



# METRO

## PLAZA SALTILLO - LEASE REVENUE AUDIT (22-03)

Terry Follmer, VP of Internal Audit

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## EXECUTIVE SUMMARY

As part of our Fiscal Year 2022 Internal Audit Plan approved by the Capital Metro Board, we performed an audit of the Plaza Saltillo lease agreement to determine whether there were sufficient internal controls to ensure contract compliance and accurate lease payments for the CMTA-owned Saltillo development. The scope included a review of controls over contract monitoring and lease revenue payments from Calendar Year’s 2020 through 2021. The audit results including the objective, scope, and conclusion are as follows.

### Background

CapMetro owns a 10-acre, six-block, mixed-use development in East Downtown Austin locally known as the Saltillo Development which is adjacent to the Plaza Saltillo commuter rail station (see Appendix A for a map). The land was originally purchased by CapMetro in 1987 from the Southern Pacific Transportation Company and was an old railroad yard. In 2017, CapMetro executed a Master Development Agreement (contract #1943024.38) with Plaza Saltillo TOD, LP<sup>1</sup> to develop the property with residential, retail, and office buildings, together with a small park. Construction was completed in 2020. The goal of the Transit-Oriented Development project was to increase transit ridership, generate long-term revenue and optimize the value of assets, create and promote equitable mixed-used and mixed-income communities around transit, and respond to local community vision and values.

In 2017, CapMetro entered a 101-year Ground Lease (contract #1961840.31) with Plaza Saltillo TOD (Transit-Oriented Development), LP<sup>1</sup> (the “Tenant”) to rent the land, with rent payments starting in October 2019. See Appendix B for a Legal Entity Diagram. The terms of the Ground Lease specify CapMetro retains ownership of the land and any buildings on the property at the end of the contract in 2118. Tenant pays all taxes, utilities, repairs, improvements, and other expenses. The development includes 796 apartments, 23 restaurants, grocery stores, fitness clubs, and other retail businesses, and an 8-story office building. At a minimum, CapMetro will receive \$217 million in lease revenue over 99 years (lease payments started 2 years after the contract start date in 2017). The Tenant must pay CapMetro quarterly Base Rent payments and semi-annual Percentage Rent payments. Both payment calculations have provisions built in that increase lease payments to CapMetro when the Tenant and Subtenants perform well and earn higher revenue.

#### What Is a Ground Lease?

A ground lease is an agreement in which a Tenant is permitted to develop a piece of property during the lease period, after which the land and all improvements are turned over to the property owner. The property owner receives a steady stream of income while retaining ownership of the land.

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<sup>1</sup> Plaza Saltillo TOD, LP, is considered a ‘pass-through’ entity and funded/owned by the California State Teachers’ Retirement System (CalSTRS). The following companies were hired to develop/build on the land, perform day-to-day operations, collect rent, and general upkeep of the property: Columbus Realty Partners (land developer), Lionstone Advisory Services (asset manager), Endeavor Real Estate Group (property manager), Lincoln Property Company (property manager), and Saltillo DMA Housing, LLC (asset manager and property manager). Not all companies worked on both the Master Development Agreement and Ground Lease. See Appendix B for a Legal Entity Diagram for the Ground Lease.

On CapMetro's side, a Program Manager within the Strategic Planning & Development Department monitors contract compliance and Finance Department staff process payments and record journal entries. Monitoring includes ensuring the Tenant pays complete and accurate lease payments, proper insurance is purchased, property is kept in good condition, prohibited businesses are not allowed to operate, etc.

The Ground Lease also includes provisions for the formation of a Condominium (Condo) Association. The Condo Association was created in case individual building unit leases were sold to different owners and ensures CapMetro receives rent payment directly from the Condo Association. CapMetro only receives one lease payment even if portions are sold off. Currently Endeavor Real Estate Group pays lease to CapMetro on behalf of the Condo Association. The contract terms for the Condo Association include an annual operating budget, bylaws, common expenses, monthly assessment, and a 7-member Board of Directors, plus an 8th non-voting member appointed by CapMetro. The 7 Board of Director members include 2 from the Retail Unit; 2 from the Residential Units; 1 from the Work Force Residential Unit; and 2 from the Office Unit. Currently, CapMetro has appointed the Project Manager from the Strategic Planning & Development Department to serve as the 8<sup>th</sup> non-voting member. See Appendix B for a list of Board Members.

## **Audit Objective & Scope**

The primary objective of this audit was to determine whether there were sufficient internal controls to ensure contract compliance and accurate lease payments for the CMTA-owned Saltillo development. The scope included a review of controls over contract monitoring and lease revenue payments from Calendar Year's 2020 through 2021.

## **Opinion**

In our opinion, internal controls are generally in place and properly functioning over the Plaza Saltillo Ground Lease. We identified some areas where internal controls could be further documented and enhanced as follows:

- 1) Develop Permanent File & Procedures
- 2) Enhance Controls Related to Lease Payments

More details regarding the issues/risks and recommendations can be found below in the detailed audit report. This audit was conducted in accordance with US Government Accountability Office's Generally Accepted Government Auditing Standards (GAGAS) and the Institute of Internal Auditor's International Standards for the Professional Practice of Internal Auditing. These standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objective. We believe the evidence obtained provides a reasonable basis for our

findings and conclusions based on our audit objectives. The audit was conducted by the following staff members in the Capital Metro Internal Audit Department:

- Sarah Daigle, Internal Auditor II (Project Lead)
- Terry Follmer, VP of Internal Audit

Recommendations to strengthen controls and improve accountability were provided to management. Management agrees with the internal audit recommendations and has provided target completion dates which are included in the detailed audit report below. A follow-up audit is performed semi-annually (i.e. May and November) to ensure management action plans for all issued audit reports are completed timely.

