DATE: August 16, 2006

TO: Chairman and Members, Community Development Commission

FROM: Economic Development and Redevelopment Department

SUBJECT: **APPROVAL OF A MEMORANDUM OF UNDERSTANDING BETWEEN S.D. MALKIN PROPERTIES, INC., AND THE COMMUNITY DEVELOPMENT COMMISSION; APPROVAL OF AMENDMENT 2 TO THE NEGOTIATION AGREEMENT TO EXTEND THE TIME PERIOD TO FILE ALL DEVELOPMENT-RELATED PERMIT APPLICATIONS; AND APPROVAL TO MOVE TO THE SECOND NEGOTIATION PERIOD.**

SYNOPSIS

Staff recommends that the Community Development Commission (CDC) approve a Memorandum of Understanding with S.D. Malkin Properties, Inc; approve Amendment 2 to the Negotiation Agreement to extend the time to submit all development-related permit applications; grant approval to move to the Second Negotiation Period; and authorize the Executive Director to execute the documents.

BACKGROUND

On September 7, 2005, the CDC entered into a Negotiation Agreement with S.D. Malkin Properties, Inc., for the development of a resort hotel on property owned by the CDC, bounded by Pacific Street on the west, Seagaze Drive on the south, Meyers Street on the east, and Pier View Way on the north. The Negotiation Agreement set forth a process to develop an MOU that would be a non-binding recital of the proposed investment by the CDC and City of Oceanside, the financial mechanisms to be used, and the framework for the lease of the Community Development Commission-owned real property and development of a downtown beach resort hotel. The Agreement also contemplated that upon acceptance of the MOU the CDC and the developer would have an opportunity to move to the Second Negotiating Period, at which time a more detailed lease and financial commitments would be documented into the Development and Disposition Agreement (DDA).

At this time the CDC and the developer are at a point to choose to move to the Second Negotiating Period. If the CDC approves moving to the Second Negotiating Period, the developer will prepare and submit all development applications including the Regular Coastal Permit and the Draft Environmental Impact Report (EIR). At this time the developer has requested an additional 60 days to complete all the detailed submittal requirements such as traffic reports, historic reports, etc. The formal way to allow the added time is to extend the term of the Negotiation Agreement by 60 days. The new maximum amount of time, with the amendment, to complete the application, the EIR, the DDA, and getting the approvals would now be 600 days. These are maximum times and through diligence on the part of the developer and the City, the time frames may be shorter.

In addition, should the inclusion of the fractional time shares or any other vacation ownership use be contemplated and require clarification in the Local Coastal Plan, the time to incorporate such a clarification would need to be accounted for in the schedule. Assuming that any other approvals such as Coastal approvals could be done concurrently, at the time of entitlement the developer would submit grading and building plans and upon approvals, would then begin the twenty-four-month construction process. The entire schedule has been extended by 90 days due to one 30-day extension and the requested 60-day extension. While it is possible that the hotel could be completed by the end of 2009, it may be spring 2010.

This has been a deliberate process starting with direction from the Council, community and stakeholder outreach; the distribution of a Request for Qualifications; receipt and review of fourteen proposals; selection and review of finalists; a public meeting with the finalists; and the ultimate selection on April 20, 2005, of S.D. Malkin Properties, Inc.

Since September 7, 2005, staff and consultants have met approximately 45 times. Consultants on the project include Delmar Williams, of Best Best and Krieger; Paul Marra and Curt Lewis of Keyser Marston Associates, Inc.; C.Jay Scott of Scott Hospitality Consultants; Maurice Robinson of Maurice Robinson and Associates, LLC; Brian Forbath of Stradling Yocca Carlson & Rauth; and Keith Curry of Public Financial Management, Inc. Core staff to the Financial Negotiating Team included John Mullen, City Attorney; Mike Blessing, Deputy City Manager; and Jane McVey, Economic Development and Redevelopment Director. Other participating City staff includes Jerry Hittleman, Acting City Planner; Kathy Baker, Redevelopment Manager; Peter Weiss, Public Works Director; Doug Eddow, Real Property Manager; and Michele Lund, Treasury Manager.

The core tasks since September 7, 2005, were for the developer to make the design as final as possible; to analyze the costs and revenues based on the final design; and to develop a plan for the infusion of the Community Development Commission/City investment. To do that required the developer, S.D. Malkin, to move from a broad concept of the layout and site plan to a more refined concept, including determining the preferred alternative for placement of the Top Gun/Graves House.

