Agenda Report

April 3, 2017

TO: Honorable Mayor and City Council

FROM: City Manager Department- Economic Development Division

SUBJECT: **ECONOMIC DEVELOPMENT SUBSIDY REPORT PURSUANT TO GOVERNMENT CODE SECTION 53083 FOR A GROUND LEASE AGREEMENT BY AND BETWEEN CITY OF PASADENA AND KHP III PASADENA LLC (KHP)**

RECOMMENDATION:

It is recommended that the City Council:

1. Find that on August 15, 2016, the City Council adopted findings pursuant to the California Environmental Quality Act ("CEQA") certifying an Environmental Impact Report, adopted a Mitigation Monitoring and Reporting Program, and approved the YWCA/KHP Hotel Project, and that there are no changes to the Project, changed circumstances, or new information which would trigger further environmental review; and

2. Adopt a motion accepting and approving the Economic Development Subsidy Report pursuant to Government Code Section 53083 for a Ground Lease Agreement by and between City of Pasadena and KHP III Pasadena LLC.

BACKGROUND:

In August 2016, the City Council conducted a public hearing on KHP's request for the development and construction of a 181 room hotel. The approvals included:

1. Certification of the Final Environmental Impact Report (FEIR);
2. Adoption of the Mitigation Monitoring and Reporting Program for the project;
3. Four Conditional Use Permits;
4. Surplus Property declaration and exemption from the competitive sale requirement: To determine that real property of the City is not needed for the purpose for which it was acquired or for any other public purpose and to allow the City to enter into a long-term lease with the developer most suited to successfully rehabilitate the YWCA building rather than to the highest bidder;
5. Three Minor Conditional Use Permits;
6. Two Variances;

7. Public Tree Removals;
8. The location, setbacks and general massing of the project presented in the Alternative 2A design study outlined in the FEIR with a maximum of 185 rooms

KHP proposes to rehabilitate the existing 40,570-square-foot historic YWCA building and construct a new two-to-six-story, 87,342-square foot new building, both of which would become an approximate 127,912-square-foot, 181-room Kimpton Hotel with restaurant and banquet facilities on land totaling 1.93 acres. The project site is bound by Garfield Avenue on the east, Union Street on the south, Marengo Avenue on the west and Holly Street on the north. Parking for the proposed project is valet only and would be provided off-site.

City Acquisition and Request for Proposals:

In 2010 the City Council authorized eminent domain to acquire the building for the preservation of an historic asset. Rather than continue with a costly eminent domain action, both parties agreed to mediation which culminated in a court approved Stipulation Agreement which gave the City ownership in April 2012.

Notwithstanding the City budget constraints at that time, coupled with the elimination of redevelopment, the City desired to move forward with the rehabilitation of the historic structure by issuing a Request for Proposal (RFP) seeking proposals from private developers. The RFP did not specify a particular land use desired by the City, only that it be consistent with the site's Zoning Code and Specific Plan designations. The goals and objectives of the RFP were:

- Preserve the historic asset for the purpose of rehabilitation
- Implement a use that is appropriate in the Civic Center
- Serve as an added catalyst for continued economic growth and provide a direct economic benefit to the City
- Respond to and respect the architectural and spatial context of the site and surrounding historic district

ECONOMIC SUBSIDY:

Government Code Section 53083 defines an economic development subsidy to mean any expenditure of public funds or loss of revenue to a local agency in the amount of one hundred thousand dollars ($100,000) or more, for the purpose of stimulating economic development within the jurisdiction of a local agency, including, but not limited to: bonds, grants, loans, loan guarantees, enterprise zone or empowerment zone incentives, fee waivers, land price subsidies, matching funds, tax abatements, tax exemptions, and tax credits.

As part of its original submittal in 2013, KHP proposed to pay the City ground rental payments that were the greater of three-percent of the hotel's gross revenues, or three-hundred thousand annually. In 2016, as hotel project costs increased, KHP scaled down the proposed ground rental payments to a flat three-hundred thousand annual payment for the first 10 years, and then in year 11 the payment would adjust $377,000 per year with adjustments every ten years based on changes in CPI. Staff engaged two appraisal firms, who concluded different fair market rental values, one of $300,000/yr and the other $363,000/yr. Based on these estimates, KHP's proposed ground rental payment could be considered as fair market value.

