Evaluation of Rent Proposal
Crystal Springs Golf Course

Burlingame, San Mateo County, California

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Introduction and Background

Crystal Springs Golf Course is an 18-hole regulation length municipal golf course located in Burlingame, San Mateo County, California. The golf course is owned by the City and County of San Francisco and leased to Crystal Springs Golf Partners. The San Francisco Public Utilities Commission (SFPUC), a public agency of the City and County of San Francisco, is responsible for administering the lease. The golf course is managed for Crystal Springs Partners by CourseCo, Inc., a California-based professional golf course management company.

The current lease expires March 31, 2017. After consideration of a number of factors, including an analysis conducted for the SFPUC by an independent consulting firm (EPS), the SFPUC has elected to negotiate a new 20-year lease with the current operator rather than conduct a bidding process to re-lease the golf course property at the end of the current lease term. First, there are a number of near-term capital improvements required at the golf facility in order to remain competitive, and Crystal Springs Golf Partners has expressed willingness to fund such improvements. CourseCo has performed well in a challenging golf market, and the SFPUC has been satisfied with this performance. CourseCo also has demonstrated environmental leadership in its maintenance and operating practices. Finally, with weak demand in the golf course leasing market, an RFP process is likely to result in few, if any, qualified respondents.

Tentative terms have been formulated regarding a new lease agreement between the SFPUC and Crystal Springs Partners. The following presents an evaluation of the proposed lease structure in the context of current and anticipated market conditions.

Market Overview

- During the 1990s and early part of the 2000 decade, the national golf market exhibited strength, with most golf courses operating at close to full effective capacity and sustaining greens fees increases well above general price inflation.
- However, the golf market has softened considerably over the past 10-15 years. The number of golfers in the U.S. declined from 30.4 million in 2003 to 24.7 million in 2014, and then dropped further to 24.1 million in 2015, a reduction of over 20 percent. Accordingly, the number of rounds played declined from 520 million to 457 million over the same time frame.
- The national golf participation rate over the 2003-2015 period declined sharply from 12.4 percent to 8.5 percent of the population over 6 years old. Among the most disturbing statistics is that the largest departing golfer segment is the 18-34 year age group. The decline in the number of golfers in this age cohort does not portend a near term recovery of the golf industry.
- Since 2007, an annual average of 40 golf courses have been added to the national inventory, while the annual number of course closures has average 150.

- The softening of the golf market over the past 10-15 years is due to a variety of factors including:
  - The dramatic increase in the supply of public golf courses;
  - Development of golf courses located within master-planned golf communities, justified by housing economics rather than golf market conditions;
  - Fundamental changes in lifestyle and entertainment/recreation pursuits affecting the underlying demand for golf;
  - The sharp downturn in the economy commencing in 2007/2008.
- For the most part, the Bay Area golf market has mirrored the national market. Since 1990, 30 new public golf courses were added to the Bay Area inventory, an increase of 40 percent. Rounds on most public golf courses have declined approximately 25 percent over the past 15 years.
- After sharp declines in overall performance, the Bay Area golf market has stabilized over the past three years. Nonetheless, the relatively flat performance over the past several years is concerning in the context of an improving economy.
- Irrigation water availability and cost has become an extremely important factor in the operation of Bay Area golf courses.
- Challenged by soft golf market conditions and irrigation water availability/cost, six Bay Area golf courses have closed in the past year alone, including the 36-hole Sunol Valley Golf Course in the Sunol Valley area of the East Bay.
- The mid- to long-term outlook for the regional golf market is highly uncertain at this time. Some analysts believe that the aging baby boomer population (participation and frequency of play increase with age), few if any additions to the golf course inventory, and an improvement in overall economic conditions suggest stabilization or possible marginal industry growth. Other analysts suggest that the market is still seeking its bottom, with the hope of achieving some stability in the next 3- to 5-years.

Crystal Springs Historical Performance

- Annual play (paid rounds) at Crystal Springs Golf Course for the 2007-2015 period is reported as follows:

Exhibit 1: Crystal Spring Annual Paid Rounds	
Year	Rounds
2007	73,654
2008	70,037
2009	71,083
2010	61,330
2011	62,084
2012	63,849
2013	67,929
2014	65,146
2015	69,577

- Play over the past four years, averaging 66,625 rounds per year, has benefited from drought conditions. Play for 2015, for example, adjusted for normal rainfall, would have been in the range of 65,000 rounds compared to the 69,577 rounds recorded.
- While play has increased over the 2012-2015 period, the average golf (greens fees, member dues, carts and range) revenue per round has declined from $51.09 to $49.76 over this period.
- Operator net operating cash flow for the 2007-2015 period is reported as follows (note that there is an allowance for a management fee included in general and administrative expenses):

