THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Additional Information on Proposed Belmont Park Lease Amendment

OVERVIEW

On September 9th, our office released IBA Report 14-31 which examined the proposed lease amendment for Belmont Park. The proposed lease was heard at the City Council on September 24th; at that meeting Council rejected the proposal and directed City staff to attempt additional negotiation with the current lessee, and to report back to the City Council in November.

On November 7th, Council District 2 issued a memo that requested our office provide additional information regarding the proposed lease amendment for the Belmont Park property in Mission Bay. The memo includes five specific questions, which this report responds to.

FISCAL/POLICY DISCUSSION

1. *Item No. 7 in the July 9, 2013 Letter of Intent removes a provision that 2.5 percent of gross income per year be expended on capital improvements.*

- *What is the value of 2.5% of gross over the life of the existing lease (23 years)?*
- *What is the value if it was left in for the term of the proposed lease (55 years)?*

The terms of the existing lease require the lessee to expend 2.5% of annual gross revenues on capital improvements at Belmont Park. Before rent payments are calculated, that 2.5% amount is deducted from the lessee's gross revenues - the lessee does not pay percentage rents on that amount. This requirement is *not* included in the proposed lease amendment. If the proposed amendment is adopted, the 2.5% provision would be eliminated upon execution of the amended lease.

Over the 23 years remaining on the existing lease, this provision would require the lessee to spend approximately $18.8 million in capital improvements at the property. Because that amount would not be subject to percentage rent, the City would forgo collecting approximately $939,000 in percentage rent in exchange for that capital expenditure commitment.

If the 2.5% provision were to be re-inserted into the proposed lease amendment, it would require the lessee to expend approximately $67.9 million in capital expenditures through 2069, and result in the City forgoing collection of $3.6 million in percentage rents.

It may be helpful to use a discounted cash flow analysis to consider the present value of those amounts. The tables below illustrate the complete amount of that commitment and the corresponding reduction in rent to be received by the City, and the present value of those amounts.

***Total Value* 2.5% Commitment and Corresponding Reduced Rent**		
	Total 2.5% Commitment	*Reduction in Rent*
2015-2038	$18,787,606	$939,380
2039-2069	$49,070,910.78	$2,657,121
Total	$67,858,517	$3,596,501

***Present Value* 2.5% Commitment and Corresponding Reduced Rent**		
	2.5% Commitment	*Reduction in Rent*
2015-2038	$9,308,317.36	$465,416
2039-2069	$4,883,384	$293,640
Total	$14,191,702	$759,056

2. *Analyze the terms and processes related to this proposal and how it comports with Council Policy 700-10, including provisions relating to an appraisal, assessment of fair market rents, annual lease audits, incremental gross revenue resulting from subleases, requirement for a portfolio management plan, among others. Specifically, if and how have we deviated from the Council Policy?*

Council Policy 700-10 (Policy) establishes several procedures that are intended to optimize the lease rent from City-owned real estate by requiring appraisals and assessments of fair market rents to be completed before new leases are entered into. Page 1 of the Policy provides:

> "The City shall optimize the sale price or lease rent from City-owned real estate based on relevant factors, including 1) an appraisal reflecting current market value when either a transaction or authorization to sell or lease is presented to the City Council, 2) prevailing economic conditions and market trends, and 3) any special benefits to accrue from the sale or lease."

<u>Appraisal</u>

An independently developed appraisal reads like a narrative report and typically includes (but is not be limited to): an overview of the area, community and neighborhood; a detailed site and building description; a zoning analysis; a highest and best use analysis; market rent and trend studies; an in-depth discussion of different valuation approaches to value; and a recommendation of the most appropriate valuation to use. It can take up to a month for an outside appraisal to be developed for a property like Belmont Park.

In preparing the proposed lease amendment, no full and independent outside appraisal was conducted. The Real Estate Assets Department (READ) did prepare and provide a valuation spreadsheet covering the proposed lease that was developed in-house. They state that as the proposal represents a lease amendment and not a new lease, the operating history of the parcel and its anticipated future uses were used as a guide in development of their valuation, and that that valuation fills the role of an appraisal in determining the value of the lease.

We note that this proposal is technically an amendment to the existing lease, though given the significant changes to financial requirements and the term, one could view it as a new lease. The Policy requires that all new leases be competitively solicited from the open market; however, in limited situations, negotiations may take place with a single party if that party submits a business case (initially to City staff and ultimately to City Council) convincingly stating their ability to optimize the use of the property in a way that negates the need for a competitive process. In July of 2013, the City signed a letter of intent to pursue a lease amendment that had been proposed and negotiated in June of 2013. The valuation prepared by READ staff was prepared in July of 2014.

Assessment of Fair Market Rents

Page 10 of the Policy requires that percentage leases provide for adjustment of percentage rents every ten years to current fair market rates. The Policy states "For purposes of determining fair market rent percentage rates, the City shall adopt and publish a schedule of benchmark percentage rents that will be updated to current market rents on a periodic basis by appraisal." The Policy further states "The appraisal will be guided by prevailing market percentage rates for similar operations primarily within the Southern California area."

