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: May 26, 2021 Budget and Finance Committee Meeting

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EXECUTIVE SUMMARY

Legislative Objectives

- The proposed resolution would approve Amendment No. 2 to the Terminal 3 lounge lease between San Francisco International Airport (Airport) as landlord and American Express Travel Related Services Company, Inc. (American Express) as tenant, (a) expanding the leased premises to 15,287 square feet; (b) establishing a new Minimum Annual Guaranteed (MAG) rent of $3,226,546, (e) increasing the promotional charge to $15,287, and (f) extending the term by seven years through November 5, 2031.

Key Points

- American Express has operated the 8,199 square foot Centurion Lounge in Terminal 3 since November 2014. According to Airport staff, prior to the COVID-19 pandemic, the lounge was very popular with travelers and often reached maximum capacity. Airport staff has explored expanding the space to accommodate demand and increase revenue.
- Airport staff has identified 7,088 square feet of pre-security space adjacent to the lounge suitable for expansion. The space is occupied by offices and vacant corridor space and is not marketable as stand-alone concession space. The Airport and American Express have agreed to amend the lease to include the expansion space. The amendment extends the lease seven years through November 5, 2031 to amortize the expansion construction costs.

Fiscal Impact

- Under the proposed Amendment, American Express would pay MAG rent of $3,226,546, subject to annual adjustment. Over the approximately nine-year and four-month term of the new rent structure, the Airport would receive at least $30,114,429 in total MAG rent.

Policy Consideration

- The negotiated rental rate of $160 per square foot for the expansion premises is less than the annual rental rate of $255.21 per square foot for Category II terminal space set in the FY 2020-21 Airport Rates and Charges. The negotiated rate of $160 per square foot for the expansion space is based on American Express' costs to construct tenant improvements. Although the lease states that the minimum tenant investment per square foot is $350, according to Airport staff, tenant investment costs are estimated to be approximately $1,200 per square foot. Therefore, the proposed resolution should be amended to state that the Airport estimates that American Express' cost to construct tenant improvements in the expansion space is at least $1,200 per square foot.

Recommendations

- Amend the proposed resolution to state that the Airport estimates that American Express' cost to construct tenant improvements in the expansion space is at least $1,200 per square foot.
- Approval of the proposed resolution as amended is a policy matter for the Board of Supervisors because (1) the negotiated rent is less than the scheduled rent set in the Airport Rates and Charges, and (2) the proposed lease term exceeds the original 10-year term advertised in the RFP.

MANDATE STATEMENT

City Charter Section 9.118(c) states that (1) any lease of real property for ten or more years, including options to renew, (2) have anticipated revenues to the City of $1,000,000, or (3) the modification, amendment or termination of these leases is subject to Board of Supervisors approval.

BACKGROUND

In 2012, the San Francisco International Airport (Airport) conducted a Request for Proposals (RFP) for an airport lounge lease in Terminal 3. American Express Travel Related Services Company, Inc. (American Express) submitted the only proposal and was determined to be a responsive and responsible proposer and was awarded a lease. In October 2013, the Board of Supervisors approved a lease with American Express, with initial annual rent of $1,515,475 and a term of 10 years, from November 6, 2014 through November 5, 2024 (File 13-0779).

Under the lease, American Express occupies approximately 8,199 square feet, branded as Centurion Lounge. According to Airport staff, prior to the COVID-19 pandemic, the lounge was very popular with travelers and often reached maximum capacity and had to turn away members and guests. Airport staff has explored expanding the space to accommodate demand and increase revenue. The lounge was closed from March 20, 2020 through October 11, 2020 but has now reopened and American Express expects demand to return. Furthermore, the Airport and American Express expect there to be an increased sensitivity to crowding due to the pandemic.

Airport staff has identified approximately 7,088 square feet of pre-security space adjacent to the lounge suitable for expansion. The space is occupied by offices, an employee break room and smaller concession operators under storage permits that can be terminated with 30 days' notice, as well as vacant corridor space. Due to the location of the space on a pre-security mezzanine level, the space is not marketable as stand-alone concession space. In November 2020, the Airport Commission approved Amendment No. 2[1] to the American Express lease to include the expanded space.

DETAILS OF PROPOSED LEGISLATION

The proposed resolution would approve Amendment No. 2 to the Terminal 3 lounge lease between the Airport as landlord and American Express as tenant, expanding the leased premises to approximately 15,287 feet, establishing a new Minimum Annual Guaranteed (MAG) rent of $3,226,546, and extending the term seven years through November 5, 2031.