We appreciate the cooperation and assistance provided to us throughout this audit.

<i>Issues &amp; Risk</i>	<i>Recommendation</i>	<i>Management Action Plan</i>
<p><b><u>1. DEVELOP PERMANENT FILE &amp; PROCEDURES</u></b></p> <p>We reviewed contract management and monitoring controls related to the Plaza Saltillo lease payments and noted the following weaknesses:</p> <ul style="list-style-type: none"> <li>• While the Program Manager and Finance Department had previously created a high-level Sharepoint folder for Saltillo Development, they had not established a comprehensive permanent file of key documents (e.g. meeting minutes; legal structure; contact information; etc.)</li> <li>• Written procedures have not been established and job descriptions do not mention Saltillo related responsibilities.</li> <li>• An annual meeting between Saltillo property management and CapMetro Finance Department and Program Manager has not been occurring.</li> </ul> <p>Establishing detailed permanent files and written procedures that can be used by current and future CapMetro staff will help in managing the risk and related lease revenues over the life of this 101-year agreement.</p>	<p>The Program Manager assigned by the Strategic Planning &amp; Development Department, along with the Controller in the Finance Department, should consider the following improvements:</p> <ol style="list-style-type: none"> <li>a) Establish a comprehensive permanent file of key documents (e.g. meeting minutes; legal structure; contact information; etc.) and ensure that both the Finance and Strategic Planning &amp; Development Departments have a copy and access to these files.</li> <li>b) Create written procedures that establishes the roles and responsibilities between the Finance and Strategic Planning Department to be used for the 101-year life cycle of this agreement. Ensure appropriate staff have their Saltillo responsibilities listed in their job descriptions and new staff are properly trained.</li> <li>c) Establish at least an annual cadence of meetings between Saltillo property management and CapMetro’s Finance and Strategic Planning &amp; Development Departments.</li> </ol>	<p>Management agrees with the recommendations.</p> <p><b><u>Target Completion Date:</u></b> July 31, 2022</p>

<i>Issues &amp; Risk</i>	<i>Recommendation</i>	<i>Management Action Plan</i>
<p><b>2. ENHANCE CONTROLS RELATED TO LEASE PAYMENTS</b></p> <p>Lease payments to CapMetro is based on two categories: Base Rent and Percentage Rent. Annually the Base Rent amounts are adjusted based upon the following two variables: rentable square footage and the percentage increase in Net Operating Income for the Saltillo property development<sup>2</sup>. We reviewed the contract and current practice and controls and noted the following opportunities for improvements:</p> <ul style="list-style-type: none"> <li>• Establish a matrix of required documents (e.g. Financial Statements; Insurance Certificates; Board Agendas &amp; Minutes; etc.) with defined cadence.</li> <li>• Periodically contract with an independent architect to recalculate rentable square footage based on engineering drawings and inspections.</li> <li>• Develop plan to address annual audit rights and evaluate using an independent CPA firm to periodically validate accuracy of financials and related lease payments to CapMetro based on contract terms.</li> <li>• PM and Finance Department should establish a Contract Monitoring Plan based upon the division of roles and responsibilities of the PM and Finance Department assigned staff.</li> </ul> <p>Enhancing the controls with the items identified above will help in the risk management and oversight of this 101-year Ground Lease agreement.</p>	<p>The Program Manager within the Strategic Planning &amp; Development Department, along with the Controller within the Finance Department, should complete the following:</p> <ol style="list-style-type: none"> <li>a) Develop a matrix of required reports/documents, due dates, distribution list, etc. (E.g. Insurance certificates; Board Agendas and Minutes; Financial Statements, etc.)</li> <li>b) Perform yearly walk-throughs to determine whether Tenant has built on the property/actual RSF has changed, all operating retail businesses are correctly included in the Percentage Rent calculation, prohibited businesses are not operating on the property, and the property is in good condition (i.e. no trash or graffiti).</li> <li>c) Evaluate using an independent architect to recalculate rentable square footage based upon inspections and engineering drawing when the Tenant builds on the property (changes in RSF affect Base Rent calculations).</li> <li>d) Evaluate using a CPA firm to review and validate the following records that impact rental payments to CapMetro as follows: Financial Statements; Net Operating Income; subtenant contracts that have Percentage Rent clauses with “breakpoints” that escalate rental payments.</li> <li>e) Create a Contract Monitoring Plan based upon the division of roles and responsibilities of the PM and Finance Department assigned staff.</li> </ol>	<p>Management agrees with the recommendations.</p> <p><b>Target Completion Date:</b> July 31, 2022</p>

<sup>2</sup> For years 1-5, Base Rent payments are increased by 3%. For years 6-10, Base Rent payments are increased by the greater of 2.35% or percentage increase in Net Operating Income. For years 11-99, Base Rent payments are increased by the percentage increase in Net Operating Income.

# Appendix A

## Map of Plaza Saltillo



## Appendix B

### Ground Lease - Legal Entity Diagram

