MEMORANDUM

To: Anthony Bardo

From: James Musbach, Michael Nimon, and Edward Sullivan

Subject: Crystal Springs Golf Course Lease Renegotiation Considerations; EPS #131057

Date: March 6, 2014

The Economics of Land Use

Economic & Planning Systems, Inc. (EPS) prepared this analysis for the San Francisco Public Utilities Commission (SFPUC) to inform the negotiation strategy and tenant selection process for the Crystal Springs Golf Course.

This memorandum builds on the financial analysis and lease negotiation support that EPS completed for the SFPUC in July 2013. It also reviews the overall responsiveness of golf course industry operators to requests for proposals (RFPs) recently issued by comparable publicly-owned golf course owners. This memorandum provides other considerations based on EPS interviews with comparable golf course owners and other EPS research.

Background

The SFPUC owns the Crystal Springs Golf Course (CS Golf Course), an 18-hole golf course located adjacent to the City of Burlingame in unincorporated San Mateo County. The SFPUC has a lease agreement with Crystal Springs Golf Partners, L.P. (CSGP), which operates the Crystal Springs Golf Course.[1] The lease term expires in March 2017.

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[1] Crystal Springs Golf Partners, L.P. has a management agreement with CourseCo for daily operations; CourseCo, in turn, entered a joint venture agreement with ZGolf in 2003, under which ZGolf manages food and beverage facilities at Crystal Springs. Both are referred as “Tenant” or “CourseCo” in this document.

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The SFPUC must renegotiate its current lease with CSGP to reflect recent changes to the leased premises necessary to accommodate new Pacific Gas and Electric Company (PG&E) easements for state-mandated gas line upgrades and testing. In addition, CSGP requests a rent reduction due to the decrease in the Crystal Springs Golf Course's performance and the overall contraction of the golf industry. At the same time, CSGP requests an extension of the lease term to accommodate CSGP's desire to make capital improvements to the Crystal Springs Golf Course and recoup such investment.

The SFPUC's key objectives are to continue generating revenue from the Crystal Springs Golf Course while minimizing its own financial risk, and to ensure that a qualified operator manages the Crystal Springs Golf Course to meet the SFPUC's mission to provide its customers with high-quality, efficient, and reliable water, power, and sewer services in a manner that values environmental and community interests and sustains the resources entrusted to its care.

Within this context, the SFPUC also seeks to address the need for additional capital improvements that are expected to improve the course's attractiveness in an increasingly competitive industry. To achieve these objectives, the SFPUC seeks a lease agreement with a highly qualified operator with a demonstrated track record of successfully managing golf courses in an environmentally sensitive and sustainable manner.

Given the SFPUC's mission and the need to modify its existing lease with CSGP to accommodate new PG&E easements, the SFPUC is considering the following two approaches:

1) Engage in exclusive negotiations with CSGP to modify existing rental terms and extend the lease for 10 years to minimize operator and revenue risk to the SFPUC in response to CSGP's request for modification, and to address recent changes to the lease premises necessary to accommodate the new PG&E easements, or

2) Modify the lease at this time to reflect the new PG&E easements and issue an RFP at the expiration of the existing lease with CSGP with the hope of identifying a willing operator that can perform better than CourseCo.

Tenant Overview

CourseCo is the largest golf operator in the Bay Area and is one of the 25 largest golf operators in the United States. Formed in 1989, it operates 25 golf courses, including 20 courses owned by public entities. It provides a full range golf management services, including golf operations, course maintenance, environmental management, food and beverage services, marketing and accounting, capital budgeting, and construction management.

CourseCo successfully manages Boundary Oak Golf Course in Walnut Creek, Napa Golf Course, Metropolitan in Oakland, and Foxtail in Rohnert Park, all Bay Area municipal golf courses. It generates $60 million in revenues and has over 1,000 employees. CourseCo is known for its community engagement efforts, leadership in environmental management, and sustainable golf course maintenance (see **Appendix A**).

