APPROVAL OF AMENDMENT NO. 2 TO THE INTERNATIONAL TERMINAL DUTY FREE AND LUXURY STORES LEASE NO. 17-0303 WITH DFS GROUP, L.P. , WHICH TEMPORARILY MODIFIES THE PERCENTAGE RENT STRUCTURE EFFECTIVE JANUARY 1, 2021 AND ENDING NO LATER THAN DECEMBER 31, 2023 CONTINGENT UPON COMPLETION OF CERTAIN CONSTRUCTION PROJECTS BY DECEMBER 31, 2021, 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 consists of a joint venture partnership between DFS Group L.P., with 75% ownership, and the following five small business partners, each with 5% ownership: Bay Cities Concessions, J.R. Lester & Associates, Marilla Chocolate Co., Skyline Concessions, Inc., and Skyview Concessions, Inc.; and

WHEREAS, on March 17, 2020, by Resolution No. 20-0051 the Commission amended the Lease by establishing the Base Rent as 33% of gross revenues for Lease Year 1 which ends December 31, 2020; and

WHEREAS, on January 1, 2021, Percentage Rent reverts back to the sum of the following 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, on January 1, 2021, the Minimum Annual Guarantee will be suspended in accordance with the Lease's Severe Decline in Enplanement language and reinstatement is not expected until the end of 2023; and

WHEREAS, due to the COVID-19 pandemic and ongoing travel restrictions, the recovery of international passenger traffic is presently anticipated to take three to five years; and

WHEREAS, sales during Lease Years 2, 3 and 4 are expected to be below the Airport's forecast by an average of 64% and the originally contemplated Percentage Rent structure will lead to significant losses for DFS Group, L.P. and its ACDBE joint venture partners; and

WHEREAS, continuing the revised Percentage Rent structure of 33% of gross revenue conditioned upon Tenant's timely completion of certain construction projects in the International Terminal by December 31, 2021 is in the best interest of the Airport in that it will help preserve the economic feasibility and continued operations of duty-free offerings to travelers at SFO; now, therefore, be it

RESOLVED, that this Commission hereby approves Amendment No. 2 to the Lease, which continues the temporary modification of the Percentage Rent structure to 33% of sales through the earlier to occur of the end of Lease Year 4, which is December 31, 2023, or the reinstatement of the Minimum Annual Guarantee; and, be it further

RESOLVED, that the temporary modification of Percentage Rent in Amendment No. 2 is contingent upon Tenant's completion of the construction the Yves Saint Laurent store, two luxury watch stores, and the two flow-through entrances from the security checkpoints directly into the Boarding Areas A and G galleria locations, no later than December 31, 2021; and, be it further

RESOLVED, that this Commission hereby directs the Commission Secretary to forward Amendment No. 2 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 DEC 1 2020

Secretary

MEMORANDUM

December 1, 2020

TO: AIRPORT COMMISSION
Hon. Larry Mazzola, President
Hon. Eleanor Johns, Vice President
Hon. Richard J. Guggenhime
Hon. Everett A. Hewlett, Jr.
Hon. Malcolm Yeung

20-0222

DEC 1 2020

FROM: Airport Director

SUBJECT: Approval of Amendment No. 2 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. 2 TO THE INTERNATIONAL TERMINAL DUTY FREE AND LUXURY STORES LEASE NO. 17-0303 WITH DFS GROUP, L.P., TEMPORARILY MODIFYING THE PERCENTAGE RENT STRUCTURE EFFECTIVE JANUARY 1, 2021 THROUGH NO LATER THAN DECEMBER 31, 2023, SUBJECT TO TENANT'S TIMELY COMPLETION OF CERTAIN CONSTRUCTION PROJECTS, 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). The Base Term commenced April 1, 2020 and the Base Rent structure is the greater of a Minimum Annual Guarantee (MAG) of $42,000,000.00 or Percentage Rent, which is the sum of 45.8% of gross revenue to $100,000,000.00, plus 41.8% of gross revenue between $100,000,000.01 and $160,000,000.00, plus 30% of gross revenue of $160,000,000.01 and above.

On March 17, 2020, by Resolution No. 20-0051, the Commission approved Amendment No. 1 to the Lease, which provided for a temporary suspension of the MAG and a modification of the Percentage Rent structure to equal 33% of gross revenue through December 31, 2020 due to the following factors in the time period leading up to the commencement of the Lease: (i) the severe reduction in international flights related to the COVID-19 outbreak, (ii) global economic issues impacting the value of the Chinese currency and (iii) dramatic decrease in the spending patterns of the Chinese traveler.

