CITY AND COUNTY OF SAN FRANCISCO

BOARD OF SUPERVISORS

BUDGET AND LEGISLATIVE ANALYST

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TO: Budget and Finance Committee

FROM: Budget and Legislative Analyst

SUBJECT: April 3, 2024 Budget and Finance Committee Meeting

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EXECUTIVE SUMMARY

Legislative Objectives

- The proposed resolution authorizes MOHCD to spend $890,000 from the SOMA Community Stabilization Fund.

Key Points

- The SOMA Community Stabilization Fund accounts for certain development impact fee revenue in SOMA and requires the Board of Supervisors to approve spending. MOHCD administers the fund, including managing competitive solicitations to allocate spending. The associated Community Advisory Committee (CAC) recommended FY 2023-24 funding for eight projects on April 27, 2023. The CAC recommended an additional year of funding at the same level for all eight projects on February 15, 2024.
- The organizations receiving funds are: the San Francisco Study Center, Filipino-American Development Foundation, Kultivate Labs, United Playaz, and Centers for Equity and Success. Projects include housing services, business and non-profit assistance, and education programs.

Fiscal Impact

- If the proposed resolution is approved, the SOMA Community Stabilization Fund balance will be reduced from $1,683,129 to $793,129

Recommendation

- Approve the proposed resolution.

MANDATE STATEMENT

In accordance with Planning Code Section 418.7, all funds in the South of Market Area (SOMA) Community Stabilization Fund are to be expended to address the effects of destabilization on residents and businesses in SOMA due to new residential development in the Rincon Hill Area. SOMA Community Stabilization Fund expenditures are administered by the Mayor's Office of Housing and Community Development (MOHCD), subject to approval by resolution of the Board of Supervisors.

BACKGROUND

SOMA Community Stabilization Fund

In August 2005, the Board of Supervisors approved a new Section 418 to the City Planning Code which, among other provisions, (a) established the Rincon Hill Downtown Residential District,[1] (b) imposed a Rincon Hill Community Infrastructure Impact Fee ($16.16 per gross square foot of new residential development in the District), (c) created a Rincon Hill Community Improvement Fund for the deposit of the Rincon Hill Community Infrastructure Fees collected, (d) imposed a SOMA Community Stabilization Fee ($20.55 per gross square foot on new residential development within the District), (e) created the SOMA Community Stabilization Fund for the deposit of SOMA Community Stabilization Fees collected, and (f) established a SOMA Community Stabilization Fund Community Advisory Committee (CAC) to advise the MOHCD and the Board of Supervisors on the uses of the SOMA Community Stabilization Fund (Ordinance 217-05).[2]

The legislation specifies that all funds collected in the SOMA Community Stabilization Fund are to be used to mitigate the impacts of destabilization on residents and businesses in SOMA.

Legislative History

On May 6, 2008, the Board of Supervisors approved a resolution (File 08-0544): (a) approving the SOMA Community Stabilization Fund Strategic Plan, (b) authorizing MOHCD to administer the SOMA Community Stabilization Fund in accordance with this Strategic Plan, and (c) authorizing MOHCD to work with the SOMA Stabilization Fund Community Advisory Committee (CAC) to issue RFPs for non-profit agencies to provide services addressing the effects of destabilization on residents and businesses in SOMA, consistent with the Community Stabilization Fund Strategic Plan.

RFP Process

On January 27, 2023, MOHCD issued an RFP for community-based organizations to apply for funding from the SOMA Community Stabilization Fund to provide SOMA services in FY 2023-24

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[1] The Rincon Hill Downtown Residential District is defined as the area bounded by Folsom Street, the Bay Bridge, the Embarcadero, and Essex Street.

[2] San Francisco Citywide Development Impact Fee Register, effective January 1, 2024

with an option to extend for an additional period of up to 18 months based on funding availability, achievement of outcomes and deliverables, and community needs. The four priority funding areas, according to the RFP, were: (1) Housing, (2) Small Business Support, (3) Youth and Family Support, and (4) Community Action Grants/SOMA Community Collaborative.

Proposals were reviewed by a scoring panel[3] and evaluated based on the following: SOMA Target Population (15 points), Program Design (20 points), Experience (10 points), Staffing (10 points), Advancing Racial Equity (10 points), Partnerships (5 points), Impact/Outcome (10 points), Evaluation (5 points), and Program Budget (15 points). Eight organizations submitted proposals, and all were awarded grants.[4] The CAC recommended FY 2023-24 funding for all eight projects on April 27, 2023. Based on year-to-date outcomes and ongoing community needs, the CAC recommended an additional year of funding at the same level for all eight projects on February 15, 2024.

