBank were remitted to the bond Trustee, The Bank of New York (BNY) Mellon Trust Company, N.A., and CalSTRS was provided access to the bond proceeds for payment of HQE Project construction costs.

- Once the HQE Project is substantially complete, CalSTRS will make semi-annual lease payments (debt service) to repay the principal borrowed (the par value), along with interest due, to the IBank, and the IBank will then passthrough these payments to BNY to pay the semi-annual debt service due on the bonds.

Security and Source of Bond Lease Payments:

- CalSTRS is obligated to make bond lease payments from any lawfully available funds of CalSTRS, including all net assets of the State Teachers' Retirement Plan (STRP).

- As the HQE Project is considered an investment of CalSTRS, lease payments (debt service) will be continuously appropriated under state statutory law, such that the lease payments are subject to neither CalSTRS nor the State's budget processes.

Rental revenues are not identified as a direct source of funds for CalSTRS facility lease payments to the IBank, which the IBank will subsequently use to make the debt service payments. As noted above, "any lawfully available funds of CalSTRS, including all net assets of the STRP" are the source for our lease payments to the IBank. Thus, any future revenues from leasing of the headquarters and the payment of debt service on the Bonds are separate and distinct transactions.

Any additional bonds we issue to complete the HQE Project will be structured similarly. As a result, our ability to lease the existing headquarters will also have no direct impact on any debt service payments for any additional bonds issued to complete the HQE Project.

Additional information on the bonds payable can be found in CalSTRS June 30, 2021, Annual Comprehensive Financial Report, on pages 70 to 71 and 81 to 82 at CalSTRS.com.

3. GFOA Triple Crown

The Government Finance Officers Association awarded CalSTRS a special "Triple Crown" to recognize the receipt of all three GFOA awards: the Certificate of Achievement for Excellence in Financial Reporting award, Distinguished Budget Presentation award, and the Popular Annual Financial Reporting award, for the fiscal year 2018-19. To commemorate the achievements, GFOA provided a medallion which can be added to our existing award plaque as a "testament to the government's commitment to producing annual reports that evidence the spirit of full disclosure and transparency."

4. CalSTRS Chief Auditor is Retiring

CalSTRS' Chief Auditor, Larry Jensen has announced his retirement. He joined CalSTRS as Chief Auditor in July 2014, following 19 years working at CalPERS, where he served as Chief Risk Officer from 2010 to 2014. This is his last Teachers' Retirement Board meeting.

During Larry's career at CalSTRS he has championed a thorough and rigorous approach to audits and compliance. Under his leadership, the employer audit program was reengineered to focus on detecting and correcting issues before members retirement, including new limited-scope desk audits. These enhancements allowed the number of employer audits to grow from 15 to 100 annually. He also prioritized working with stakeholder organizations to increase awareness of the audit process.

Larry has aligned the internal audit program to assist in the achievement of CalSTRS strategic goals and objectives and to manage risk. The internal audit team is now performing 10-12 audits per year. He has focused on developing staff and implementing a quality improvement program to align with the Standards for Professional Practice of Internal Auditing. In 2021, the Institute of Internal Auditors gave CalSTRS office of audit services the highest rating available for meeting professional standards.

CalSTRS Enterprise Compliance Services program has also benefited from Larry's leadership. He helped develop and mature the program, which resulted in the implementation of the Compliance and Ethics Hotline, and the development of multiple processes and compliance collaboration across the organization.

Larry's colleagues praise him for positive attitude and his commitment to ethics, teamwork, and working with stakeholders. He has made a huge difference at CalSTRS, and he will be missed. His plans for retirement include spending time with family (four grandchildren), traveling, and enjoying the great outdoors while bike riding, camping, hiking, and fishing.