ANALYSIS

Financial Commitment

The financial commitment required has risen due to a significant increase in construction costs and the increased size of the hotel project since originally envisioned. The estimate for the cost of the hotel in April 2005, based on construction costs immediately prior to that time, was $110,000,000. At this time the cost of the construction of the project is estimated to be $187,000,000. Given the expected revenues at the cost of $110,000,000 a $9.9 million investment was needed to fill the gap. At this time the Agency and City will need to invest an additional $17.1 million for a total investment of $27 million.

The project has increased in size from 302 hotel rooms and 72 time shares to 336 hotel rooms (including the boutique hotel of 47 rooms) and 48 fractional time shares. Component parts include a 289-room hotel on the south block, including a space suitable to seat 500 plus a dance floor. The parking requirement of the ballroom space is a driving factor in the construction of a $22 million two-level underground parking garage. The north block contains a 47-unit boutique hotel, a 48-unit fractional time share building, a shared lobby and amenities, and the Top Gun/Graves House.

In addition, the Local Coastal Plan requires that thirty percent of the site be left as public open space and that 18,000 sq. ft. of Visitor Serving Commercial space be included.

<u>Redevelopment Agency Tax Increment Extension</u>

The City of Oceanside has had a Redevelopment Agency since November 1975, as allowed in State law. The Redevelopment Agency was created to eliminate blight in the downtown and to further the economic goals of the City in a specific area, the 375-acre core downtown area. In that area, the increase in the property tax from the Redevelopment Project Area can only be used to enhance the downtown. Major projects such as moving the train switching yard from the downtown, environmental cleanup, a portion of the new parking garage at the Transit Center, North Coast Highway landscaping, and certain catalyst projects like the San Miguel condominiums and the Pacific Village Row Homes are examples of projects that have been done through the Redevelopment Agency. The City Council sits as the Board of Directors, or Commissioners, of the Redevelopment Agency, which is technically called the Community Development Commission (CDC). In essence, a Redevelopment Agency is a financing tool to achieve specific goals. The main source of revenue has been the increase in property tax since the inception of the Agency. The use of the money is tightly controlled by State law and can only be used in the Redevelopment Area. The Redevelopment Agency is set to expire in November 2015.

Redevelopment Agencies under California Law are allowed to invest in projects that meet the goals of the Agency. The goal of having a destination resort hotel has been in the Redevelopment Plan since it commenced in November, 1975. For a variety of reasons, it has not yet been achieved.

Due to the age of the Agency, a procedure to extend the ability of the Agency to incur debt must be undertaken, no matter what the investment. The Agency's ability to incur debt expired on December 31, 2003. There are two separate mechanisms to extend the ability to incur debt based on two separate provisions in the law. The Legislature has now allowed Agencies who have paid a portion of their property tax increment to the State as required by the State imposed Educational Revenue Augmentation Fund (ERAF) to extend the life of the Redevelopment Plan by one year for each year an agency has paid ERAF. The Oceanside Agency, along with all other agencies, has been forced to pay three years of ERAF money to the State, and as such will be allowed through ordinance to extend the life of the Redevelopment Plan by three years.

In addition, the Agency may, through ordinance, extend the ability of the Agency to incur debt by an additional ten years. Therefore, the Redevelopment Plan, which was due to expire in November 2015, through the use of both of these mechanisms may be extended to November 2028. This is significant as the ability to receive tax increment and re-invest in the project is governed by State law. As the Oceanside Agency is quite old, there is a limited time horizon that is allowed to the Agency at this time. When the Redevelopment Plan expires the City will assume the Agency's rights and responsibilities. For purposes of this report, the term Agency also means City at the end of the Redevelopment Plan.

In order to extend the life of the ability of the Agency to incur debt, the Agency, which up to now has been able to keep all the Tax Increment, must now share that increment with other districts such as the school district, the county and all other taxing districts that would have otherwise received property taxes from the 375-acre Redevelopment area. The extension of the ability to incur debt will require that payments back to 2004 to be made to those agencies. From that time forward, the Tax Increment to the Agency will be net of not only the 20% Set Aside money, but also the amounts to be distributed to other taxing jurisdictions. All revenue amounts noted in this report are net numbers. The mechanism and procedure to extend the life of the agency will be brought forward to the CDC in the coming months.