Following the August 2016 entitlement approvals, the project's scope and design was further refined and contributed to the increasing construction cost. In addition, the KHP team continued refining the construction budget and found that materials and labor costs were increasing in large part due to the strong economy. The increased construction budget had a domino effect on other budget line items such as: City development fees, construction period interest costs, and higher construction costs result in more interest being paid on the debt and contingency costs. In January 2017, KHP reevaluated the anticipated financial returns and proposed yet another change in the ground rental payment. KHP also indicated that during the nearly four years since they responded to the RFP, project costs have substantially increased, while the projected financial rate of return has decreased from at or near market comparable standards to below industry standards. Overall, since 2013, the total cost per room has increased from $289,900 to $451,459, an increase of nearly 64%. Moreover, KHP's original cost projections contemplated paying market rate wages for construction, and not paying the higher "prevailing wage" established by the State. Prevailing wages have historically been required to be paid by contractors on any project considered a "public work" and paid for in whole or in part from public money. As a charter city, Pasadena was considered exempt from the Prevailing Wage Law. Recently, changes in the Prevailing Wage Law have imposed penalties on charter cities for failing to comply with the Prevailing Wage Law. To the extent construction of this hotel uses any public funds; it would be considered a public work project subject to the Prevailing Wage Law. Anything less than a "fair market rental rate" could be argued to be public funding of the hotel construction thereby subjecting it to the Prevailing Wage Law. Agreeing on the terms of what constitutes a "fair market lease" for this unique project with absolute certainty is impossible. Therefore, rather than attempting to stipulate that this project should be exempt from the Prevailing Wage Law, KHP has agreed to comply with the Prevailing Wage Law. Prevailing wages are projected to be approximately 15% higher than market rate wages, which adds $8.9 million to construction costs.

The table below shows the project's historical costs from 2013 to present and the anticipated financial returns:

	2013	2014	August 2016	January 2017
No. of Rooms	150	180	180	181
Overall Project Costs	$43,490,000	$53,981,000	$72,762,252	$81,714,082
Cost Per Room	$289,900	$299,900	$402,001	$451,459
Return on Costs*				
Before Ground Rent	8.5%	8.2%	7.5%	7.1%
After Ground Rent	7.4%	7.2%	7.1%	NA

*Industry standard range is 9%-11% (source: Keyser Marston) at stabilization

Notwithstanding the overall project increases, KHP remains committed to the project and is committed to moving forward in a manner that will achieve the original goals and objectives mentioned previously. However, as a result of the increased project costs, KHP is now requesting two economic subsidies: 1) no ground rental payments and 2) no charge for hotel parking. These subsidies may be reduced by payments back to the City if the hotel generates room revenues above an agreed upon threshold. As shown in the table below, when examining the overall benefits of the project: projected increases in transient occupancy tax, property and sales taxes, and opportunities for local hiring over a 20 year period, they far outweigh the combined costs of the requested subsidies. Therefore, staff recommends that the City approve the requested subsidies.

	Net Present Value @ 5%	Gross Revenues (no discount)
TOT Revenues	$25.99 M (calculated at 12.11 TOT tax rate %)	$43.98 M
Sales Tax Revenue	$1.30 M	$2 20 M
Property Tax Revenue	$2.46 M	$4.07 M
Total	$29.75 M	$50.26 M

Ground Rental Payments:
KHP is requesting an economic subsidy in the form of no ground rent for the first 50 years of the 99 year lease. In year 50 there will be a Fair Market appraisal conducted of the rent and the rent will adjust to the then Fair Market Value. Staff has estimated the amount of gross (not discounted) ground rent that the City will subsidize over the first 20 year period is approximately $7 million (present valued at $4.2 million discounted at 5%). In exchange for not receiving ground rental payments, the City will have two distinct participation opportunities, a one-time sale participation and an ongoing percentage participation. These two participation opportunities are intended to provide the City with material financial benefits in a case where the hotel outperforms expectations.