Exhibit 2: Crystal Springs Golf Course Net Operating Income ($000)									
	2007	2008	2009	2010	2011	2012	2013	2014	2015
Gross Revenue	$4,105	$3,838	$3,791	$3,368	$3,375	$3,610	$3,904	$3,662	$3,817
Less: Merchandise COS	165	150	201	194	208	168	201	167	163
Gross Profit	$3,940	$3,688	$3,590	$3,174	$3,167	$3,442	$3,703	$3,495	$3,654
F & B Contribution[1/]	527	567	446	479	544	639	611	628	716
Total	$4,467	$4,255	$4,036	$3,653	$3,711	$4,081	$4,314	$4,123	$4,370
Operating Expenses									
Golf Operations	$385	$446	$479	$450	$443	$554	$528	$541	$604
Maintenance	807	836	778	779	744	718	695	843	911
General & Admin	874	901	861	868	829	836	801	835	835
Total	$2,066	$2,183	$2,118	$2,097	$2,015	$2,108	$2,023	$2,219	$2,350
Net Income (EBITDAR)[2/]	$2,401	$2,072	$1,918	$1,556	$1,696	$1,973	$2,291	$1,904	$2,020
Less: Rent	$1,421	$1,400	$1,447	$1,490	$1,508	$1,566	$1,622	$1,665	$1,708
Less: CIP Contribution	126	122	116	107	112	123	128	125	135
Net Operating Cash Flow	$854	$550	$355	($42)	$76	$285	$541	$114	$177

[1/] Estimated net contribution from food and beverage operations joint venture. [2/] Before rent and CIP contribution.

Crystal Springs Partners' original capital investment totaled approximately $2.2 million in 1997. Based on audited financial statements for the period 1997 through 2015, the internal rate of return on initial investment is calculated at 1.43 percent.

Golf Course Rents

- Annual rent paid in 2014 for selected Bay Area facilities based on their performance and the lease terms of the agreement is summarized below.

Exhibit 3: Rent Paid at Selected Bay Area Regulation Length Golf Courses--2015						
	Crystal Springs	Monarch Bay	Spring Valley	Metropolitan	Tilden Park	Chuck Corica
	Burlingame	San Leandro	Milpitas	Oakland	Berkeley	Alameda
	18 Holes	27 Holes[1/]	18 Holes	18 Holes	18 Holes	45 Holes[2/]
Gross Revenue ($000)						
Greens Fees	$2,485	$1,674	$2,086	$1,530	$1,680	$3,470
Cart Rentals	613	410	462	430	390	715
Range Fees	268	304	120	292	600	500
Subtotal Golf	$3,366	$2,388	$2,668	$2,252	$2,670	$4,685
Merchandise	$239	$189	116	$215	$180	$330
Food & Beverage	2,702	394	639	1,586	600	835
Instruction/Other	237	28	74	92	75	---
Total	$6,544	$2,999	$3,498	$4,145	$3,525	$5,850
Rent ($000)						
Minimum Rent	$1,665	$750	$312	$604	$375	$300
Percentage Rent						
Golf	$944	$669	$336	$450	$465	$375
Merchandise	19	11	12	9	9	26
Food & Beverage	239	24	67	63	56	71
Instruction/Other	108	2	8	4	4	---
Total	$1,310	$696	$423	$526	$536	$472
Rent Paid	**$1,708**	**$750**	**$423**	**$302**[3/]	**$536**	**$472**

[1/] One regulation length 18-hole and one 9-hole executive length course.

[2/] Two 18-hole regulation length and one 9-hole par-3 course. Revenue and rent forecast for FY2016-17 when capital improvements are completed.

[3/] Rent relief equal to 50% reduction in minimum/percentage rent.

- An adjusted “annual facility cost,” comprised of rent paid plus amortization of lessee-funded initial capital improvements, for selected Bay Area municipal golf facilities is shown below:

Exhibit 4: Adjusted Annual Rent Paid at Selected Bay Area Facilities			
Facility	**Annual Rent Paid**	**Amortization of Initial Capital[1/]**	**Total Annual Facility Cost**
Crystal Springs Current	**$1,708,000**	**$192,000[2/]**	**$1,900,000**
Monarch Bay Golf Club (27 holes)	750,000	640,000	$1,390,000
Spring Valley Golf Course	423,000	195,000	618,000
Metropolitan Golf Links	302,000	625,000	927,000
Tilden Park Golf Course	536,000	260,000	796,000
Chuck Corica (45 holes)	472,000	445,000	917,000

[1/] Represents lessee-funded initial capital improvements amortized over 25 years at a 6% cost of capital.
[2/] Calculation based on original lease minimum capital investment of $2.2 million amortized over 20 years.