FISCAL ANALYSIS

Annual Revenues

The following presents a summary of potential revenues from the hotel project. At year four the hotel project is expected to stabilize with Average Daily Rates at $271 and fractional time share values of $154,000. At stabilization the hotel project will yield the Agency and the City the following gross revenues on an annual basis:

Source	City of Oceanside	Redevelopment Agency
Transient Occupancy Tax (TOT)	$2.5 M	
Net Property Tax Increment		$ 1.0 M
Sales Tax	.173 M	

75-Year Net Present Value Revenues

The life of the lease is proposed to be 75 years, with a re-appraisal and an option for a 24-year extension. In Net Present Value, or at today's dollars, deflated for future inflation, over the 75-year term the hotel will yield the following gross revenues:

Source	City of Oceanside	Agency	Total
Transient Occupancy Tax	$40.4 M		$40.4 M
Property Tax	$ 3.0 M	$11.8M	$14.8 M
Sales Tax	$ 2.8 M		$ 2.8 M
Lease Revenue		$14.7 M	$14.7 M
Total	$46.2 M	$26.4 M	$72.6 M

Based on the proformas, the CDC will recapture the $27 million investment in year 10 of the lease, which is year 8 of operations. With 8 percent interest added, the CDC will recapture the $27 million in year 14 of the lease or year 12 of operations.

Additional Revenue

In addition to these revenues, there are provisions in the MOU that are not able to be quantified, but will add additional revenue to the amounts noted above as follows:

- Bonus Rent, to be paid if the project does better than the proforma.
- Participation in refinancings (one half of one percent of net refinancing after the first refinancing)
- Participation in sales (one percent of sale of the lease)

These provisions are complex and are spelled out in the MOU, but in essence are mechanisms to assure that the Agency and City receive a portion of any windfall profits and are also a way to recoup the initial investment into the Public Private partnership.

To put the participation in sales in some perspective, the original San Miguel condo project on The Strand was a Redevelopment project, as were the Pacific Village row homes which were the advent of the row homes north of Pier View and east of the railroad tracks. Both of those projects were required, for a thirty-year period, to pay 1.5 percent and 1 percent respectively of sale price to the agency for all sales. Since 1998 the Agency has received $ 927,665 and the properties have a combined 2006 value of $94 million, with 2006 tax increment estimated to be $1,015,340. While bonus rent and participation from the hotel project cannot be quantified at this time, there will be additional revenue potential to the City and the Agency above the amount previously noted.

Under this proposed financing structure, 81 percent of the investment comes out of the Redevelopment Agency, and the General Fund is the recipient of 63 percent of the financial benefit.

Indirect Benefits

None of the dollars represented in the fiscal analysis are indirect revenues such as spin-off effects or multiplier effects. There is one indirect benefit, however, that must be pointed out. In the Local Coastal Plan is a subset called the Nine Block Master Plan, which states that 240 hotel rooms must be built within the 9 blocks before any given block can pull building permits or that block/project must build their pro rata share of the

240 hotel rooms. Adjacent to this project is the five-block Citymark project, which must either contain 133 hotel rooms (five-ninths of 240 rooms) or wait until the hotel project has begun. This project is a significant one that will establish an urban tourist and resident village in the downtown area. In addition, the proposed second parking garage on Lot 23 at Cleveland and Pier View also cannot proceed unless it produces 27 hotel rooms or waits until the hotel project is built. This requirement and the difficulty in achieving it have created the existing donut effect within the downtown area with the middle remaining empty.

The construction of the hotel project meets the goals of the Redevelopment Agency and also adds a customer base for the existing merchants in the downtown area.

Investment Mechanisms

The investment was structured with a goal to use money coming out of the project itself as the principal source of revenue to re-invest in the project. But for the financial partnership of the Agency and the City, a hotel of this quality would not be built, and this money would not be available. In addition, the selected financial structure puts the burden of performance on the developer.

The following summarizes the uses of funds:

Use	Source	Amount
Environmental Impact Report	Redev. Funds	\$200,000
Off-site infrastructure	CFD reimbursed by tax increment from project	\$4.8M
Garage	Agency issues bond to net money for a portion of garage	\$17M
	City receives 1st \$1M annually in TOT. City contributes 75 percent of remainder until developer is repaid	\$ 5M
Total		\$27M

No existing revenues will be used, except for \$200,000 in Oceanside Redevelopment Agency Tax Increment.