Golf Operator Models

There are a large number of golf course operators in the United States with a wide range of company sizes, managed assets, and specializations. Privately held golf courses comprise the majority of the industry. This analysis focuses on publicly owned golf courses. There are many municipally owned golf courses in the Bay Area and beyond. While some of these golf courses generate revenues, most operate at a loss incurred by their respective municipalities.

Given the contraction of the golf industry as a whole and increased regional competition, revenue from food and beverage sales and banquet events has become a larger share of overall golf course revenues as special events tend to generate stronger economic performance. The special event volume varies widely by golf course, with the Callippe Preserve golf course in Pleasanton generating 14 percent of its revenue total from food and beverage sales, relative to the Crystal Springs Golf Course's 40 percent of revenue total. User experience features like soil conditions, clubhouse improvements, and other amenities have also become more important for competitiveness. Given its vital role in attracting special events users, clubhouse improvements could have a significant impact on the long-term competitiveness of Crystal Springs. Competitive golf course features underline the importance of investing in capital facilities and other performance related improvements designed to attract golf and special event users.

Typical Deal Terms

Municipal golf course management firms are typically compensated either through a lease participation model or a contract fee model. Under a lease participation model, managers retain all operating revenues and costs and pay a percentage of gross revenue to the owners with a minimum base rent that is independent of actual performance. Under a contract fee model, owners retain operating revenues and costs and pay an operator fee. While some publicly owned golf courses are operated based on the lease participation model, EPS research shows that contract fee compensation is more common.

Under a contract fee compensation structure, operators typically receive a base fee with additional performance incentives. Recent examples of this compensation structure include Boundary Oak Golf Course in Walnut Creek and Municipal Golf Course in Napa. Many municipalities choose the contract fee model to control fees, policies, budget levels, capital improvements, and other standards, while operators like this model due to lower risk relative to lease participation. Under a contract fee arrangement, owners retain the upside from better than expected performance. However, as mentioned earlier, present market conditions cause most municipal golf courses to operate at a loss incurred by their respective municipality.

In other cases, the lease participation model is preferred by municipalities, such as the SFPUC, to reduce financial risk in case of underperformance. This deal structure works when golf course performance generates net revenues with operators incentivized to maximize the upside. Comparison of owner benefits between the two deal structures is provided in **Table 1**.

Table 1 Key Municipal Benefits from Operator Compensation by Deal Structure

Lease Participation Model	Contract Fee Model
• Reduces financial risk • Lowers overhead • Utilizes private capital for capital improvements through rent concessions	• Greater owner control • Financial upside by owner • Better financing terms (lower cost, tax-exempt financing) • Potential possessory interest tax exemption (subject to short-term agreements)

Prior EPS Analysis

EPS completed a market analysis designed to inform the evaluation of the Crystal Springs Golf Course lease agreement with the Crystal Springs Golf Course operator in July 2013. It included a market overview of the golf industry and economic trends, financial forecast of the Golf Course's performance, analytic comparison of the existing and proposed rent structure, and a review of other lease terms for comparable golf courses. The EPS analysis reached the following conclusions:

- ***National golf activity has experienced a major decline, while competition from local courses and food and beverage/special event venues has increased.***
- ***Declining financial performance of the Crystal Springs golf course has resulted in revenue reductions and tenant losses under the existing rent structure. Going forward, the financial performance of Crystal Springs will likely remain flat, considering the golf course's strong location offset by the increasingly competitive landscape in a contracting industry.***
- ***CourseCo's proposal to restructure existing rent terms would improve the tenant's financial performance.***
- ***Reduced rent is likely necessary to justify the tenant's additional capital improvement investment.***

Key Findings

EPS has since conducted further research and analysis regarding recent RFP issuances and golf course compensation structures, as described above. This effort produced the following results:

1. ***Operator interest in RFPs seeking lease participation is uncertain, given several unsuccessful recent issuances where municipalities were seeking tenant capital investment.***

   - The lack of recently-issued RFPs that specify lease participation structure makes the level of operator interest unclear.[2] While operator contract fees are popular with public agencies seeking control over investment decisions and operators seeking lower risk positions, the structure creates more financial risk for the owners. Therefore, the level of interest for a lease participation structure is likely to be lower than that for a contract fee. Disappointing responses to lease participation structure RFPs that requested capital improvement investments by tenants has been recently experienced by multiple municipalities.[3]

   - There have been a number of public RFP issuances for golf course management in recent years. Although the response to RFPs has generally been strong and public entities were happy with the issuance.[4] The majority of the RPFs were seeking a contract fee operator arrangement, which is not directly comparable to the current Crystal Springs lease structure.