DETAILS OF PROPOSED LEGISLATION

The proposed resolution authorizes MOHCD to spend $890,000 from the SOMA Community Stabilization Fund. Exhibit 1 below summarizes the projects and the grant awards for each.

[3] The scoring panel consisted of two reviewers: a MOHCD Senior Community Development Specialist II and a MOHCD Senior Community Development Specialist I.

[4] The average scores for each of the organizations are as follows: Kultivate Labs (Accelerator): 92.5, West Bay Pilipino Multi Services Center: 92.5, Filipino American Development Foundation/Filipino Education Center: 92, United Playaz: 89.5, San Francisco Study Center/Bill Sorro Housing Program: 88, Filipino American Development Foundation - South of Market Community Action Network: 87.5, Kultivate Labs (Events): 85.5, Centers for Equity and Success, Inc.: 82.5

Exhibit 1: FY 2024-25 Funding Recommendations

Organization	Project Description	Amount
San Francisco Study Center[5]	Outreach, housing education, and case management services to increase access to affordable housing	$85,000
Filipino-American Development Foundation[6]	Tenant counseling, outreach, workshops, and legal representation for residents	$85,000
Kultivate Labs (Events)	Monthly night market to promote small business owners, entrepreneurs, and artists	$85,000
Kultivate Labs (Accelerator)	Business growth program for small businesses through one-on-one technical assistance	$85,000
Filipino American Development Foundation/Filipino Education Center	Afterschool programming, such as field trips and community-service learning activities, for Bessie Carmichael/Filipino Education Center students	$100,000
West Bay Pilipino Multi-Service Center	College prep services, such as workshops and college field trips, for increased access to higher education	$150,000
United Playaz	School Site Coordination program activities at the Bessie Carmichael School, such as hosting an annual teacher retreat with nonprofit partners	$50,000
Centers for Equity and Success, Inc.	Coordination of the SOMA Community Collaborative and support of SOMA-based nonprofit organizations and groups through technical assistance	$250,000
		$890,000

Source: MOHCD

FISCAL IMPACT

Exhibit 2 below summarizes the current and projected balance of the SOMA Community Stabilization Fund if the proposed spending resolution is approved.

[5] Fiscal sponsor of the Bill Sorro Housing Project
[6] Fiscal sponsor of South of Market Community Action Network

Exhibit 2: SOMA Community Stabilization Fund, Current and Projected Balance

	Amount
Unallocated Balance as of February 28, 2024	$1,683,129
Proposed Resolution	(890,000)
Remaining Balance	**$793,129**

Source: MOHCD

As shown above, if the proposed resolution is approved, the SOMA Community Stabilization Fund balance will be reduced from $1,683,129 to $793,129.

RECOMMENDATION

Approve the proposed resolution.

Item 7 File 23-1153	Department: San Francisco International Airport (Airport)

EXECUTIVE SUMMARY

Legislative Objectives

- The proposed resolution would retroactively approve the fourth amendment to the concession lease between the Airport as, landlord, and DFS Group, L.P. as tenant, decreasing the percentage rent and establishing a temporarily reduced Minimum Annual Guarantee (MAG) for three years starting January 1, 2024.

Key Points

- DFS Group leases the International Terminal Duty Free and Luxury Stores from the Airport under a concession lease agreement with a 14-year term that began in April 2020. DFS Group consists of a joint venture partnership between DFS Group, L.P., with 75 percent ownership, and the following five small business partners, each with 5 percent ownership: Bay Cities Concessions, J.R. Lester & Associates, Marilla Chocolate Co., Skyline Concessions, and Skyview Concessions, Inc. The lease agreement has been amended three times to reduce rent and/or fees paid to the Airport due to the COVID-19 pandemic.
- Due to increases in international enplanements, MAG was reinstated in May 2023 and percentage rent increased from 33 percent of gross revenues to a tiered percentage rent ranging from 45.8 percent of gross revenues up to $100 million to 30 percent of gross revenues above $160 million. Although international enplanements have nearly recovered to pre-pandemic levels, duty free sales have not recovered due to a sustained reduction in travelers from China. Under the proposed fourth amendment, the percentage rent would be reduced from the tiered percentage rent to 36 percent of gross receipts for three years beginning January 1, 2024. The proposed 36 percentage rent is three-percentage points greater than the second amendment’s 33 percent, which ended in April 2023.