Under the existing lease, American Express pays $2,092,467 in annual rent. The rent is determined by the FY 2020-21 Airport Rates and Charges, which sets the annual rental rate for Category II terminal space, including VIP clubs and lounges, at $255.21 per square foot. Under the proposed Amendment No. 2, American Express would pay a negotiated Minimum Annual

[1] In October 2020, the Airport Commission approved Amendment No. 1 to the lease to memorialize the Airport's COVID-19 Emergency Rent Relief Program, which waived certain rents and fees to encourage business recovery, employee rehiring, and continued concession operations at the Airport (File 20-1278).

Guaranteed (MAG) rent of $3,226,546. The MAG amount is based on the current annual rental rate of $255.21 per square foot for the existing premises and a negotiated annual rental rate of $160 per square foot for the expansion premises, as shown in Table 1 below.

Table 1: Initial MAG Rent Calculation

Premises	Square Footage	Rental Rate per Square Foot	Total Rent
Existing	8,199	$255.21	$2,092,467
Expansion	7,088	160.00	1,134,080
Total	**15,287**		**$3,226,546**

Source: Airport. Totals may not add due to rounding.

According to Airport Management, the lower rental rate of $160 per square foot was negotiated based on the location of the expansion premises, the significant demolition and construction costs to be incurred by the tenant in reconfiguring and incorporating the expansion premises from a pre-security mezzanine level space into a natural extension of the post-security existing premises, and the requisite buildout of lounge features and improvements for the expansion premises.[2] The total MAG rent of $3,226,546 would be adjusted annually based on the Consumer Price Index (CPI), rather than through annual adjustments to the Airport Rates and Charges.

The proposed Amendment No. 2 would also extend the term of the lease seven years, through November 5, 2031, for a total term of 17 years. The 17-year term exceeds the 10-year lease term advertised in the 2012 RFP. According to Airport Management, the seven-year term extension allows the tenant to amortize the capital investment for the expansion and buildout costs. The Airport may also require the facility to close due to the future T3 West project. If closure is required, the lease may be extended by the amount of time the facility is closed.

The key terms of the proposed Amendment No. 2 are shown in Table 2 below.

Table 2: Key Provisions of Lease Amendment

Premises	15,287 square feet (increase of 7,088 square feet)
Term Extension	7 years, through November 5, 2031
Options to Extend	None
MAG Rent	$3,226,546
MAG Adjustment	Annually based on CPI
Minimum Investment Amount	$350 per square foot of expansion space ($2,480,800)
Promotional Charge	$1 per square foot per year ($15,287)
T3 West Project Closure	Airport may require closure due to T3 West project with 90 days' notice. MAG rent is abated during closure period. Lease may be extended by number of days facility is closed.

Source: Proposed Lease Amendment No. 2

As noted above, the negotiated rate of $160 per square foot for the expansion space is based on American Express' costs to construct tenant improvements. Although the lease states that the minimum tenant investment per square foot is $350, according to Ms. Cheryl Nashir, Airport

[2] According to Airport staff, American Express invested $10.3 million in its facility in 2014 and is expected to invest an additional $9 million on this expansion.

Director of Revenue Development and Management, tenant investment costs are estimated to be approximately $1,200 per square foot. Therefore, the proposed resolution should be amended to state that the Airport estimates that American Express' cost to construct tenant improvements in the expansion space is at least $1,200 per square foot.

According to Ms. Nashir, the anticipated rent commencement date for the expansion premises is July 1, 2022. Until the expansion premises is opened, American Express will continue paying the Category II rental rate for the existing premises, which is currently $255.21 per square foot annually.

FISCAL IMPACT

Under the proposed Amendment No. 2, American Express would pay $3,226,546 in initial MAG rent, starting on the expected date of July 1, 2022, subject to annual adjustment. Over the approximately nine-year and four-month term of the new rent structure, the Airport would receive at least $30,114,429 in total MAG rent.

The expansion premises are currently occupied by United Airlines and Covenant Security Services, which pay $502,508 in combined annual rent. According to Ms. Nashir, both tenants will be relocated into other vacant space at the Airport, so rent will not be lost when the space is converted into a lounge.

POLICY CONSIDERATION

The proposed negotiated annual rental rate of $160 per square foot is less than the annual rental rate of $255.21 per square foot for Category II terminal space set in the FY 2020-21 Airport Rates and Charges. Over the approximately nine-year and three-month term of the negotiated rate structure, American Express will pay approximately $6,298,586 less than it would have to under the Category II rental rate. The negotiated rental rate may signal to other prospective Airport terminal concessions tenants that the posted rates and charges are negotiable. According to Ms. Nashir, space rent published in the Airport Rates and Charges document is used solely for two common use lounge leases, and for concessions storage and office 30-day permits. All other terminal concessions rent is based on Minimum Annual Guarantees and sales activity.