2. ***Given the economics of the golf industry, the capital investment needs at Crystal Springs, and the likelihood of low operator interest, there is a risk that an RFP issuance will yield disadvantageous rent terms or a golf course operator that does not suit the SFPUC's needs.*** The golf industry has experienced a major decline on a national level, and prospects for Crystal Springs are flat with the locational strengths of the Course off-setting declining interest in the sport. Given these trends, a range of potential rent terms resulting from the RFP process may fall below the level currently proposed by CourseCo.

3. ***As a practical matter, it could be potentially economically disadvantageous to issue an RFP for the Crystal Springs Golf Course.*** The current lease participation structure of the lease is advantageous to the SFPUC, particularly while prospects for the industry decline, as it seeks to reduce financial risk and provide a more certain revenue stream to the SFPUC. Recent RFP releases indicate operator preference for a contract fee structure, suggesting that

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[2] In the case of the RFP issued for the Deer Park golf course in Texas in 2012, the compensation strategy was not specified. The RFP generated seven responses with six proposals for the contract fee structure and one for the lease participation structure with the contract fee structure proposal ultimately being picked.

[3] Los Angeles County's Marshall Canyon course and Portland's Heron Lakes complex received no bids, while Westchester Golf Course in Los Angeles received one bid.

[4] For example, an RFP issued by the City of Lemoore in 2010 generated 27 responses, while an RFP issued by the City of Walnut Creek for Boundary Oaks in 2008 generated 18 responses.

the lease participation structure with another operator would not likely result in better deal terms for the SFPUC. ***Retention of CourseCo and extension of the existing lease will likely incentivize additional investments in capital facilities and improvements to the Crystal Springs Golf Course.*** A tenant's willingness to invest in long-term capital improvements is tied to the length of the lease. Extending the time horizon for operation and amortization of investments and creating additional certainty will increase CourseCo's willingness to make additional capital investments.

- CourseCo has operated the Crystal Springs Golf Course since November 26, 1996, under a 20-year lease agreement set to expire on March 31, 2017. CourseCo has invested in capital facility improvements specified under the lease terms, estimated at over $4 million since the beginning of its operation.

- CourseCo estimates that approximately $1.3 million in additional capital improvements could improve the long-term competitiveness of the Crystal Springs Golf Course (see **Table 2**).[5] A combination of funding sources, including CourseCo, the SFPUC rent credits, and the Crystal Springs' Capital Improvement Fund will cover capital facility costs. This estimate is somewhat uncertain, given the subjective nature of identifying necessary capital improvements, as well as estimating a financial return on their investment over an unspecified time horizon.

4. ***CourseCo has a successful history of managing the Crystal Springs Golf Course and has made the capital improvement investments specified under the existing lease.*** CourseCo is the largest golf operator in the Bay Area and operates 20 publicly owned golf courses. It made capital improvements to the Crystal Springs Golf Course, despite the reduction in the Crystal Springs Golf Course's performance. However, CourseCo indicated it will be unable to continue making these investments unless the lease terms are amended and extended to provide additional certainty and investment incentives. A lack of investment in capital facility improvements could result in infrastructure deterioration that would affect long-term competitiveness of the site. Diminished competitiveness would affect the lease terms that could be negotiated at the expiration of the current lease.

5. ***CourseCo's operation of the Crystal Springs Golf Course satisfies the SFPUC's mission.*** CourseCo won a number of industry awards, including environmental management and sustainability like the Governor's "Environmental and Economic Leadership Award" for outstanding contributions in sustainable practices, Environmental Leadership in Golf award, and the Land Use Planning & Management in Environmental Golf Courses award. CourseCo was the only golf organization to receive the Governor's Environmental and Economic Leadership Award. CourseCo has also made philanthropic, charitable, and youth development contributions as well as broader community investments.

