THE CITY OF SAN DIEGO

OFFICE OF THE INDEPENDENT BUDGET ANALYST REPORT

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Review of Proposed Lease Extension for Belmont Park

OVERVIEW

On July 24th, our office received a memorandum from Council District 2 requesting that we review a proposed ground lease extension with Pacifica Enterprises – doing business as Symphony Asset Pool XVI, LLC (Symphony) – to operate Belmont Park in Mission Beach. The memorandum specifically requested that we examine whether the proposed lease extension would generate actual returns to the City and whether the terms of the proposed extension are consistent with the best practices of other cities.

In our review, we consulted with staff from the Real Estate Assets Department (READ) and other California cities. We examined the proposed lease extension, along with comparable leases executed by the City of San Diego and other California cities.

Our review finds that the 50 year term of the proposed extension is longer than the average municipal ground lease, and its initial percent-of-gross rental rates seem slightly lower than the percentage-rent average of comparable municipal leases in other California cities. Symphony has, however, committed to making substantial up-front investments to repairing and improving the Belmont Park property, and READ staff has praised Symphony's management of Belmont Park since it acquired the property's leasehold.

The proposed extension would generate additional revenue for the City beyond what it currently receives, and – provided the City exercises its options in the lease to adjust percentage-rents to market rates every ten years – overall lease revenue should remain roughly in line with market rates throughout the life of the lease.

Details on the property, the proposed lease, expected revenues, best practices, and comparable leases are discussed below.

FISCAL/POLICY DISCUSSION

Belmont Park is a City-owned oceanfront amusement park and retail/dining center in Mission Beach. In 2000, the City adopted an amended lease agreement with the previous lessee, which established a rental rate of between 3 and 7% of gross revenues, required the lessee to make various improvements to the property, and provided rent credits of $12.5 million to offset the cost of those improvements. After expiration of one set of rent credits, the previous lessee was unable to make increased rent payments, and entered into bankruptcy proceedings. In 2012, the leasehold was acquired by Symphony. The existing lease runs through 2038, provides $2.9 million in remaining rent credits, and requires a percentage-rent payment of 5% of gross receipts, with a minimum annual payment of approximately $863,000, adjusted every three years.[1]

Upon acquiring the leasehold, Symphony assumed responsibilities for the operation and maintenance of Belmont Park, began making improvements to the property, and entered into negotiations with READ for a lease extension. READ indicates that Symphony has already made substantial repairs and renovations throughout Belmont Park, and is committed to making continued improvements and repairs to the property.[2] Symphony indicates that it increased occupancy at Belmont Park from 77.5% when it acquired the leasehold to 100% today, and that it increased the leasable footprint of property by 12,829 square feet.

Proposed Lease Amendment

The proposed lease amendment makes modifications to the existing lease held by Symphony and establishes both an initial term and a potential extended term. The initial term of the proposed lease expires in 2038, and requires the lessee to make rental payments roughly equal to 5.3% of total gross revenues,[3] in the amounts shown in the table on the following page. The minimum annual rent paid to the City is set at $900,000.[4] The lease requires Symphony to perform repairs and major structural maintenance – including pool water seepage, metal corrosion, HVAC, and ADA compliance issues – to the Plunge Swimming Pool building that are necessary to make the building useable and code compliant, and to manage and maintain a community meeting room on the property. A total of $8.1 million in rent credits is provided in the lease, with $2.9 million consisting of rent credits remaining on the existing lease, and an additional $5.2 million to offset costs for repairs

Existing Lease

- Lease expires in 2038.
- $2.9 million in remaining rent credits available to lessee.
- Lessee pays 5% of gross revenues in rent to the city.
- Percentage-Rent can be adjusted to market rate every 10 years.

Proposed Lease Amendment

- Initial Term runs through 2038.
- If lessee makes $10 million in improvements and repairs in first 3 years, lease can be extended 50 years *(see details below)*.
- City provides $8.1 million in rent credits.
- Lessee pays 5.3% of gross revenues in rent to the city.
- Percentage-Rent can be adjusted to market rate every 10 years.