- In terms of annual rent paid, Crystal Springs is by far the highest of the six Bay Area golf courses shown. When a component is added to reflect the annual cost of amortizing initial lessee-funded capital improvements, yielding total annual facility cost, Crystal Springs obligation is still significantly above the other golf courses shown.

- Compared with Southern California municipal golf courses which are leased, Crystal Springs annual rent of $1,708,000 exceeds all but one of the forty-five regulation length 18-hole Southern California golf facilities operating under a long-term lease agreement. Annual rent at Los Angeles County’s 13 regulation length facilities, for example, averages just under $1.0 million per 18-hole facility. Most of these facilities are located in very strong golf markets, benefit by more favorable weather than similar municipal courses in the Bay Area, and are relatively easy to maintain.

- Notably, the municipal golf course lease market has softened considerably over the past 10-15 years. Requests for proposals for leasing opportunities have attracted very limited bidders and, in many cases, there have not been any bidders (Los Angeles County Marshall Canyon Golf Course; East Bay Regional Park District Willow Springs Golf Course).

- In recent years a number of California municipal golf course lessees, several in the Bay Area, have sought and received rent relief from the public agencies which own the courses. Moreover, there are numerous lessees which are in the process of restructuring their leases to remain economically viable.

Proposed Crystal Springs Lease Terms

The following basic terms are proposed at Crystal Springs:

- Term: 20 years
- Initial Investment:

  Year 1: $1.25 million

  Year 11: $1.0 million
- Rent Deposit: $400,000 (returned at conclusion of lease term)
- Base Rent: $1.0 million (years 1-3, then at 80% of prior 3 years' percentage rent)
- Percentage Rent:

Department	Revenue Threshold[1/]	Percent of Gross: Below Threshold	Percent of Gross: Above Threshold
Golf (greens fees, carts, range)	$4.0 M	25.0%	30.0%
Merchandise	.4 M	5.0	6.0
Food & Beverage	---	7.0	---

- Capital Improvement Replacement Reserve:

  Tenant: 2.0% of total gross revenue

  Lessor: 2.0% of total gross revenue

[1/] Increased by 1.5% per year

Pro Forma Operating Income

- A stable year (2017) pro forma operating income statement is presented in Exhibit 5 based on a series of factors and assumptions, and reflecting the proposed lease terms (note that a 20-year financial model is available under separate cover). The values are expressed in constant 2017 dollars, and are based on 67,320 annual rounds (annual play over the past four drought years has averaged 66,625 rounds). The average greens fees ($37.57 per round) and cart rental revenue ($8.95 per round) are consistent with actual results for 2015.
- Operating expenses include a deduction for the lessee's share of the capital improvement reserve and an allowance for a standard management fee. Expenses also include an ongoing annual reserve for replacement of golf course maintenance equipment and a cart fleet lease obligation.

Exhibit 5: Crystal Springs Golf Club Stable Year Net Cash Flow (thousands of constant 2016 dollars)			
	Baseline	**Upside**	**Downside**
Rounds	67,360	70,000	65,000
Gross Revenue			
Greens Fees/Member Dues	$2,531	$2,660	$2,340
Cart Rentals	603	595	555
Range Revenue	275	300	275
Subtotal Golf	$3,409	$3,555	$3,170
Merchandise	241	260	230
Food & Beverage	2,500	2,750	2,400
Other	56	100	40
Total	$6,206	$6,690	$5,840
Less: Cost of Sales			
Merchandise	$169	$182	$161
Food & Beverage	775	960	840
Subtotal	$944	$1,142	$1,001
Gross Profit	$5,262	$5,548	$4,839
Operating Expenses			
Course Maintenance	$1,013	$1,013	$1,013
Golf Operations	608	608	608
Food & Beverage	1,225	1,300	1,200
General & Administrative	894	925	875
CIP Contribution	124	134	117
Total	$3,864	$3,980	$3,813
EBITDAR	$1,398	$1,568	$1,026
Rent to SFPUC	$1,042	$1,101	$1,000
Net Cash Flow	$356	$467	$26

- In addition to the baseline stable year projection, modest upside and downside scenarios are formulated. The upside projection reflects an annual play level of 70,000 rounds at a $38 average greens fees, while the downside is based on annual play of 65,000 rounds at a $36 average greens fees.
- Under the baseline scenario, earnings before interest, taxes, depreciation, amortization and rent (EBITDAR) is projected at approximately $1.4 million per year. Deducting rent yields operator net cash flow of $356,000.
- As golf is largely a fixed cost business (expenses do not significantly vary with changes in revenues), very modest changes in rounds and/or greens fees have amplified impacts on net operating income. As the exhibit illustrates, in the upside scenario an 8 percent increase in gross revenue results in a 31 percent increase in net cash flow. Similarly, in the downside scenario a 6 percent decrease in gross revenue produces over a 90 percent reduction in net cash flow (just above breakeven). This high degree of sensitivity translates into greater risk than most non-golf business operations.
- The financial risk for properties like Crystal Springs is magnified due to the high minimum rent provision of the lease.