Off-site infrastructure – Community Facilities District

A Community Facilities District (CFD) is a Mello Roos district, allowed by State Law, and has been used to finance the construction of infrastructure as required by the City in industrial and residential projects in Oceanside. Under this proposal, the lessee, S.D. Malkin, as the owner of the long-term lease, would apply to the City Council to request the creation of a CFD after the environmental process has been completed and the project is entitled. The developer will pursue the construction of the off-site infrastructure with construction loans and its own money. Off-site infrastructure includes such items as drainage enhancements, sewer lines, water lines, traffic signals, etc. After the appropriate and required legal documents have been prepared and the City Council votes to create the CFD, a bond can be issued, secured by special taxes levied on the hotel site and based on the projected value of the hotel construction that would net the amount needed to buy the off-site infrastructure from the developer. The CFD tax is a special tax on the developer's tax bill, and the Agency would rebate tax increment from the hotel project back to the developer in an amount to pay the CFD tax plus interest. In that way the value of the hotel project generates tax increment to pay the developer back for building the off-site infrastructure and the legal responsibility to pay the CFD tax is with the developer.

Parking Garage Tax Anticipation Bonds

The Agency proposes to contribute $17 million toward a portion of the parking garage. After the extension of the limitation to incur debt, the Agency would issue Tax Anticipation Bonds (TABs) and use the money raised to contribute up to $17 million toward the garage.

When the Agency issues bonds, it receives funds from the sale of the bonds, and then uses the annual increment from the Redevelopment Project Area to pay the debt service on the bonds. While some non-hotel tax increment would be used to pay the debt service on the new bonds, the hotel will generate $1,043,000 in tax increment annually at year 4, which would be a large portion of the tax increment to pay the debt service on the new bonds.

Typically these bonds are 30-year bonds. However, even with the extension of the ability of the Agency to incur debt, there is only a 20-year window for the longest length of a bond before the Redevelopment Plan expires. Therefore, the impact is that as the time period shortens, the debt service must rise. It would be similar to the difference between a 30-year mortgage and a 20-year mortgage; however, in this instance a 30-year bond will not be available to the Agency.

Parking Garage – TOT

The Agency proposes that $5 million of Transient Occupancy Tax (TOT) be contributed to the parking garage. The TOT is a tax on the revenue paid by hotel guests that goes into the General Fund. The formula would be that the City keeps the first $1,000,000 of TOT annually, and contributes 75 percent of the amount over the first million. In year two and each succeeding year, the million is proposed to be indexed by a Consumer Price Index (CPI). For example, in year one, the hotel is expected to produce $1.8 million in TOT. The General Fund would get $1.2 million ($1million plus 25 percent of $800,000) and the contribution to the garage would be $600,000. In year two, assuming a CPI of 3 percent, the City would keep the first $1,030,000 and 75 percent of the amount over that would be pledged to the garage. Under this approach, the developer is fronting the cost of the construction of the parking garage, and getting paid back after the fact through the TOT that the hotel itself produces. Until the developer has received the full $5 million, it will want 12 percent interest on the remaining balance. The TOT contribution is expected to be complete in year 13 and will expire no later than year 15.

Lease Provisions

The lease term is 75 years, with an appraisal at that time and a 24-year extension opportunity. The lease begins at the time the property is made available for construction. There are several components of the rent.

Fixed Rent

The first component is a fixed rent provision which is an absolute amount that grows quite slowly to allow the hotel time to construct, which is about 2 years, and to become established in the marketplace. For the first 12 years of the lease there is no fixed rent provision. In year 13 the rent begins at $100,000 a year and increases as follows:

Fixed Rent

Lease Years	**Rent**
1 - 12	$0
13	$100,000
14	$200,000
15	$300,000
16	$400,000
17	$500,000
18	$600,000
19	$700,000
20 - 75	75 percent previous 5 years average total rent - every 10 years

Percentage rent

In addition to the fixed rent is a percentage rent, which is paid on the margin between the fixed rent and the percentage rent. As with the fixed rent, the percentage rent is zero for the first 12 years to allow for construction and to become established in the marketplace. At the 13th year the developer will pay 0.5 percent on the gross room revenue and 0.25 percent on the food and beverage and other revenue. It increases as follows:

Percentage Rent Lease Years	Rooms	F&B/Other
1 - 12	0.0%	0.00%
13 - 15	0.5%	0.25%
16 - 18	1.0%	0.50%
19 - 22	2.0%	1.00%
23 - 26	3.0%	1.50%
27 - 30	4.0%	2.00%
31 - 35	5.0%	2.50%
36 - 50	6.0%	3.00%
51 - 75	7.0%	3.50%

<u>Time share rent</u>

The developer/master lease holder will pay to the Agency $350 per interval, per year, on sold intervals only. In addition, the developer/master lease holder will pay 1 percent of the proceeds of any resale.

<u>Bonus Rent</u>

To assure that the Agency has a mechanism to recapture the investment should the hotel make more money than projected, for every lease year that gross revenues exceed 110 percent of proforma projects, the rent for that year will move to 7 percent of room revenues and 3.5 percent of food and beverage and other revenues exceeding 100 percent of proforma. This is a recapture mechanism.

<u>Revenue Sharing on Sale</u>

It is contemplated that the hotel developer will sell the project between year 9 and 13. The return is both the return on operations and also the return they make on the sale. In the spirit of partnership, as the Agency has invested in the project to make it successful, the CDC will participate in the sale. The tenant will be allowed to recapture their equity plus a 20 percent return on equity from the first sale. Above that the CDC will receive 10 percent of the proceeds of the sale. If the return on equity is above 25 percent, the CDC will receive 15 percent of the proceeds of the sale until the CDC receives $27 million plus 6 percent compounded interest.

This proposal to participate in sales continues with subsequent buyers throughout the 75 years. However, if at the first sale the original tenant (S.D. Malkin), does not receive at least a 17.5 percent compounded return, then the buyer of the lease from Malkin is not subject to having the CDC take a portion of the sale, until lease year 20. For all later sales the CDC receives 1 percent of gross sale proceeds net of transaction costs.

Sharing in Refinancing Proceeds

S.D. Malkin will have a construction loan and when the project is finished/almost finished will take out the construction loan with permanent financing. The CDC will not participate in this refinancing. However, later refinancings by S.D. Malkin will be treated the same as a sale. For any subsequent tenant, the CDC will receive 0.5 percent of the gross refinancing proceeds net of transaction costs, with amounts received by the CDC from refinancings credited against amounts due to the CDC from the same tenant on a future sale of the lease. In this way, the CDC is hedged against the tenant withdrawing equity from the project, or selling the project incrementally over time. The mathematical impact will be that if the tenant pays 0.5 percent for refinancings, and they are credited against the 1 percent at sale, effectively the CDC will always get at least 1 percent of sale.

Renovations

The tenant will be required to establish a reserve fund for renovations, furnishings and capital improvements as a percentage of gross revenues. The tenant will then have to submit a Furnishings Plan for review in year 7 and every 5 years afterward. For major renovations, the tenant shall submit a Renovation Plan in year 12 and every 10 years thereafter. Pragmatically, renovations and replacement of furnishings, fixtures and equipment will likely be controlled by the franchise agreement with the operator and brand. However, in the event that the hotel is ever unbranded and there is no franchise agreement, this provision allows control to assure timely update.

CITY ATTORNEY'S ANALYSIS

The City Attorney and outside legal counsel have approved as to form the Memorandum of Understanding and Amendment 2 to the Negotiation Agreement.

COMMITTEE/COMMISSION REPORT

The Redevelopment Advisory Committee will hear this report at their August 14, 2006, meeting. The Economic Development Commission will hear this report at a special meeting on August 15, 2006.

RECOMMENDATION

Staff recommends that the Community Development Commission approve the Memorandum of Understanding with S.D. Malkin Properties, Inc.; approve the Second Amendment to the Negotiation Agreement; approve moving to the Second Negotiation Period; and authorize the Executive Director to execute the documents.

PREPARED BY:	**SUBMITTED BY:**
________________________	____________________________
Jane McVey Economic Development & Redevelopment Director	Barry Martin Interim City Manager

REVIEWED BY:

Michelle Skaggs Lawrence, Assistant to the City Manager ____
Mike Blessing, Deputy City Manager ____

Attachments:
Attachment 1: Memorandum of Understanding
Attachment 2: Second Amendment to the Negotiation Agreement