The duty-free stores were ordered closed in mid-March, under local public health orders related to COVID-19 and will begin reopening in December 2020. Duty free sales activity will be severely compressed due to COVID-19 related travel restrictions and the protracted recovery from the pandemic that the industry anticipates. The MAG will continue to be suspended from January 1, 2021

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in accordance with Severe Decline in Enplanement language in the Lease. It will stay in suspension until passenger traffic in the International Terminal is back to at least 80% of what it was prior to the start of the Lease, for a period of two consecutive months. Right now, that is anticipated to happen in 2023. Staff requests the Commission approve a second amendment to the Lease, which maintains the lower Percentage Rent structure of 33% until the earlier to occur of (i) the date that the Minimum Annual Guarantee is reinstated or (ii) the end of Lease Year 4, which is December 31, 2023.

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 Lease through a joint venture partnership, named SFO Duty Free & Luxury Store Joint Venture, made up of itself, with 75% ownership, and the following five small business partners each with 5% ownership: Bay Cities Concessions, J.R. Lester & Associates, Marilla Chocolate Co., Skyline Concessions, Inc., and Skyview Concessions, Inc. Each of the small business partners is a certified Airport Concessions Disadvantaged Business Enterprise (ACDBE).

On March 17, 2020, by Resolution No. 20-0051, the Commission approved Amendment No. 1 to the Lease, which suspended the MAG and lowered the Percentage Rent structure to 33% of gross revenue for Lease Year 1. Lease Year 1 is the nine-month period from April 1, 2020 through December 31, 2020. Lease Years, thereafter, follow the calendar year except for the final lease year. The MAG is prorated for any Lease Year that is less than 12 months.

Under the Lease, Tenant will operate 16 retail stores at 12 locations branded as DFS Duty Free, Hermes, Yves Saint Laurent (YSL), Burberry, Gucci, Coach, Swarovski, and APM Monaco, as depicted on Attachment 1 to this memorandum. Most of the locations remain closed due to the lack of passengers. Yet to be constructed are two luxury watch locations (Boarding Area A and Boarding Area G), YSL (Boarding Area A), the Terminal 1 duty free galleria, and two second entrances to the Boarding A and Boarding Area G duty free galleria locations creating a flow-through directly from the security checkpoints into the stores.

Duty free sales peaked at nearly $149,000,000 in calendar year 2017. It was forecast that the first year of sales under the new Lease would be between $150,000,000 and $160,000,000. The Airport now expects sales to average 64% below the initial forecast for the next three calendar years due to severely depressed enplanement activity. While the MAG is suspended, significant financial losses for the Tenant (which includes each of the five small business joint venture partners) can still be expected if the Percentage Rent structure reverts to original calculations required in the Lease on January 1, 2021. The Airport projects losses to Tenant during Lease Year 2 (calendar year 2021) to be more than $11,000,000 if the Percentage Rent structure remains unchanged. Each joint venture partner (including each ACDBE) will bear any loss in proportion to their percentage ownership, and conversely will enjoy the benefit of the lower percentage rent structure offer in proportion to their percentage of ownership.

Proposal

Staff recommends temporarily modifying the Percentage Rent structure to 33% of gross revenues for Lease Years 2, 3 and 4, or until reinstatement of the Minimum Annual Guarantee to ensure the viability of the important concession, which provides world class retail offerings as well as earns more revenue for the Airport than all other retail leases combined. Staff also recommends that this continued reduction in rent be contingent on Tenant's timely completion of construction of all facilities in the International Terminal by December 31, 2021, which includes the YSL store, two luxury watch stores, and the two flow-through entrances from the security checkpoints directly into the Boarding Areas A and G galleria locations. If Tenant fails to satisfy this condition, the Percentage Rent reduction set forth in Amendment No. 2 will be void, and Tenant will have to pay the original Percentage Rent structure set forth in the Lease retroactive to January 1, 2021.

Tenant has agreed to provide, and Airport staff will review the joint venture's quarterly reports of disbursements and assessments during the rent relief period to ensure the benefit of the lower percentage rent structure is being passed along to each of the five ACDBE partners in proportion to their percentage ownership. This requirement will also be included in Amendment No. 2 as an ongoing obligation of Tenant under the Lease during the period when the modified rent structure is in effect.

Recommendation

I recommend the Commission adopt the accompanying Resolution (1) approving Amendment No. 2 to the International Terminal Duty Free and Luxury Stores Lease No. 17-0303, which establishes Percentage Rent during Lease Years 2, 3 and 4 at 33% of gross revenues until the earlier to occur of (i) the reinstatement of the MAG under the Severe Decline in Enplanement provision of the Lease and (ii) December 31, 2023, subject to the Tenant's timely complete of certain construction projects by December 31, 2021, and (2) 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: Kevin Bumen
Chief Commercial Officer

Attachments

Attachment 1

International Terminal Duty Free and Luxury Stores Lease