Fiscal Impact

- Based on estimated gross receipts for the three-year period, the Airport anticipates receiving $126.7 million in rent under the proposed amended lease, which reflects a reduction of $32.4 million in rent compared to rent projected under the existing lease. This would result in decreased transfers to the General Fund of approximately $1.5 million to $1.7 million annually for a total of $4.9 million over the three-year period.

Policy Consideration

- The proposed rent relief mitigates the impact of not only the COVID-19 pandemic but also changes in preferences and/or incomes of Chinese tourists, which is a risk that DFS assumed when it entered into a lease for retail luxury goods at the Airport. The proposed estimated level of rent relief ($32.4 million) is approximately 44 percent of losses incurred since lease commencement in 2018 ($74.39 million).

Recommendation

- Approve the proposed resolution.

MANDATE STATEMENT

City Charter Section 9.118(c) states that modification of any lease of real property for a period of ten years or more or that has revenue to the City of $1 million or more is subject to Board of Supervisors approval.

BACKGROUND

In February 2018, the Airport Commission selected DFS Group, L.P. (DFS Group) for the International Terminal Duty Free and Luxury Store lease following a competitive solicitation process. DFS Group was the highest scoring vendor (96.67 out of 100) of the four that submitted proposals for the lease. DFS Group consists of a joint venture partnership between DFS Group, L.P., with 75 percent ownership, and the following five small business partners, each with 5 percent ownership: Bay Cities Concessions, J.R. Lester & Associates, Marilla Chocolate Co., Skyline Concessions, and Skyview Concessions, Inc.

On March 20, 2018, the Board of Supervisors approved a concession lease agreement (Lease No. 17-0303) between the Airport as landlord and DFS Group as tenant for the International Terminal Duty Free and Luxury Lease (File 18-0079). The lease is for 46,295 square feet of retail space, comprising 12 different stores. The original agreement was for a term of 14 years, from April 1, 2020 through March 2034, an initial Minimum Annual Guaranteed (MAG) rent of $42 million, and percentage rent ranging from 45.8 to 30 percent, depending on sales. The lease commenced on October 1, 2018, but the phase between the commencement date and March 31, 2020 was designated as the Development Term, during which DFS was undertaking construction of tenant improvements within the leased sites and rent was 30 percent of gross revenues.

Amendment History

The lease has been amended three times. In July 2020, the Board of Supervisors approved the first amendment to the lease which suspended the MAG rent and established a percentage rent of 33 percent of all sales for the remainder of lease year 1, which ended on December 31, 2020 (File 20-0542). In February 2021, the Board of Supervisors approved the second amendment to the lease continuing the percentage rent of 33 percent gross revenues until the earlier of December 31, 2023, or the reinstatement of the MAG, which was suspended on all concession leases due to a pandemic-related decline in enplanements (File 20-1348). The reinstatement of MAG would occur when passenger traffic in the International Terminal returned to at least 80 percent of what it was before the start of the lease term, for at least two consecutive months.

In January 2021, the Board of Supervisors provided the Airport delegated authority to amend leases to waive MAG and percentage rents under the Airport's COVID-19 Emergency Rent Relief Program (File 20-1278). This Rent Relief Program was funded by federal stimulus monies under the CARES Act. The Rent Relief Program allowed the Airport Commission to amend eligible leases to waive various types of rents and fees for certain periods of time, without Board of Supervisors approval, as would typically be required by City Charter Section 9.118(c). Under that authority, the Airport executed the third amendment to the lease, which waived certain rents and fees due to the Airport between April 2020 and December 2020.

On October 17, 2023, the Airport Commission approved the fourth amendment to the lease (Commission Resolution No. 23-0256). The proposed fourth amendment is now pending approval from the Board of Supervisors.

DETAILS OF PROPOSED LEGISLATION

The proposed resolution would retroactively approve the fourth amendment to the lease between the Airport as, landlord, and DFS Group, L.P. as tenant, decreasing the percentage rent from a tiered percentage rent ranging from 45.8 to 30 percent of gross revenues to 36 percent of all gross revenues in Years 5 through 7, and establishing a temporarily reduced Minimum Annual Guarantee (MAG) of $30 million for Year 5, which would increase annually in Years 6 and 7 to the greater of the existing MAG ($30 million) or 90 percent of rent paid in the previous year. For Lease Year 8, the rent would revert to the original percentage rent structure (45.8 percent to 30 percent of gross sales, depending on level of sales), and the original MAG ($42 million), adjusted annually from Year 1. The proposed amendment also includes labor peace provisions. The proposed lease changes are summarized in Exhibit 1 below.

