AIRPORT COMMISSION

CITY AND COUNTY OF SAN FRANCISCO

RESOLUTION NO. 20-0051

APPROVAL OF AMENDMENT NO. 1 TO THE INTERNATIONAL TERMINAL DUTY FREE AND LUXURY STORES LEASE NO. 17-0303 WITH DFS GROUP, L.P., WHICH TEMPORARILY AMENDS THE RENT STRUCTURE DURING THE FIRST LEASE YEAR, AND DIRECTING THE COMMISSION SECRETARY TO REQUEST APPROVAL OF THE AMENDMENT BY THE BOARD OF SUPERVISORS

WHEREAS, on December 5, 2017, by Resolution No. 17-0303, the Commission awarded the International Terminal Duty Free and Luxury Stores Lease No. 17-0303 (the Lease) to DFS Group, L.P. (Tenant) to operate twelve duty free and luxury stores in the International Terminal and Harvey Milk Terminal 1 for a term of 14 years expiring March 31, 2034; and

WHEREAS, Tenant operates the business through a joint venture partnership between DFS Group L.P., as majority partner, and the following five small business partners, each of which are Airport Concession Disadvantaged Business Enterprises: Bay Cities Concessions, J.R. Lester & Associates, Marilla Chocolate Co., Skyline Concessions, Inc., and Skyview Concessions, Inc.; and

WHEREAS, the Lease is currently near the end of the Development Term, during which the majority of the stores were to be renovated and rent was set at 30% of gross revenues; and

WHEREAS, the Development Term ends on March 31, 2020 and the Base Term commences on April 1, 2020 along with the Base Rent, which, on an annual basis, is the greater of (i) a Minimum Annual Guarantee (MAG) of $42,000,000.00 or (ii) the sum of the following percentage rent tiers: 45.8% of sales to $100,000,000.00, plus 41.8% of sales between $100,000,000.01 and $160,000,000.00, plus 30% of sales of $160,000,000.01 and above; and

WHEREAS, Lease Year 1 will be nine months in duration commencing on April 1, 2020 and ending December 31, 2020 with each subsequent Lease Year being a calendar year with the exception of the final Lease Year which will be three months; and

WHEREAS, sales during Lease Year 1 are expected to be between 57% and 60% lower than forecast by the Airport and Tenant due to (1) severe reduction in international flights related to the COVID-19 outbreak, (2) global economic issues impacting the value of Chinese currency, and (3) the growth of arrivals duty free shopping opportunities in China; and

WHEREAS, in response to significant financial losses anticipated by DFS Group L.P. and its five small business joint venture partners during Lease Year 1, and in an effort to preserve a high level of customer service and experience provided by duty free shopping, Airport staff recommends changing the Base Rent structure for Lease Year 1 by temporarily suspending the MAG and changing the tiered rent structure in favor of charging a percentage rent equal to 33% of gross revenues; and, now therefore, be it

RESOLVED, that this Commission hereby approves Amendment No. 1 to the Lease, which temporarily modifies the Base Rent structure by suspending the Minimum Annual Guarantee and changing the tiered in favor of 33% of gross revenues; and, be it further

RESOLVED, that this Commission hereby directs the Commission Secretary to forward Amendment No. 1 to the Board of Supervisors for approval pursuant to Section 9.118 of the Charter of the City and County of San Francisco.

I hereby certify that the foregoing resolution was adopted by the Airport Commission

at its meeting of MAR 17 2020

Secretary

San Francisco International Airport

MEMORANDUM

March 17, 2020

20-0051

MAR 17 2020

TO: AIRPORT COMMISSION
Hon. Larry Mazzola, President
Hon. Eleanor Johns
Hon. Richard J. Guggenhime
Hon. Malcolm Yeung

FROM: Airport Director

SUBJECT: Approval of Amendment No. 1 to the International Terminal Duty Free and Luxury Stores Lease No. 17-0303 with DFS Group, L.P.

DIRECTOR'S RECOMMENDATION: (1) APPROVE AMENDMENT NO. 1 TO THE INTERNATIONAL TERMINAL DUTY FREE AND LUXURY STORES LEASE NO. 17-0303 WITH DFS GROUP, L.P., TEMPORARILY CHANGING THE RENT STRUCTURE DURING THE FIRST LEASE YEAR; AND (2) DIRECT THE COMMISSION SECRETARY TO REQUEST APPROVAL BY THE BOARD OF SUPERVISORS.