According to Ms. Nashir, the negotiated rental rate is unique for this lease and is unlikely to be replicated for future leases. The proposed Amendment No. 2 is a mid-term modification of an existing lease, not a new lease. American Express will incur significant costs to convert existing office and corridor space into an airport lounge. According to Ms. Nashir, American Express spent approximately $1,200 per square foot to construct the existing lounge in 2014 and will likely spend more for the expansion due to cost escalation and COVID-19 safety requirements. The tenant also provides free access to its lounge for American Express premium cardholders and does not receive sales revenue from the facility, unlike other concession tenants. Additionally, it differs from an airline lounge frequented by passengers who have made a purchase in the form of an airline ticket. According to Ms. Nashir, the premises cannot be marketed as stand-alone concession space as it on a mezzanine level not within the passenger flow and currently has no post-security access, so utilizing the space for the lounge expansion provides the Airport the best opportunity to generate revenue.

The Budget and Legislative Analyst considers approval of the proposed resolution to be a policy matter for the Board of Supervisors because (1) the negotiated rent is less than the scheduled rent set by the Airport Commission in the Rates and Charges, and (2) the proposed lease term is extended by seven years beyond the original 10-year term advertised in the RFP.

RECOMMENDATIONS

1. Amend the proposed resolution to state that the Airport estimates that American Express' cost to construct tenant improvements in the expansion space is at least $1,200 per square foot.

2. Approval the proposed resolution as amended is a policy matter for the Board of Supervisors.

Item 2 File 21-0444	Department: Airport

EXECUTIVE SUMMARY

Legislative Objectives

- The proposed resolution would approve the Fourth Amendment to the Lease Agreement between the Airport and Marilla Chocolate Company, Inc. to extend the term from May 31, 2020 to no later than June 30, 2023.

Key Points

- The original lease between Marilla Chocolate Company and the Airport for a food and gift store concession in Terminal 3 was approved in December 2010. The initial lease term was for seven years from the commencement of operations in approximately April 2011 to April 2018, at which time the lease went into month-to-month holdover status due to the Airport's planned Terminal 3 renovation between Gates F1 and F4 (T3 West Project). Under the terms of the original lease, Marilla Chocolate Company paid percentage rent but not Minimum Annual Guarantee (MAG) rent during the holdover period. Because of delays in implementing the T3 West Project, the Airport approved the First and Second Amendments to extend the lease term to May 2020, in which Marilla Chocolate Company continued to pay percentage but not MAG rent; and due to the decline in Airport enplanements because of the COVID-19 pandemic, the Airport approved the Third Amendment to include the COVID-19 Emergency Rent Relief Program for Airport Concession Tenants.
- Because the Airport plans to implement a new concessions program to replace existing stores and restaurants in the area (including Marilla Chocolate Company) as part of the T3 West Project, the Airport has chosen to extend the existing lease with Marilla Chocolate Company rather than issuing a Request for Proposals (RFP) for a new lease. Under the proposed Fourth Amendment, Marilla Chocolate Company would continue to pay percentage but not MAG rent.

Fiscal Impact

- On April 30, 2018 the Airport terminated Marilla Chocolate Company's Minimum Annual Guarantee (MAG) rent of $121,031 per year due to Terminal 3 construction. Since then, Marilla Chocolate Company has paid percentage rent to the Airport. In calendar year 2019, the last full year before the COVID-19 pandemic, Marilla Chocolate paid the Airport $101,356.1 in percentage rent. According to estimates provided by Ms. Nashir, based on projected enplanements in 2021 through 2023, total percentage rent to be paid by Marilla Chocolate Company over the extended term is $103,000.

Recommendation

- Approve the proposed resolution.

MANDATE STATEMENT

City Charter Section 9.118(c) states that any lease of real property for ten or more years, including options to renew, and having anticipated revenues to the City of $1,000,000, or the modification, amendment or termination of these leases is subject to Board of Supervisors approval.

BACKGROUND

On December 17, 2010, following a competitive selection process, the Airport Commission (Airport) awarded Marilla Chocolate Company, Inc. the “Terminal 3, Boarding Area F Food and Gifts Store” Lease, for an initial term of seven years and Minimum Annual Guarantee (MAG) of $101,440 for the first year or tiered percentage rent, whichever is greater. The Lease did not provide an option to extend. The Lease expired on April 30, 2018, and was on a month-to-month holdover tenancy, paying percentage rent according to the Lease.

Because the Airport plans to renovate Terminal 3, between Gates F1 and F4 (T3 West Project), including a new concessions program to replace existing stores and restaurants in the area (including Marilla Chocolate Company), the Airport has chosen to extend the existing lease with Marilla Chocolate Company rather than issuing a Request for Proposals (RFP) for a new lease. The Airport is still determining the best use of space in consideration for the planned redevelopment, and in the interim, to preserve customer service and maintain revenue, the Airport has negotiated lease amendments with affected concession tenants. The T3 West Project was anticipated to begin in 2020 but continues to be postponed due to the COVID-19 pandemic.