READ staff provided an appraisal of other Mission Bay and Port percentage rents that was prepared in-house in 2010.

Portfolio Management Plan

The Policy also requires the development and continued updating of a comprehensive Portfolio Management Plan, and the presentation of that plan to the City Council on an annual basis. That plan was last presented in its entirety to Council in 2010; READ staff indicates that it submitted the proposed lease amendment individually to the City Council, as the Policy allows transactions that fall outside the parameters of an approved Portfolio Management Plan to be submitted individually for approval.

Lease Audits and Other Policy Requirements

The proposed lease seems to be in compliance with the remainder of Council Policy 700-10, including periodic audit requirements, requirements concerning the adjustment of minimum and percentage rents, and payment of a portion of the incremental revenue generated by subleases (READ indicates that for the purposes of the percentage-rent lease proposed for Belmont Park, the retail leases at the Park are not considered subleases; sales by those sub-lessees are instead included when determining the total percentage rent to be paid by the lessee to the City).

3. *What is the average amount of revenue the City is collecting from leases on Mission Bay? Is this average consistent with other City of San Diego leases, or with comparable assets leased by other cities?*

The percentage rent rates for various business activities in the proposed lease amendment are roughly consistent with the percentage rent rates charged by the City at other Mission Bay properties and with percentage rents charged by the Port of San Diego. These rates are included on the table below:

	Proposal	**Sea World**	**Dana Inn**	**Bahia**	**Hyatt MB**	**Hilton MB**	**Port Properties**
Food, Non-Alcohol Bev.	3%	3%	3.5%	3%	3.5%	3.5%	3%
Alcohol. Bev	6%	6%	6.5%	6%	6.5%	6.5%	5%
Specialty Shops	4%	9%	7.5%	7%	9%	7.5%	5%
Game rooms, min.golf.	5%	3%	n/a	n/a	n/a	n/a	n/a
Health Club/Pool	5%	n/a	n/a	7%	n/a	n/a	10%
Telecom	50%	50%	n/a	33%	50%	n/a	50%
Valet Parking	5%	n/a	n/a	n/a	n/a	n/a	10%
All others	10%	9%	10%	10%	10%	10%	10%

The Real Estate Assets Department indicates that the City's own percentage rent ground leases provide the best comparables for new projects, as other California cities generally do not make use of ground leases in managing their properties. This is discussed further in our response to Question 5.

4. *What is the approximate value of the anticipated increase in sales tax revenue to the City if the proposed lease were to be extended?*

This is difficult to determine, and we are unable to provide an accurate estimate. Under existing sales tax law, the City receives 1% of the value of taxable sales that take place in the City. While increased activity and sales in and around Belmont Park will result in an increase in sales tax receipts received by the City, calculating the anticipated increase requires forecasting the difference in taxable sales that would result under both the existing and the proposed lease. To the extent that additional activity at Belmont Park increases overall sales, and to the extent that such increased activity and foot-traffic also increases sales at nearby businesses, the City stands to benefit.

The current lessee under the existing lease is anticipated to continue on should an amended lease be approved. As the lessee will retain over 90% of the gross rent on the property, the lessee is strongly incentivized to develop and maintain the property in a manner that attracts public interest and maximizes revenues. In order to estimate sale tax implications, it is therefore necessary to determine if elements of the proposed lease amendment are likely to increase taxable sales on the property.

The proposed lease amendment does require $10 million of additional capital investment in the property over the first three years, and an additional $5.9 million in repairs and improvements to the Plunge Swimming Pool (this is partially offset by $5.2 million in rent credits). It is reasonable to expect that these improvements will increase the attractiveness of the property in the near-term and increase taxable sales in and around the property.

Conversely, the proposed lease amendment eliminates the annual 2.5% capital investment requirement that was discussed in our response to Question 1; the present value of that expenditure requirement is $14.2 million, though over a 55 term those expenditures would total $67.9 million. Absent any capital expenditures beyond the initial investments mandated by the lease, it would be reasonable to assume that the reduced capital investment over time could reduce the attractiveness of the property and adversely impact taxable sales.

Given the proposed lease amendment's requirement for short-term capital expenditures and corresponding elimination of long-term capital expenditures, we are unable to accurately estimate the effect on taxable sales.

5. *The City of San Diego commonly uses these types of ground leases. Does this reflect best practices in comparison to other cities, or are other types of leases more commonly used?*

San Diego manages over 500 ground leases. We are unaware of any other city in California that uses ground-leases as frequently as San Diego does; as reference, San Francisco makes use of only 25 ground leases.

READ has indicated that while San Diego's high usage of ground leases is unusual compared to other California cities, it results in large part due to San Diego being in possession of a large number of parcels that, due to regulations or other restrictions, cannot easily be sold or that face restrictions on development. Given this, READ states that ground-leases allow the City to contract with lessees to develop those parcels so that they can be used and to generate revenue, while the City can continue to maintain ownership and control of the parcels themselves.

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