Operator Economics

- The baseline operating margin (the ratio of EBITDAR to gross revenue) is calculated at 22.5 percent. While this margin is somewhat low for well performing courses such as Crystal Springs, the margin before deduction of a standard management fee is calculated at 26.5 percent. Considering the high proportion of food and beverage gross revenue at Crystal Springs, where margins are relatively low, the 26.5 percent margin is consistent with similar courses.
- Projected annual EBITDAR, before rent and management fees, under the baseline totals approximately $1.65 million. With modest lessee-funded capital improvement requirements, a typical split of EBITDAR is roughly two-thirds to the lessor and one-third to the lessee. Under the baseline, the projected distribution of annual EBITDAR is about $604,000 (36 percent) to the lessee and $1,042,000 (64 percent) to the lessor.
- Alternatively, under the baseline scenario, the lessee's EBITDA (before management fees) is just over twice the standard management fee of 4 percent. Again, given the modest capital investment level and high risk associated with golf operations, earnings equal to twice the management fee under a lease agreement is in-line with the expectations of most operators.
- Based on the 20-year financial model prepared by the SFPUC and its consultants, the internal rate of return on the lessee's investment is calculated at 13.95 percent under the baseline case (see Exhibit 6).

- The Society of Golf Course Appraisers Financing and Investment Survey, probably the most reliable source of data on golf property investment criteria, shows "unleveraged" internal rates of return (present value discount rates) ranging from 10 percent to 22 percent, averaging 14 percent. Thus, the IRR under the baseline scenario for Crystal Springs is consistent with current industry investment criteria.
- The internal rate of return on the lessee's invested capital is highly sensitive to changes in performance. For example, baseline projections reflect an annual increase in demand (golf play) at .6 percent. The internal rate of return drops to zero if demand growth slows to .3 percent annually.
- The net cash flow earned by the operator also is pre-tax, with only nominal depreciation available on a leasehold property to shelter net earnings. Moreover, the proposed venture relates to a leasehold with a relatively short investment horizon of only 20 years. Such investment is difficult to finance, and the finite period in which the investment needs to be recovered presents substantial additional risk. Lastly, the extremely high financial risk is evidenced by the large disparity between net operator earnings of $1.6 million versus the $26.6 million in projected rent payments over the 20-year lease term, most of which is guaranteed by the $1.0 million annual minimum rent.

Summary

- The current rent structure at Crystal Springs is substantially above market, and is not supportable going forward.
- Given the level of front-end capital improvements required, current and anticipated market conditions, and expected operating performance at Crystal Springs, the proposed percentage rental terms are well within the range of present market experience. Minimum rent should be set at about 80 percent of the expected percentage rent amount.
- The return on invested capital, given the expected performance, relatively short lease term and risk profile, appears reasonable and appropriate from the lessee's perspective. As well, the share of EBITDAR accruing to the SFPUC in the form of facility rent payments is in-line with market experience.

Exhibit 6: Crystal Springs Operator Internal Rate of Return Calculation ($000)				
Year	**EBITDAR**	**Less: SFPUC Rent**	**Less: Capital Investment**	**Net Cash Flow**
0	---	---	$1,650	($1,650)
1	$1,397	$1,042	---	$355
2	1,430	1,068	---	362
3	1,444	1,094	---	349
4	1,462	1,122	---	340
5	1,470	1,150	---	320
6	1,486	1,179	---	308
7	1,502	1,208	---	294
8	1,517	1,238	---	279
9	1,530	1,269	---	261
10	1,543	1,301	---	242
11	1,554	1,333	1,000	(779)
12	1,564	1,367	---	197
13	1,572	1,401	---	171
14	1,578	1,436	---	142
15	1,582	1,472	---	110
16	1,584	1,512	---	72
17	1,584	1,552	---	32
18	1,581	1,594	---	(13)
19	1,575	1,637	---	(62)
20	1,566	1,680	(400)	285
Total	30,521	26,655	(2,250)	1,616
Internal Rate of Return	---	---	---	13.95%