To date, there have been three Amendments to Airport Lease No. 10-0309 with Marilla Chocolate Company, none of which have met the threshold for Board of Supervisor’s review under City Charter Section 9.118:

- On March 5, 2019, the Airport approved Amendment No. 1 which extended the lease term to December 31, 2019.
- On December 3, 2019, the Airport approved Amendment No. 2 which extended the lease term to May 31, 2020.
- On October 6, 2020, the Airport adopted via Amendment No. 3 the COVID-19 Emergency Rent Relief Program for Airport Concession Tenants.

According to Ms. Cheryl Nashir, Airport Director of Revenue Development and Management, the Airport has not required Marilla Chocolate Company to pay the MAG since expiration of the original lease in April 2018 because the lease initially went into a twelve-month holdover period during which the existing lease specified percentage rent only is to be paid. After the twelve-month holdover, and during each of the two successive lease term extensions, Airport Staff left the holdover rent structure in place of the percentage rent only.

According to Ms. Nashir, between May 2020 and May 2021, Marilla Chocolate Company has only opened the concession, California Lifestyle, for a four-week period, but sales were not sufficient to continue operations, and the concession has been closed since late December 2020. Marilla Chocolate Company paid percentage rent for the four weeks of operation.

On December 15, 2020, the Airport approved by resolution Amendment No. 4 to the Lease with Marilla Chocolate Company, which was submitted to the Board of Supervisors for approval on May 5, 2021. Marilla Chocolate Company, Inc. was a wholesale company founded in 1985 and was located in San Francisco. It's business now consists strictly in ownership in concessions at the Airport.

DETAILS OF PROPOSED LEGISLATION

The proposed resolution would approve the Fourth Amendment to the Lease Agreement between the Airport and Marilla Chocolate Company, Inc. to extend the term from May 31, 2020 to no later than June 30, 2023. According to the proposed resolution, the current MAG would not change, subject to adjustments in accordance with the terms of the Lease. However, as noted above, the prior amendments to Lease, enacted since the expiration of the original Lease in April 2018, have not required payment of the MAG.

The Amendment provides that the Airport Director may terminate the lease earlier that June 30, 2023 by providing six months' advance written notice, primarily to allow for flexibility around the timeline of the T3 West Project. Below is a summary of the original and proposed lease provisions:

Exhibit 1. Summary of Original and Proposed Fourth Amendment Lease 10-0309 Provisions

	Original Lease	**Fourth Amendment to Lease**
Total Term	Seven Years: May 1, 2011- April 30, 2018	Twelve Years: May 1, 2011 - June 30, 2023
Options to Extend	None	None
Premises	455 square feet of space in Terminal 3 Boarding Area F	455 square feet of space in Terminal 3 Boarding Area F
Minimum Annual Guarantee (MAG)	$223 per square foot- $101,440 per year	Suspended since April 30, 2018
MAG Adjustment	Adjusted annually based on the Consumer Price Index (CPI)	Suspended
Revenue Percentage Rent	12 percent of revenues up to and including $500,000	12 percent of revenues up to and including $500,000
	Plus 14 percent of revenues between $500,000.01 up to and including $1,000,000	Plus 14 percent of revenues between $500,000.01 up to and including $1,000,000
	Plus 16 percent of revenues over $1,000,000	Plus 16 percent of revenues over $1,000,000
Annual Promotional Fee	$1.00 per square foot- $455 per year	$1.00 per square foot- $455 per year
Deposit Amount	50 percent of the current MAG	$60,516
Minimum Initial Investment	$350 per square foot - $159,250	N/A

Source: SFO-MRG Lease Agreement and Amendment No. 4

Airport staff will not be conducting a new Request for Proposals for this lease agreement because due to the COVID-19 pandemic, there is deemed to be insufficient interest to conduct a strong competitive process.

FISCAL IMPACT

On April 30, 2018 the Airport terminated Marilla Chocolate Company's Minimum Annual Guarantee (MAG) rent of $121,031 per year due to Terminal 3 construction. Since then, Marilla Chocolate Company has paid percentage rent to the Airport. In calendar year 2019, the last full year before the COVID-19 pandemic, Marilla Chocolate paid the Airport $101,356.1 in percentage rent. According to estimates provided by Ms. Nashir, based on projected enplanements in 2021 through 2023, total percentage rent to be paid by Marilla Chocolate Company over the extended term is $103,000.

RECOMMENDATION

Approve the proposed resolution.