



Confidential Memorandum

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To: Members of Council

From: Gul Nawaz, Chair Finance Committee

**Copies: Finance Committee members
CEO/Registrar, Director of Administrative Services**

Date: December 22, 2008

Subject: Purchase of 40 Sheppard Ave. West

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The Finance Committee met on December 19th to provide comments on the comprehensive report related to the purchase of 40 Sheppard Avenue West that the CEO/Registrar is preparing for the February Council meeting. At the November Council meeting, Council had issued the following Council directive:

That the CEO/Registrar prepare a report that includes the following elements:

- 1. an up-to-date valuation of 40 Sheppard Avenue West;**
- 2. the business case for 40 Sheppard Avenue West;**
- 3. a risk assessment 40 Sheppard Avenue West;**
- 4. the business cases for alternatives to purchasing 40 Sheppard Avenue West;**
and
- 5. all other proper investigation and documentation that is considered part of a normal purchasers due diligence in such a major business transaction.**

During that meeting, Council had recommended that the report should include comments from the Finance Committee.

The Finance Committee discussed the issues regarding the ability of PEO to justify to the members paying in excess of the appraised value of \$21,800,000 with PEO owning and occupying the building. It was noted that the appraised value for use as an investor is \$20,866,000 as it factors in an ongoing vacancy rate. The committee concluded that it was not unreasonable to pay a premium for a building that is in the location preferred by Council and given that it was not on the market. The committee commended the President and the CEO/Registrar for being able to reduce the purchase price from \$24 million to \$22,575,000.

Some members of the committee felt Council is paying a large premium to be located at the subway, when other suitable accommodations could be obtained for considerably less if proximity to the subway was not an essential criterion. One member of the committee noted that 15 years ago, when PEO located at 25 Sheppard

Avenue West, the Council of the day also supported paying a premium to be located close to the subway.

The committee reviewed the comprehensive analysis and concluded that PEO can afford to purchase 40 Sheppard Avenue West. The committee recommended putting as much money down as possible, as PEO's return on investments will be less than the interest rate of the mortgage. The committee commented that it appreciated Council approving its recommendation to revise the reserve policy to include the equity in the building as part of the reserve requirement. It is expected that this policy change will enable PEO to put at least an extra \$3 million into the down payment. Based on the higher down payment and the lower interest rates expected on the term sheet from the banks (i.e. 5.25 per cent vs. 6.5 per cent used in the modeling), reduced purchase price and maintaining the same payment schedule, PEO would own 40 Sheppard Avenue West in 12 years and four months, as compared to 25 years in the model.

The committee agreed that the decision to purchase should be based on what's best in the long run for PEO and using PEO's owner's equity, five years out is a useful way to provide a meaningful comparison.

Property	"owner's equity" Dec. 31, 2013	Years for PEO to fully own the building	Committee Comments
25 Sheppard Ave. W. (rent 50,000 square feet)	\$14.5M	N/A	<ul style="list-style-type: none"> ➤ Should be used as the base case ➤ Does not build equity ➤ Most expensive alternative
25 Sheppard Ave. W. (rent 30,000 square feet)	\$18.5M	N/A	<ul style="list-style-type: none"> ➤ Does not meet space requirements ➤ Does not build equity
40 Sheppard Ave. W. (original purchase price)	\$19.8M	25 years	<ul style="list-style-type: none"> ➤ Transitional issues as enough space may not be available Dec. '09 ➤ Possible financial risk due to need for tenants ➤ Second best alternative; however, becomes the best alternative if the planning horizon is 10 years or longer.
40 Sheppard Ave. W (reduced purchase price and increased down payment to \$10.5M)	\$21.4M	13 years and 9 months	<ul style="list-style-type: none"> ➤ Transitional issues as enough space may not be available Dec. '09 ➤ Possible financial risk due to need for tenants ➤ Lowering of the purchase price makes it the best alternative five years out
41 Lesmill	\$19.4M	2 years and 4 months	<ul style="list-style-type: none"> ➤ New building ➤ No transitional issues ➤ No risk from loss of tenants ➤ Only 45,000 square feet ➤ No mortgage would be required if maximum down payment was made

Property	"owner's equity" Dec. 31, 2013	Years for PEO to fully own the building	Committee Comments
39 & 41 Lesmill	\$19.1M	4 years and 2 months	➤ Provide additional space
405 Gordon Baker	\$20.2M	Cash purchase, own it immediately	➤ Best from a financial perspective.

The committee reviewed the business cases presented and concurred with the analysis. However, the committee noted that the business cases presented were conservative as to the comparison of continuing to rent 30,000 square feet at 25 Sheppard Avenue West versus 50,000 square feet at another location. If PEO needs 50,000 square feet, comparisons should be made to renting 50,000 square feet at 25 Sheppard Avenue West. This comparison would result in an addition \$800,000/year in occupancy costs. When compared to renting 50,000 square feet, the purchase options create between \$4.6 million and \$5.7 million in additional owner's equity five years out.

The purchase of 40 Sheppard Avenue West relies on income from tenants. The loss of tenants presents the greatest financial risk. Even with the loss of all tenant revenue at 40 Sheppard, which is extremely unlikely and would require PEO to pay for all operating costs of the building, the purchase of 40 Sheppard is still doable. However, it reduces the owner's equity to about \$14.8 million (at the reduced price), which is comparable to renting 50,000 square feet at 25 Sheppard.

The committee viewed that acquiring 41 Lesmill would be a less risk alternative, as PEO would not be relying on revenue from tenants. PEO could have the outright ownership of this property immediately, based on the ability to make a down payment of \$10.5 million. PEO would not have the risk of transitional issues and the potential cost of transferring tenants, as the building is currently vacant. Acquiring the property directly south would fully meet Council space requirements and provide the opportunity to meet all of PEO's future requirements.

While the current real estate climate is very uncertain, the committee felt in the long term, 40 Sheppard Avenue West, due to its location, would increase at a rate higher than 41 Lesmill.

The decision regarding the trade-off of a property with a lower capital cost, no tenant risk, and no transitional changes versus a location next to the subway at a premium over the appraised value is clearly Council's decision and not the purview of the Finance Committee.

In conclusion, the committee supports the analysis to acquire 40 Sheppard Avenue West. The committee complemented staff on its comprehensive review.