THE CITY OF SAN DIEGO

MANAGER'S REPORT

DATE ISSUED: June 22, 2005 REPORT NO. 05-151

ATTENTION: Honorable Mayor and City Council
Docket of June 27, 2005

SUBJECT: Lease Agreement - Hyatt Regency Islandia Hotel and Marina

SUMMARY

Issue - Should the City Manager be authorized to enter into a new lease agreement with KenCal Ownership LLC, a California limited liability company, in order to facilitate the acquisition and reinvestment of $25 Million Dollars into the leasehold interest in the Hyatt Regency Islandia Hotel and Marina?

Manager's Recommendation - Approve the lease agreement.

Other Recommendations - On June 7, 2005, the Mission Bay Park Committee referred this item to its finance sub-committee. The Mission Bay Park Committee generally focused on the uses of the revenues to be generated. The committee recommends only utilizing revenue generated in Mission Bay for expenditures within Mission Bay. Since the transaction's timing necessitates Council approval prior to the next scheduled Mission Bay Park Committee meeting on July 5, 2005, the Chair of the Mission Bay Park Committee will address Council regarding the matter. The proposed lessee will provide periodic updates on the refurbishment project to the Mission Bay Park Committee.

Fiscal Impact - Approval of the lease agreement will result in an increase in revenue due to the renegotiated rent structure and the anticipated improvement in the lessee's business performance resulting from the refurbishment of the property. Budgeted revenue for FY06 is approximately $1.9 million dollars. During the 14-month renovation period beginning in November 2005, the rental income is expected to be reduced by up to $800,000 due to the unavailability of some rooms during the construction, but this is more than offset by the $1,200,000 that will be paid to the City upon sale of the leasehold interest from the current lessee to KenCal Ownership LLC. It is anticipated that the new rental rate structure will generate in excess of $6.5 million through 2038.

BACKGROUND

The 421 room Hyatt Regency Islandia Hotel in the Quivira Basin area of Mission Bay Park was constructed in three phases between 1961 and 1987. Adjoining the hotel is a 179 slip marina with a fuel dock and sportfishing operations. The leasehold consists of 9.73 acres of land for the hotel, restaurant and two parking garages, and 9.119 acres of water for the marina.

The Hyatt Corporation has been the operator of the hotel since 1974 under a management agreement with the lessee. In 1976, the previous lessee, the hospitality unit of Pacific Southwest Airlines, assigned the leasehold interest in the property to the current lessee, Islandia Associates, Ltd. A 50-year lease agreement between the City and Islandia Associates, Ltd. was approved in February 1987 and commenced in December 1998. A 76-room addition that was constructed as part of the development plan of the 1987 lease resulted in the current hotel configuration totaling 421 rooms. The marina facility underwent an approximate $2,000,000 renovation in 1999.

DISCUSSION

Islandia Associates, Ltd. has negotiated the sale of its leasehold interest to KAREC California Development Program LLC, a California limited liability company ("KAREC"). The sale is expected to be closed on July 5, 2005. KAREC will assign the leasehold interest to KenCal Ownership LLC ("KenCal"), a separate entity being formed by KAREC that will be the new lessee. KenCal is a hotel asset management company based in Seattle, Washington. The company specialized in managing luxury and independent hotels and resorts including W Hotel in San Diego. KenCal presently manage a portfolio of ten properties in the USA comprising of 1,669 rooms. KenCal is proposing to own and manage the improvements on the property through an operating sublease and management agreements with the Hyatt Corporation for the hotel and JG Management for the marina. The Hyatt flag will remain in place. In addition, KenCal will oversee a comprehensive refurbishment of the hotel portion of the property. The estimated minimum cost of the refurbishment is $25,000,000 and will involve upgrading the rooms, common areas and support facilities to reposition the property as one of the premier lodging and meeting destinations on Mission Bay. KenCal is planning to have the renovation begin in November 2005 and completed over a period of 14 months.

Since the existing lease with Islandia Associates, Ltd. has 33 years remaining, KenCal has requested modifications to the lease to finance the transaction and to amortize the cost of the improvements. A new 50-year lease has been negotiated that addresses the needs of the lessee, updates the lease to present City standards, and provides the City with an improved rent structure. The revised percentage rates are as follows:

	Existing Lease Rate	New Lease Rate	
Room Rental	7.0%	7.25%	Years 1- 5
		7.5%	Years 6 - 10
		7.75%	Years 11 - 25
Food and Non-alcoholic Beverages	3.0%	3.25%	Years 1 - 5
		3.5%	Years 6 - 25
Alcoholic Beverages	6.0%	6.25%	Years 1 - 5

		6.5%	Years 6 - 10
		7.0%	Years 11 - 25
Gift and Lobby Shops	7.0%	8.5%	Years 1 - 5
		9.25%	Years 6 - 10
		10.0%	Years 11 - 25

Other percentage rate categories represent a very small percentage of overall revenue and are comparable to existing market rates and are recommended to remain unchanged. All percentage rent categories will be subject to upward adjustment based on market rates after 25 years. Fixed increases during the initial underwriting period will also facilitate financing. City staff obtained an independent review of the proposed lease terms by a consultant and MAI appraiser specializing in hospitality properties, Maurice Robinson & Associates (Exhibit A). This review confirmed that the proposed rent structure reflects and represents the upper end of the market rates for properties of this type and location.

During the refurbishment phase, the minimum rent to the City will be reduced for one year to $1,000,000. Percentage rent will still apply, but due to the potential number of rooms which may be off-line due to renovation, an estimated reduction in rent of up to $800,000 during the construction period could occur. This will be offset by the approximately $1,200,000 the City will receive as additional consideration upon the assignment of the leasehold interest. Once renovation is completed, it is estimated that the annual rent will be increased to $2,163,000 in 2007.

CONCLUSION

The City Manager recommends approval of the proposed lease agreement. The City will receive more revenue under the terms of the new lease with income from refurbished units, upgraded percentage rental rates and ability to share in the proceeds from the sale or refinancing of the leasehold. Projected revenue comparison of the existing lease against the proposed lease through the remaining term of the existing lease (2038) indicates that the City's General Fund will receive an estimated $6.7 Million (an average $203,000 per year).

ALTERNATIVES

Do not authorize the City Manager to execute the lease agreement.

Respectfully submitted,

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William T. Griffith
Real Estate Assets Director

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Approved: Bruce A. Herring
Deputy City Manager

GRIFFITH/VEB-sb

Attachment: Exhibit A, Letter from Maurice Robinson & Associates, LLC, dated June 15, 2005