SFO

San Francisco International Airport

MEMORANDUM
October 17, 2023

23-0256

OCT 17 2023

TO: AIRPORT COMMISSION
Hon. Malcolm Yeung, President
Hon. Everett A. Hewlett, Jr., Vice President
Hon. Jane Natoli
Hon. Jose F. Almanza
Hon. Mark Buell

FROM: Airport Director

SUBJECT: Approval of Amendment No. 4 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. 4 TO THE INTERNATIONAL TERMINAL DUTY FREE AND LUXURY STORES LEASE NO. 17-0303 WITH DFS GROUP, L.P., MODIFYING AND EXTENDING A REDUCED PERCENTAGE RENT STRUCTURE TO DECEMBER 31, 2026, AND ESTABLISHING A TEMPORARILY REDUCED MINIMUM ANNUAL GUARANTEE, IN EACH CASE SUBJECT TO TENANT'S TIMELY COMPLETION OF THE HARVEY MILK TERMINAL 1 LOCATIONS, AND (2) DIRECT THE COMMISSION SECRETARY TO REQUEST APPROVAL OF THE AMENDMENT FROM THE BOARD OF SUPERVISORS PURSUANT TO SECTION 9.118 OF THE CHARTER OF THE CITY AND COUNTY OF SAN FRANCISCO.

Executive Summary

DFS Group, L.P. (Tenant) currently operates exclusive duty-free retail operations at San Francisco International Airport (Airport or SFO) under the International Terminal Duty Free and Luxury Stores Lease No. 17-0303 (Lease). The Base Term commenced April 1, 2020, with a Base Rent structure equal to the greater of (i) a Minimum Annual Guarantee (MAG) of $42,000,000.00 (subject to adjustment in accordance with the Lease) or (ii) Percentage Rent (Percentage Rent) equal to 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 (Original Base Rent Structure).

Duty-free sales activity continues to be severely impacted as a result of the COVID-19 pandemic and the negative impact it has had on international travel. MAG was suspended in accordance with Severe Decline in Enplanement provisions in the Lease from June 1, 2020 through May 1, 2023. Pursuant to Amendment No. 2 to the Lease, the Percentage Rent was reduced to a non-tiered, flat amount of 33% of gross revenue through the end of Lease Year 4, December 31, 2023, or the reinstatement of the MAG, whichever occurs first. Staff requests the Commission approve a further amendment to the Lease which (i) continues a reduced Percentage Rent structure, but increases the Percentage Rent amount to 36% of gross revenue, commencing with Lease Year 5 (January 1, 2024) and continuing

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through the last day of Lease Year 7 (December 31, 2026), and (ii) establishing a temporarily reduced Minimum Annual Guarantee of $30,000,000.00 for Lease Year 5, which will adjust as specified in the Lease for Lease Years 6 and 7. Upon the commencement of Lease Year 8 (January 1, 2027), the Base Rent reverts to the Original Base Rent Structure in place at Lease award, including the original MAG, as adjusted from Lease Year 1.

Background

On December 5, 2017, by Resolution No. 17-0303, the Commission awarded the Lease to Tenant with a Base Term of 14 years, with a potential extension of the term relating solely to the Airport constructing a single central security checkpoint in the International Terminal. 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 provided for a temporary suspension of the MAG and a temporary reduction in the Percentage Rent structure to equal 33% of gross revenue through December 31, 2020, necessitated by the following unanticipated factors in the time period leading up to the commencement of the Lease of April 1, 2020: (i) the severe reduction in international flights related to the COVID-19 pandemic, (ii) global economic issues impacting the value of the Chinese currency, and (iii) dramatic decrease in the spending patterns of the average Chinese traveler.

On December 1, 2020, by Resolution No. 20-0222, the Commission approved Amendment No. 2 to the Lease (Amendment No. 2), which continued the temporary modification of the Percentage Rent structure due to the prolonged recovery from the pandemic.