Executive Summary

DFS Group, L.P. (Tenant) currently operates under the International Terminal Duty Free and Luxury Stores Lease (the Lease), an exclusive lease for duty free operations at San Francisco International Airport (Airport or SFO). Tenant operated at the Airport under a previous lease. Renovation of their existing premises is still underway with the last store scheduled to open in Harvey Milk Terminal 1 in May 2021. During this construction period (the Development Term), Base Rent is equal to thirty percent (30%) of Tenant's Gross Revenues. Upon the termination of the Development Term, which occurs on April 1, 2020, the regular term (the Operating Term) commences and Base Rent is equal to the greater of a Minimum Annual Guarantee of $42,000,000.00 or the sum of 45.8% of sales to $100,000,000.00, plus 41.8% of sales between $100,000,000.01 and $160,000,000.00, plus 30% of sales of $160,000,000.01 and above.

Sales activity for Tenant has been severely compressed due to global economic changes affecting China and the dramatic reduction in travel caused by the COVID-19 outbreak. In order to provide temporary relief to the Tenant, Staff requests the Airport Commission (Commission) approve an amendment to the Lease (Amendment) which lowers Base Rent for the remainder of calendar year 2020 (Lease Year 1).

THIS PRINT COVERS CALENDAR ITEM NO. 7

Background

On December 5, 2017, by Resolution No. 17-0303, the Commission awarded the Lease to Tenant with a Base Term of 14 years and the opportunity to extend the Lease by up to five years related solely to the Airport constructing a single, central security checkpoint in the International Terminal during the Tenant's Base Term. Tenant operates the business as a joint venture partnership between DFS Group, L.P., as majority partner, along with five small businesses: Bay Cities Concessions, J.R. Lester & Associates, Marilla Chocolate Co., Skyline Concessions, Inc., and Skyview Concessions, Inc., each of which are Airport Concession Disadvantaged Business Enterprises.

At the completion of all renovations, Tenant will operate 16 locations branded as DFS Duty Free, Hermes, Yves Saint Laurent, Burberry, Gucci, Coach, Swarovski, and APM Monaco, as depicted on Attachment 1 to this Memorandum. Prior to the Base Term, Tenant has a Development Term during which the majority of the stores must be renovated. The Development Term was extended twice due to the engineering complexities of leveling floors in the two largest stores and the time needed to secure construction permits during an exceptionally busy time caused by campus-wide construction activities at the Airport. Base Rent is set at 30% of gross revenues during the Development Term, which terminates March 31, 2020.

The Base Term commences April 1, 2020, along with the Base Rent structure, which is the greater of a Minimum Annual Guarantee of $42,000,000.00 or the sum of 45.8% of sales to $100,000,000.00 plus 41.8% of sales between $100,000,000.01 and $160,000,000.00 plus 30% of sales of $160,000,000.01 and above. The Minimum Annual Guarantee is prorated for any Lease Year which is less than 12 months.

The Airport expects sales under the Lease to be 57% lower than initially forecasted for this calendar year. Tenant is currently expecting sales to be 60% lower than forecast. Either event will lead to significant financial losses for DFS Group, L.P. and each of the five small business joint venture partners. The Airport projects losses to Tenant during Lease Year 1, which is the nine-month period from April 1, 2020 through December 31, 2020, to be more than $15,000,000.00. Sales declines are attributed to (1) severe reduction in international flights related to the COVID-19 outbreak and (2) different spending behavior by Chinese customers, who were responsible for more than one-half of total duty-free sales in recent years. A sharp decline in spending by these customers is thought to be caused by the value of Chinese currency and China's efforts to expand duty free shopping opportunities for its citizens upon arrival home from travel abroad.

Temporarily modifying the Base Rent structure to 33% of gross revenues for Lease Year 1 is anticipated to result in the Airport receiving $16,154,000.00 in DFS revenues. This amount is $15,346,000.00 less than the Base Rent structure would have resulted in, and is $9,473,306.00 less than we received during the same period in the last year of the former lease.

Proposal

Staff recommends modifying the Lease to temporarily suspend the Minimum Annual Guarantee and calculate the Base Rent for Lease Year 1, which is the nine-month period commencing April 1, 2020 and ending December 31, 2020, at 33% of gross revenues.

Recommendation

I recommend the Commission adopt the accompanying Resolution approving Amendment No. 1 to the International Terminal Duty Free and Luxury Stores Lease, which temporarily suspends the Minimum Annual Guarantee and calculates the Base Rent during Lease Year 1 at 33% of gross revenues. I also recommend directing the Commission Secretary to request approval of the Amendment by Resolution of the Board of Supervisors pursuant to Section 9.118 of the Charter of the City and County of San Francisco.

Ivar C. Satero
Airport Director

Prepared by: Leo Fermin
Chief Business & Finance Officer

Attachments

Attachment 1

International Terminal Duty Free and Luxury Stores Lease