DATE ISSUED: September 15, 2005 REPORT NO. 05-195

ATTENTION: Natural Resources and Culture Committee
Agenda of September 21, 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 $28 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, Mission Bay Park Committee referred the proposed lease agreement to its Finance Subcommittee to evaluate the terms of the lease and to return to the Committee with recommendations.

On June 27, 2005, City Council voted to continue the item to September 27, 2005 meeting with direction to staff to seek recommendations from the Mission Bay Park Committee, Park and Recreation Board and Natural Resources and Culture Committee.

On July 13, 2005, the Finance Subcommittee of the Mission Bay Park Committee voted to continue this item to its next meeting on August 4, 2005.

On August 4, 2005, the Finance Subcommittee of the Mission Bay Park Committee voted (0-2-1) to recommend that the Mission Bay Park Committee deny approval of the proposed lease.

On August 9, 2005, Mission Bay Park Committee voted to table the item.

On September 6, 2005, the Mission Bay Park Committee voted (6-6-0) on a motion tabled at the August 9, 2005 meeting to not recommend approval of the sale of the leasehold and the lease extension. A second motion was made during the September 6 meeting to approve the lease, with a provision that there would be a meeting with the City Real Estate Assets Department to develop a format to review leases in Mission Bay Park, and that no more leases would come forward to the committee until there is a defined process. The vote on this motion was (6-6-0). The effect of the vote on September 6, 2005, was that the Mission Bay Park Committee did not provide a recommendation to the Park and Recreation Board.

This item was docketed on the agenda of the September 15, 2005, meeting of the Park & Recreation Board. The Park & Recreation Board recommendations will be provided during the staff presentation of this item.

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 twelve months of the renovation period, the rental income is expected to be reduced by up to $800,000 due to the unavailability of some rooms during the construction, that amount 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 at least $6.7 million in additional revenue through 2038.

BACKGROUND

The 421 room Hyatt Regency Islandia in the Quivira Basin area of Mission Bay Park was constructed in three phases between 1961 and 1987. Adjoining the hotel is a 187 slip marina with a fuel dock and sportfishing operations. The leasehold consists of 9.73 acres of land for the hotel, two restaurants, two parking garages, and 9.119 acres of water for the marina and sport fishing operations. In fiscal year 2004, the City received $1,906,070 of rent from the property. The Hyatt Corporation has been the operator of the hotel since 1974 under a management agreement with the lessee. In 1976, the hospitality division of Pacific Southwest Airlines assigned its 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. 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"). Upon approval of the new lease, KAREC will purchase the leasehold interest and assign it 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 specializes in managing luxury and independent hotels and resorts including the W Hotel in San Diego.

KenCal presently manages a portfolio of ten properties nationwide 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 brand 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 $28,000,000 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 be completed over a period of 14 months.

The existing lease with Islandia Associates, Ltd. expires in November 2038. Since the lease has only 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 KenCal, updates the lease to present City standards, and provides the City with an improved rent structure. The proposed 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 representing a small percentage of the overall revenue are comparable to existing market rates and are recommended to remain unchanged. All of the percentage rent categories will be subject to upward adjustment based on market rates after the 25th lease year. The fixed percentage rent increases during the initial underwriting period will facilitate financing. Maurice Robinson, a consultant and MAI appraiser specializing in hospitality properties provided an independent review of the proposed lease terms (Exhibit "A"). His review confirmed that the proposed rent structure reflects and represents the upper end of the market rates for properties of this type and location. In addition, a review of the most recent percentage rents adopted by the San Diego Unified Port District in 2004 for similar uses confirmed that the Port District percentage rates were either at or below the percentage rates negotiated by the City in connection with the proposed lease with KenCal (Exhibit "B").

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 as a result of the renovation, an estimated reduction in rent of up to $800,000 during the construction period could occur. Any reduction in rent during the renovation will be offset by approximately $1,200,000 that the City will receive as an additional one-time payment upon the assignment of the leasehold interest. Once renovation is completed, the minimum rent will be raised to $1,320,000, it is estimated that the annual rent will increase to $2,163,000 in the first year following the completion of the renovation.

CONCLUSION

The City Manager recommends approval of the proposed lease agreement. The City will receive more revenue under the terms of the new lease from the higher gross income generated by the refurbished rooms, the improved percentage rent structure and ability to share in the increase in value of the property from any future sale or refinancing of the leasehold. A comparison of the projected revenues from the existing lease and proposed lease indicates that the City's General Fund will receive a minimum $203,000 additional rent per year over the remaining term of the existing lease ($6,700,000) through 2038.

ALTERNATIVE

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

Respectfully submitted,

William T. Griffith	Approved: Richard Mendes
Real Estate Assets Director	Deputy City Manager

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Attachments: Exhibit A, Letter from Maurice Robinson & Associates, LLC, August 25, 2005
Exhibit B, Comparison of Percentage Rates of the City and Unified Port District

Please Note: The attachments are not available in electronic format. A copy is available for review in the Office of the City Clerk.