On October 6, 2020, by Resolution No. 20-0180, the Commission approved Amendment No. 3 to the Lease when it adopted the COVID-19 Emergency Rent Relief Program which provided MAG rent relief to most Airport concession tenants for April and May 2020.

Under the Lease, Tenant currently operates 15 retail stores branded as DFS Duty Free, DFS Watches, Hermes, Yves Saint Laurent, Burberry, Gucci, Coach, Swarovski, and APM Monaco. Yet to be constructed are the Harvey Milk Terminal 1 locations as depicted on Attachment 1 to this memorandum.

Duty-free sales peaked at nearly $149,000,000.00 in calendar year 2017. It was forecast that the first year of sales under the new Lease would be between $150,000,000.00 and $160,000,000.00. The Airport expects sales to average 42% below the initial forecast for the next four calendar years due to severely depressed enplanement activity. Prior to the pandemic, travelers from the People's Republic of China (China) accounted for more than 50% of total duty-free sales. Currently, there are four weekly flights to China compared to the previous 53. Geopolitical issues continue and the return of passenger traffic from China could be slowed by a backlog of expired entry documents. Additionally, the spending patterns of travelers from China could be depressed in the coming years due to changing economic conditions in their country.

Even with a continued suspension of the MAG under a severe decline in enplanements scenario, significant financial losses for Tenant (including each of the five small business joint venture partners) can still be expected if the Percentage Rent structure reverts to the original structure on December 31, 2023 as required pursuant to Amendment No. 2. The Airport projects losses to Tenant during Lease Year 5 (calendar year 2024) to be approximately $18,000,000.00 if the Percentage Rent structure remains unchanged. Each ACDBE joint venture partner will bear any loss in proportion to their percentage ownership. Conversely, if the lower Percentage Rent structure is approved through the Amendment recommended under the current Commission action, the ACDBE joint venture partners will enjoy the benefit of such lower rent in proportion to their percentage of ownership.

Proposal

Staff recommends further amending the Lease which extends the reduced Percentage Rent Structure but increases the Percentage Rent amount to 36% of gross revenue and establishes a reduced MAG at $30,000,000.00 commencing with Lease Year 5 (2024) and continuing through Lease Year 7 (2026), with the MAG adjusting annually during that time in accordance with the Lease. This accommodation is necessary and in the best interest of the Airport by helping to ensure the economic viability and continued operation of this important concession, which provides world-class retail offerings and earns more revenue for the Airport than all other retail leases combined. At the commencement of Lease Year 8, the Original Base Rent Structure (including the payment of the original Minimum Annual Guarantee, as adjusted from Lease Year 1) will be restored.

The continued rent accommodation is conditioned on Tenant's timely completion of construction of its final facilities in Harvey Milk Terminal 1, currently contemplated to be December 31, 2024, based on current base building construction delivery schedules. If Tenant fails to satisfy this obligation, the Percentage Rent reduction set forth in the amendment will be void, and Tenant will have to pay the Original Base Rent Structure (including any applicable Minimum Annual Guarantee in the original, adjusted amount) that would have otherwise been in effect retroactive to January 1, 2024.

Recommendation

I recommend the Commission adopt the accompanying Resolution: (1) approving Amendment No. 4 to the International Terminal Duty Free and Luxury Stores Lease No. 17-0303, which extends the reduced percentage rent structure, but increases the amount of Percentage Rent to 36% of gross revenue, commencing with Lease Year 5 and continuing through Lease Year 7, and establishes a temporarily reduced MAG of $30,000,000.00 for Lease Year 5, increasing annually in accordance with the Lease through Lease Year 7, each subject to the condition stated above, and (2) directing the Commission Secretary to request approval of the Amendment No. 4 from 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 Financial and Commercial Officer

Attachments

Attachment 1

International Terminal Duty Free and Luxury Stores Lease No. 17-0303