Return requirements for hotels are generally higher than other land uses due to their high level of risk, as hotels are particularly susceptible to broader economic trends based on their transitory nature. Currently, stabilized return on costs for new hotel developments in Southern California range from 9.0% to 11.0% depending on the quality of the location and risk associated with a project. To achieve these thresholds, many developers request assistance from local jurisdictions in the form of a public revenue rebates. For instance, the City of Anaheim recently provided subsidies for three new hotels equal to 70% of the transient occupancy taxes generated over a 20-year period. The City of Los Angeles currently has a program where hotels near the convention center receive 50% of the total public revenues generated by a hotel over 25 years. Other jurisdictions throughout Southern California (e.g. San Gabriel, Long Beach, Palm Springs, Garden Grove etc.) have also subsidized hotel developments with transient occupancy tax revenues, typically providing 50% to 75% of TOT for a period of 10 to 25 years.

As previously indicated, current return on costs for hotels in the region range from 9% to 11%. The Pasadena hotel market is very strong; however, there is a significant amount of risk associated with the rehabilitation of a historic building. Understanding these factors, the Developer is moving forward with this project even though their stabilized return on costs is below market at 7.1%. Their acceptance of such a low return reflects a keen desire to be in Pasadena and likely belief there is additional upside in the market. To this end, the City negotiated a participation agreement with the Developer, whereby it would share in the gross room revenues that exceed an annual threshold.

Ongoing Percentage Participation

If the hotel generates room revenues that are 7% higher than projected in their current pro forma, the City will share 15% of the room revenues above that threshold number. The ongoing percentage participation amount is initially capped at $438,270. This cap amount includes the ground rental value of $300,000 and 136 parking spaces provided by the City and discussed below, and valued at $138,270. The cap will be adjusted annually at 3.0%. The participation is for the duration of the Ground Lease regardless of the hotel owner. The Ground Lease will have language that establishes a schedule for the participation thresholds.

One-Time Sale Participation

The City will share in the sales proceeds generated by the project if the initial hotel sale exceeds a stipulated threshold. The City shall receive a one-time sale participation payment equal to 20% of the proceeds exceeding a 14% Internal Rate of Return to the developer. The participation remains in place for the duration of KHP's ownership and applies if less than 100% of the asset is sold.

Hotel parking

In June 2015, a parking demand study was completed by Raju Associates to determine the parking demand for the project. The analysis evaluated the project's parking demand based on the Urban Land Institute's shared parking methodology and concluded that, rather than the 240 parking spaces required by the Zoning Code, peak demand would be for 136 parking spaces (an evening weekend in June). KHP is requesting that the City provide the 136 spaces for the duration of the lease. Staff has estimated the amount of gross (not discounted) parking revenue that the City will subsidize over the first 20 year period is approximately $3.7 million (present valued at $2.2 million discounted at 5%) and over a 50 year period $15.6 million is the approximate gross dollar amount (present valued at $4.28 million discounted at 5%). Although there is a specific value assigned to these spaces, the hotel's peak parking hours during evening and weekends aligns with the existing capacity in the City controlled parking spaces within the Civic Center.

Overall, since 2013, the project costs have increased mainly due to inflationary costs and the fact that KHP is now choosing to pay the prevailing construction wage rate. These increased costs have led to low financial returns to the Developer; consequently, KHP is seeking the City's assistance to help move the project forward. In return for that assistance, not only will the City's goals and objectives be realized, but also the City will have an opportunity to collect additional revenues in the event the hotel out performs its current projections.

FISCAL IMPACT:

The total project cost to the developer is estimated to be approximately $81.7 million and includes the approximately $14-$16 million that will be used to rehabilitate the city owned historic YWCA Building and the construction and operation of a new building, both of which would become a 181-room hotel. At stabilization, year three of operations, the project will generate approximately $2 million to the General Fund from transient occupancy tax, sales tax and property tax payments. The maximum gross amount of the combined subsidies over a 20 year period is $10.7 million (present valued at $6.4 million discounted at 5%). Over the same period of time, the City's General Fund will still receive five times that amount in taxes that total approximately $50.2 million (present valued at $29.7 million when operations begin discounted at 5%).

Respectfully submitted,

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Attachment A - Economic Development Subsidy Report
Attachment B - Keyser Marston's Feasibility Review- Kimpton Hotel