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[5] July 2012 Evaluation of Market Rate Structure of the Crystal Springs Golf Course by Pro Forma Advisors.

Table 2
Crystal Springs Estimated Long-Term Capital Improvements and Cost Estimates*

Improvement	Total Cost
Maintenance Facility	$100,000
Range Ball Dispenser	$30,000
Gas Tank Removal	$5,000
Sanitary Sewer Pumps	$10,000
Clubhouse HVAC	$50,000
Golf Course Entry	$25,000
Parking Lot Paving	$60,000
Entry Road Paving	$100,000
Range Lighting	$25,000
Clubhouse Solar Panels	$50,000
Irrigation Pond Supply Line	$45,000
Irrigation Pump Station	$75,000
Parking Lot Signage/Lighting	$50,000
Cart Paths	$100,000
Property Signage	$25,000
Clubhouse Improvements	$200,000
Cart Storage	$50,000
Subtotal	$1,000,000
Soft Costs (1) (15%)	$150,000
Contingency (10%)	$100,000
Total Capital Improvement Costs	**$1,250,000**

Note: exclude irrigation system and rebuilding greens based on the input from CourseCo.

(1) Includes planning, design, engineering, construction insurance, and other soft costs.

Sources: Pro Forma Advisors, CourseCo, and EPS.

Conclusion

Issuing an RFP for the operations of the Crystal Springs Golf Course may be impractical, as an RFP issuance could result in a less qualified operator for the Golf Course and with terms less favorable than those currently proposed by CourseCo. Issuing an RFP and evaluating responses is costly, particularly in terms of staff time and opportunity costs. Because it would also be expensive for CourseCo to respond to an RFP, it is not certain whether they would respond. Furthermore, even with an alternate qualified operator, transition is often costly and potentially disruptive to services and short-term revenues.

The SFPUC is satisfied with CourseCo as the operator of the Crystal Springs Golf Course and pleased with the capital investments that have been undertaken. CourseCo's operation of Crystal Springs has been consistent with the SFPUC's mission and objectives for management of its land.

APPENDIX A: COURSECO ACCOMPLISHMENTS, AWARDS, AND INVESTMENTS

Philanthropic, Charitable, Youth Development Accomplishments

- NCGA "Youth on Course" Program
- PGA's "Get Golf Ready" Program
- CourseCo Junior League
- Participation in the classroom at local elementary, middle, and high schools
- Oakland Turfgrass Education Initiative Founder (instrumental in founding four chapters of The First Tee in California)
- LPGA-USGA Girls Gold
- Home Club Junior Golf Programs
- Saving Strokes

Crystal Springs Initiatives

- Presents and sponsors LPGA Girls Golf – an initiative
- Sponsors NCGA free clinics for all golfers, mostly adults
- Presents/sponsors the PGA of America's Get Golf Ready, an attractive initiative that is particularly effective for women
- Hosts and sponsors a large annual Boys and Girls Clubs Tournament to raise funds for the organization
- Five local high school golf teams are sponsored for matches and practice at Crystal.

Awards

- First Tee Founders Award, its highest honor.
- First *Wildlife Habitat Council* certification in America
- Various *State of California* Waste Reduction awards
- Governor's Environmental and Economic Leadership Award" for outstanding contributions in sustainable practices. This is "the highest and most prestigious" environmental award of the *State of California* (CourseCo is the only golf organization to receive this recognition)
- Environmental Leadership in Golf Award Multiple Winner (National and Chapter)
- Award for Land Use Planning & Management in Environmental Golf Courses by *the Peninsula Conservation Center Foundation*

Bay Area Community Involvement

- Susan G. Komen Breast Cancer Fundraiser
- ILS Special Needs Tournament
- Blue Star Moms Tournament
- Blood drives
- Fundraisers for school supplies

Investment in Crystal Springs

Over the past 18 years, CourseCo has invested over $4 million in capital facility improvements. These projects include:

- Clubhouse renovation
- New cart paths
- Driving range and practice area
- Irrigation and drainage
- Bunkers
- Parking, landscaping, and entry repairs