Exhibit 1: Proposed Lease Amendments

	Current Lease	Under Proposed Fourth Amendment
Term	Oct 2018 - Mar 2034 (14 years, plus 1 year and 6-month Development Term)	No change
Square Footage	Approximately 46,295 square feet	No change
MAG rent	$42,000,000	**Year 5**: $30,000,000 in Year 5 (2024), **Years 6 & 7**: annual adjustments; **Year 8**: original MAG resumes ($42,000,000 or 90% of rent paid in Year 7)
MAG Adjustment	Annually to the greater of the existing MAG or 90% of rent paid in previous year	No change
Percentage Rent	45.8% of gross revenues up to $100,000,000; 41.8% of gross revenues from $100,000,000 to $160,000,000; 30% of gross revenues over $160,000,000	**Years 5-7**: 36% of gross revenues in Years 5-7 (2024 - 2026); **Year 8**: original base structure resumes
Completion of International Terminal Renovations	December 2021	No change (renovations completed)
Completion of Terminal 1 Renovations	In or around 2022	December 31, 2024
Minimum Investment Amount	$1,000 per square foot of the premises ($46,295,000), or a lesser amount deemed sufficient by Design Review Committee	No change

Source: Proposed Amendment 4

Renovations

The original lease between the Airport and DFS Group was for 12 duty free and luxury stores, comprising approximately 46,295 square feet. DFS Group now operates 17 stores under the lease, but there is no change to the size of the premises, as several spaces have been split into smaller “concept” stores. All stores are open, except for two located in Harvey Milk Terminal 1.

DFS is currently in the design and review process for two new stores in Harvey Milk Terminal 1; a Lego store and one other store, still to be determined. The Airport anticipates the Lego store will be complete in the third quarter of 2024, and the other store to be complete in fourth quarter of 2024. The proposed fourth amendment includes a construction timeframe clause: if the tenant does not complete these two stores by December 31, 2024, the entire rent accommodation will be suspended and the tenant will owe the City the rent according to the original base rent structure, retroactive to January 1, 2024 and including any MAG rent for periods when it would have been applicable.[1]

The second amendment to the lease (from February 2021) also included a renovation completion clause, where rent reductions were contingent upon the completion of tenant improvements. DFS Group did / did not complete the improvements according to schedule, avoiding any penalty.

Exhibit 2 below shows space use and rent start for the total area leased by DFS.

Exhibit 2: Rent from Facilities Included in the DFS Group Lease

Retail Site	Square Feet	Rent Start Date
Duty Free Store A	10,005	10/1/18
Duty Free Satellite Store A	1,996	10/1/18
Luxury Space A1	2,968	10/1/18
Luxury Space A2	2,494	10/1/18
Luxury Space A3	1,769	10/1/18
Kiosk	352	10/1/18
International Terminal "A" Total	*19,584*	
Duty Free Store G	17,141	10/1/18
Duty Free Satellite Store G	1,436	10/1/18
Luxury Space G1	730	10/1/18
Luxury Space G2	1,674	10/1/18
Luxury Space G3	2,016	10/1/18
International Terminal "G" Total	*22,997*	
Terminal 1 Premises	3,714	9/1/2024*
Total	**46,295**	

Source: Exhibits A and B to Airport-DFS Group Lease Agreement and Airport provided information.
Note: September 1, 2024 is the anticipated rent start date for the stores located in Harvey Milk Terminal 1.

Rent Accommodation Necessity

Due to increases in international enplanements, MAG was reinstated in May 2023, which per the terms of the lease agreement, triggered an increase in the percentage rent from 33 percent of gross revenues to tiered percentage rent ranging from 45.8 percent of gross revenues up to $100 million to 30 percent of gross revenues above $160 million. Under the proposed fourth amendment, the percentage rent would be reduced from the tiered percentage rent to 36 percent of gross receipts beginning January 1, 2024. The proposed 36 percent rent figure is a three-percentage point increase over the second amendment's 33 percent, which ended in April 2023.

[1] If delays in construction are caused explicitly by the City, then the Airport Commission Director may make an allowance in suspending the rent accommodation.

According to DFS financial statements provided by the Airport, DFS Group has incurred losses of $74.39 million as of December 2023 since lease commencement in October 2018. The Airport reports that it has an interest in mitigating DFS Group's financial distress, since 25 percent of DFS Group is owned by five small businesses that are certified as Airport Concessions Disadvantaged Business Enterprises (ACDBEs) under U.S. Department of Transportation regulations.[2]

According to the Airport, the rent accommodation provided by the proposed fourth amendment is the highest percentage rent that would be possible given projected sales to date, and the outlook over the next three years. The COVID-19 pandemic continues to have a negative impact on international travel, particularly on passengers traveling from China, which accounted for more than 50 percent of duty-free sales prior to the pandemic according to Airport staff. Although estimated international enplanements in 2023 (as of December 2023) were just eight percent lower than levels in 2019, the estimated number of Chinese visitors was 84 percent lower in 2023 compared to 2019, resulting in less duty-free spending than projected in 2018 when the lease commenced. In the meantime, sales are increasing, but the Airport forecasts that DFS Group sales in 2024, 2025, and 2026 will still be depressed, necessitating a rent accommodation.