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[1] The staff report notes that the minimum payment under the existing lease was $705,208, minus rent credits, as of 2000; $863,000 represents the most recent adjustment to that minimum payment.

[2] These repairs include retrofitting the Plunge Swimming Pool building, which Symphony estimates to cost $5.9 million.

[3] This is an approximate figure; actual percentage rent is based on different percentage rents for different business activities, as is detailed in the table on the following page.

[4] Under the terms of the proposed lease amendment, this amount would be adjusted up by 2.5% annually.

to the Plunge Swimming Pool building. Payment of credits is limited to 50% of the rent due each month. READ estimates that the total balance of rent credits would be exhausted during the first 7 to 10 years of the lease, after which rental payments in full would be due to the City.

Proposed Percentage Rents	
% of Gross Revenue	**Business Activity**
4%*	Specialty Shops
3%	Food and Non-Alcoholic Beverages
6%	Alcoholic Beverages
5%	Game Rooms, Laser Tag, Miniature Golf
5%	Health-Club and Pool Operations
50%	Wireless Telecommunication Facilities
5%	Valet Parking
10%	All Other Allowed Uses
** increases to 5% at beginning of 5th year*	

Should Symphony make $10 million in expenditures on specified capital improvements and upgrades during the first three years of the lease's initial term, it would have the option of making a $500,000 one-time payment to the City and entering into an extended term anytime during the first five years of the initial term. That extended term would expire 50 years after the exercise of that option. The minimum annual rent would be adjusted up from $900,000 to $1.1 million, with the same 2.5% annual increase and percent-of-gross rates contemplated in the initial term. As Symphony could elect to extend its lease during the fifth year of the initial term, this could result in an overall lease term of 55 years.

Under the extended term, every ten years the City would have the option to adjust percentage-rents upward to be consistent with market rates as determined by a licensed appraiser and based on similar leases in Ventura, Los Angeles, Orange, and/or San Diego Counties. As the option does not allow percentage-rents to decrease, should the City approve this lease amendment, it is important that it exercise this option – and continue to exercise this option every ten years thereafter – to ensure that its percentage-rents match market rates in the event that market rates increase.

Assuming that Symphony makes the required improvements to exercise its option for an extended lease and exercises that option during the fifth year of its initial term, the lease would expire in 2069. The City should expect to receive a minimum of $104 million over the life of the lease, based on the minimum annual rents with 2.5% annual increases, and taking into account application of rent credits.[5] This amount *does not* include any decennial market rate adjustments. Further, Symphony indicates that it expects growth in Belmont Park's gross annual revenues to continue, with 19.3% growth expected in 2014, 7.7% in 2015, and 12.3% in 2016. The actual amount of rent received by the City over the life of the lease could therefore significantly exceed $104 million.

[5] The 50-year extended term – not including any revenues received during the initial term of the lease or the application of rent credits - would require the lessee to pay a minimum of $107 million over its duration, based solely on minimum payments.

Additional Amendments triggered by Acquisition of Roller Coaster Lease

The proposed lease includes amendments which trigger if Symphony acquires the leasehold for the roller coaster at Belmont Park, which is currently held by another party, within 180 days and consolidates it into the proposed lease. If Symphony does acquire the roller coaster leasehold, it would be required to make an additional $2.5 million in improvements and repairs to the roller coaster, and the minimum annual rent of the combined Belmont Park and Roller Coaster leases would increase to $1,024,000 under the initial term, and to $1.3 million under the extended term, with both figures set to increase by 2.5% annually. Percentage rents would be amended to include ten percent of gross revenues derived from roller coaster rides, and 5% of all other rides at Belmont Park.

Best Practices and Comparable Leases

Nationwide, public and private sector percent-of-gross retail leases require lessees to pay anywhere from 5 to 10% of gross revenues, depending on the location of the lease, the type of retail business, geographic norms, and improvements and maintenance required of the lessee. Many percent-of-gross leases require payment of the percent-rent *in addition* to a minimum rent, and/or have a threshold of gross revenues below which no percent-rent is required, though flat percent-of-gross with minimum payment leases are not uncommon.

