File #: 06-0945, **Version:** 1

Recommendation to authorize City Manager to execute a lease amendment to Lease No. HD-4436 to extend the term to March 31, 2072; and accept a pre-payment of rent for the entire extended term to facilitate the rehabilitation and continued operation of the Coast Hotel at 600 Queensway Drive. (District 2)

In March 1972, the Board of Harbor Commissioners executed Lease HD-4436 (Lease) with the Feinberg Group for the development of a 195-room hotel (Land Parcel) and waterside improvements (Water Parcel), including 10 mooring locations, at 600 Queensway Drive (See Exhibit 1). Over the years, the leasehold interest has been sold and assigned to various entities . On March 8, 2005, City Council authorized the assignment of the Lease to Queensway Hotel, LLC, a Delaware limited liability company (Lessee), which operates the Coast Hotel and subleases the Water Parcel to Harborlight Landing LLC, a California limited liability company. The Lease provides for staggered termination dates as follows: for the Water Parcel, March 31, 2020 and for the Land Parcel, March 31, 2052. The Lease requires payment of the higher of base rent or percentage rent. This rent structure provides for a below fair market base rent, thereby allowing the City to participate in the success of the project through percentage rent.

Lessee intends an extensive renovation program that includes the main building, guest rooms, banquet area, meeting facilities, and landscaping, at an estimated cost of $12.7 million. To assist in financing this significant capital improvement, and to protect this level of investment, Lessee has requested an extension of the term of the Lease to March 31, 2072. This would result in a 20-year extension for the Land Parcel and a 52-year extension for the Water Parcel . Lessee has also requested a pre-payment of rent through the extended term.

Keyser Marsten Associates (KMA), the City's real estate economics consultant, reviewed past and current operating statements for the hotel, historical base and percentage rents paid, and details of the renovation cost pro-forma. Additionally,Laurain and Associates, an independent appraisal firm, determined market lease rates for both the Land Parcel and the Water Parcel as of March 20, 2006.

EXISTING TERM
For the existing term, the annual rent paid in 2006 is estimated at $297,558, which is composed of base and percentage rents for both the Land and Water Parcels. Except for 2007, when the hotel will be partially closed for renovations and only the base rent will be paid, the rent is estimated to increase at 2.5 percent annually to $926,550 in 2052. The base rent is then discounted to present value at a 7 percent rate, which reflects the reasonable reliability and low risk associated with this income stream. The percentage rent is discounted to present value at a 12 percent rate, which reflects the level of risk associated with the cyclical nature of, and market influences on, hotel operations. The present value of the combined income stream for the existing term is $3,749,216.

EXTENDED TERM
For the extended term through March 31, 2072, the current fair market rental value of the Land

Parcel and Water Parcel was first determined and a similar growth rate was applied to arrive at an annual fair market rental rate for each year of the extended term for both the Land Parcel and the Water Parcel .

Land Parcel : The Land Parcel contains 364,013 square feet of reclaimed land, subject to liquefaction during seismic events. The current Uniform Building Code requires significant soil enhancement measures if the property were to be redeveloped . These soil enhancement measures, which include a rock soil retainer dam along the river and stabilizing pilings down to bedrock, are anticipated to cost $5,405,000 ($14.85 per square foot), based on engineering estimates. Additionally, the Land Parcel is subject to development restrictions under the Public Trust Doctrine for Tidelands property, which limits uses of the land to marine or aquatic recreational activities, and visitor serving, tourist oriented retail, commercial and hotel uses. Residential uses are not allowed .

In context of these mitigating influences, the current fair market value of the Land Parcel was determined to be $8,350,000 ($22 .94 per square foot). The current fair market annual rent for the Land Parcel is based on an 8.5 percent return on fair market value, or $709,750 . The annual rent is then increased at 3 percent per year to the beginning of the extended term at which time the annual rent would be $2,847,442. It is important to note that the basis of the rental rate during the extended term was shifted to a straight return on market value, rather than a base and percentage rate, because this methodology generates a significantly higher annual rent. This base rent then increases at 3 percent per year through the extended term, reaching $4,993,008 in 2072. Considering the higher risk of an uninterrupted income stream associated with the significant increase in annual rent and the unknown market influences in the future, a discount rate of 9 percent is applied. The present value of this income stream for the extended term is $560,167.

Water Parcel : The Water Parcel contains 153,955 square feet. The current fair market value of the Water Parcel, generally established by the Ports of Long Beach, Los Angeles, and San Diego, and Marina del Rey, is within a range of ten percent to fifty percent of the adjacent land value. In view of the fact that the Water Parcel is at the mouth of the Los Angeles River subject to the collection of debris, strong currents and shifting bottom elevations, and due to zoning restrictions on mooring, limiting the ability to create a marina facility, the applicable percentage was established at ten percent of the square foot value of the Land Parcel. This equates to a current fair market value of the Water Parcel of $354,000 (153,955 square feet X $2.30 per square foot). The current fair market annual rent for the Water Parcel is also based on an 8.5 percent return on fair market value, or $30,090. This base rent is also increased at 3 percent per year through the extended term, reaching $211,680 in 2072. Considering the elevated risk of an uninterrupted income stream associated with the physical impacts discussed above, a discount rate of 11 percent is applied . The present value of this income stream for the extended term from 2020 to 2072 is $119,970.

PRE-PAYMENT

The additive present value of these three income streams is $4,429,356 ($3,749,219 +560,167+ $119,970). The Lessee proposes to pay the City this amount in two payments. The first payment will occur upon execution of the lease extension and the second payment will occur 24 months later . The second payment will also carry a 9 percent interest rate to ensure that the present value of the two payments equals 4,429,356.

This letter was reviewed by Deputy City Attorney Richard F. Anthony on August 25, 2006 and Budget

Management Officer David Wodynski on September 6, 2006.

Council consideration at its meeting of September 19, 2006 is requested in order for the Lessee to seek construction financing in a timely manner.

$4,429,356 will be deposited in two installments into the Tidelands Fund (TF) in the Department of Community Development. The first payment of $2,214,678 will occur in FY 07 and the second payment of $2,631,259 in FY 09. There will be no impact to the General Fund.

Approve recommendation.

PATRICK H . WEST
DIRECTOR OF COMMUNITY DEVELOPMENT

APPROVED:

GERALD R. MILLER
CITY MANAGER