FISCAL IMPACT

Rent paid by DFS Group to the Airport will be MAG rent or percentage rent, whichever is greater. MAG rent will be $30 million in lease year 5, increasing annually in lease year 6 and lease year 7. The Airport expects to continue receiving percentage rent, which is greater than the MAG. Based on estimated gross receipts, the Airport anticipates receiving $126.7 million in rent under the proposed amended lease, which reflects a reduction of $32.4 million in rent compared to rent projected under the existing lease, as shown in Exhibit 3 below.

Exhibit 3: Projected Decrease in Rent (in $Millions)

Lease Year (Calendar Year)	Estimated Gross Receipts	Rent under Existing Lease	Rent under Proposed 4th Amendment	Reduction in Rent to Airport
Year 5 (2024)	$108.53	$49.37	$39.07	$10.29
Year 6 (2025)	117.30	53.03	42.23	10.80
Year 7 (2026)	126.20	56.75	45.43	11.32
Total	$352.03	$159.15	$126.73	$32.42

Source: Airport

Estimated gross receipts are increasing by 14 percent in 2024 and by eight percent in 2025 and 2026. If gross receipts exceed estimates, the reduction in rent to the Airport would exceed $32.42 million. For example, gross receipts that are five percent above estimated levels would result in an additional $1 million in rent reduction to the Airport, and gross receipts that are 25

[2] Disadvantaged business enterprises are small businesses that are 51 percent owned by socially and economically disadvantaged individuals, such as members of groups that have historically faced discrimination in hiring (such as women and Black Americans).

percent above estimated levels would result in an additional $5 million in rent reduction to the Airport.

General Fund Impact

The Airport also makes an Annual Service Payment to the City's General Fund, equal to 15 percent of concession revenues. The proposed decrease in rent would result in decreased transfers to the General Fund of approximately $1.5 million to $1.7 million annually for a total of $4.9 million over the three-year period.

Rental Assistance to DFS Joint Venture Members

Over the three-year period, the proposed lease would provide $32.4 million in rental assistance to DFS, including $24.3 million to DFS Group, L.P. and approximately $1.6 million to each of the five ACDBE business for a total of $8.1 million to ACDBE businesses. As mentioned above, the five ACDBE businesses include: Bay Cities Concessions, J.R. Lester & Associates, Marilla Chocolate Co., Skyline Concessions, and Skyview Concessions, Inc.

POLICY CONSIDERATION

Although international enplanements have nearly recovered to pre-pandemic levels, duty free sales have not recovered due to changes in the make-up of international travelers. The sustained reduction in travelers from China is partially due to continued impacts of the COVID-19 pandemic on travel but also due to other factors, including changes in the Chinese economy. The proposed rent relief therefore mitigates the impact of not only the COVID-19 pandemic but also changes in preferences and/or incomes of Chinese tourists, which is a risk that DFS assumed when it entered into a lease for retail luxury goods at the Airport.

To date, the Airport has provided approximately $23 million in rent relief to DFS Group due to the impact of COVID-19 on international travel and duty-free sales.[3] The proposed amended lease would provide an additional estimated $32 million in rent relief through 2026 to relieve DFS Group of significant losses incurred since 2018. The proposed estimated level of rent relief ($32 million) is approximately 44 percent of losses incurred since lease commencement in 2018 ($74.39 million). If the previously adopted rent relief is included, the Airport's total rent relief would cover an estimated 74 percent of DFS' total financial losses. The Airport does not have a policy for sharing financial losses with concessionaires.

According to information provided by the Airport, in 2023, when the MAG and original percentage rent structure was reinstated, actual DFS losses in 2023 were less than projected. In addition, the current lease has a term through March 2034, which provides an opportunity for DFS to recover its losses from the initial period of the lease.

[3] The Airport's rent relief for DFS through 2023 includes lowering percentage rent, resulting in $22.7 million of losses to the Airport. All Airport concession leases contain provisions that waives the MAG during periods of low enplanements, which is not included in the $22.7 million figure.

RECOMMENDATION

Approve the proposed resolution.