Ground leases – those leases which allow the land-owner to retain ownership of a property while a tenant becomes responsible for the maintenance and improvement of the property – are frequently used in commercial real estate developments. They generally have long terms to allow tenants to obtain financing for improvements to the property being leased and the start-up of their operations on that property. While initial rental payments for ground leases can be based on any number of factors, they normally are adjusted to reflect the highest and best use of the property over the life of the lease.

Many of the City's leases with Mission Bay properties are based on similar percent-of-gross leases, and several have terms of or approaching 50 years. The City entered into a similar 50-year lease agreement with Sea World San Diego (Sea World) in 1998 which requires Sea World to make percent-of-growth rent payments, subject to a minimum amount, and allows the City to adjust percentage-rents every 10 years. Percentage rents in the proposed Belmont Park lease correspond with the most recently adjusted percentage-rents in the Sea World lease and other City Mission Bay lease agreements, though the various percentage rents for business activities differ somewhat from lease to lease.

During our review of the proposed lease amendment for Belmont Park, we contacted staff from the cities of Santa Monica, Oakland, and Los Angeles which also make use of percent-of-gross ground lease agreements. Most percentage-rent leases in those cities were for shorter terms, and similarly structured leases generally require lessees to pay rents varying from 6% to 9% of gross receipts. As examples, lease agreements on the Santa Monica Pier require lessees to pay between 6 and 9% of gross revenues as rent payments, lessees in Oakland's Jack London Square pay between 6 and 9%, and lessees in Los Angeles' El Pueblo de Los Angeles Plaza pay 7 to 8%.[6]

[6] While some lessees at El Pueblo de Los Angeles pay percentage-rents, many pay flat rents that are not based on gross revenues.

Most of these leases have terms of 15 to 30 years, though we do note that leases at these locations are made for individual stores or attractions, as opposed to the proposed lease for Belmont Park which includes several buildings and business activities. Lessees who provide public benefits or services in these cities often receive lower or below-market rates.

The difference between the estimated aggregate 5.3% percentage-rent included in the proposed lease and the 6% low end of percentage-rents found in comparable leases in other California cities represents a roughly $2.9 million total difference over the initial ten years of the extended lease; the difference at the 9% high end is roughly $15.8 million.[7] Each additional percent increase in percentage-rent (i.e. moving rent from 6% of gross revenues to 7%) represents an additional $4.3 million over the ten year period. Given that the proposed lease provides the City the option of setting percentage-rents to market rates after ten years, the initial percentage-rents included in this proposed lease amendment only affects the first ten years of the extended term.

CONCLUSION

The proposed lease amendment with Symphony for operating and maintaining Belmont Park should generate additional revenue for the City. While the approximate overall aggregate percentage-rent of 5.3% is slightly lower than the percentage rents charged by other California cities, READ staff indicates that it is consistent with local market rate percentage rents. Should market rates increase, the City would have the option of adjusting percentage-rents ten years into the extended term, and every ten years thereafter. Minimum payments received by the City over the life of the extended 50-year term should total $104 million. The potential for rental revenue significantly above that minimum exists, should the lessee experience continued growth in its own gross revenues, and/or should the City exercise its option to increase percentage-rents to market rates every ten years.

The decision to enter into a 50-plus-year lease agreement is a significant one, and it is worthwhile to ensure that questions and concerns are responded to before the agreement is made. Given that many other municipal leases have shorter terms, it is appropriate to consider the effects a long-term lease could have on the City's ability to respond to future issues at the property, and to carefully examine the proposed percentage rents as they compare to other comparable leases. At the same time, it may be worth considering Symphony's performance managing the property since acquiring the leasehold; READ indicates that Symphony's rental payments to date have exceeded expectations, and that Symphony has already made substantial improvements, repairs, and investments in the property, and is committed to making more.

Ultimately, the Council must weigh the long lease-term and the initial percentage-rents against the lessee's performance to date and the up-front costs it faces to make repairs and improvements necessary to generate increased revenues and rent payments.

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[7] This estimation assumes Symphony's projections for gross revenues through 2016, and a 5% annual growth in gross revenues thereafter. Actual growth may exceed or fall short of this amount.