PORT OF SEATTLE
MEMORANDUM

COMMISSION AGENDA | **Item No.** 6c
Date of Meeting March 6, 2012

DATE: February 27, 2012

TO: Tay Yoshitani, Chief Executive Officer

FROM: James R. Schone, Director, Aviation Business Development
Deanna Zachrisson, Manager, Aviation Concessions Business

SUBJECT: Lease and Concession Agreement with McDonald's Corporation for a restaurant at Seattle-Tacoma International Airport (Airport)

ACTION REQUESTED:

Authorization for the Chief Executive Officer to negotiate and execute a lease and concession agreement with McDonald's Corporation (McDonald's) to operate a restaurant in a currently vacant location on Concourse B for a term of 12 years. The draft lease (Exhibit C) is not necessarily the final version and is subject to negotiation with the stated parameters provided in this memorandum.

SYNOPSIS:

Staff requests approval to lease a vacant concessions unit on Concourse B, in close proximity to the Airport's children's play area, for a McDonald's restaurant. The proposed agreement with McDonald's represents a unique opportunity to bring a highly desired concept to the traveling public; generate new non-aeronautical revenue; upgrade a concessions unit in very poor condition at no cost to the Port; promote a new small business opportunity with a local franchisee; and create approximately 60 new full- and part-time jobs. The net present value (NPV) of Port revenue generated over the life of the lease is approximately $3 million.

Recently, the Port Commission adopted program goals for the future concessions program. Staff anticipates completing a draft concessions master plan by early 2013. The plan will guide the selection of new tenants in the 2015-2017 timeframe. Staff will present the draft plan to the Commission and seek policy guidance prior to initiating implementation. This proposal for a locally operated small business franchise of a strong national brand concept is consistent with the goals articulated in the Commission motion adopted on February 14, 2012, and at the same time allows the Airport to meet immediate passenger needs.

The concessions program in the Airport's main terminal offers a total of 12 quick-serve restaurants, with concepts varying from pizza to fish and chips to bagel sandwiches to teriyaki. Among these concepts, the main terminal has been served by only one branded hamburger concept since the closure of a Burger King in 2009. Quick-serve hamburgers, and McDonald's in particular, is one of the most sought-after restaurant concepts by travelers, in part because of a lower price point, and appeal to families. The remaining hamburger concept in the Central Terminal is the highest volume producing quick-serve restaurant in the entire Airport. Consistent with the Port's policy of encouraging concessionaires to use local themes, McDonald's intends to develop a design consistent with a Northwest look and feel. McDonald's also will use locally-sourced products in the restaurant, which expands the economic benefit derived from this lease.

BACKGROUND:

Since 2009, with the closure of Burger King on Concourse D, the main terminal has been served by only one branded quick-serve hamburger concept. Since that time staff has sought to add an additional burger concept to the main terminal. McDonald's is the most frequently requested quick-serve concept by Airport passengers. McDonald's has been interested for many years in a location at the Airport. However, McDonald's is conservative when considering expansion, and the Airport has not previously had the ability to provide a business opportunity with appeal to the company. Today, with the growing passenger demand and a location well-suited for the concept, McDonald's now is prepared to make the investment at the Airport.

Unmet Traveler Demand

The current hamburger concept in the Central Terminal is achieving sales of over $3,000 per square foot – far in excess of typical airport benchmarks for sales per square foot in food and beverage, which range from $1,250 to $2,200 per square foot. The high sales per square foot of the existing hamburger concept is consistent with staff observations of peak time lines and loss of sales due to insufficient capacity. In fact, the existing hamburger concept has achieved nearly 110% of projected sales for its 10-year lease in seven years of operation. This Central Terminal location has 40 employees and operates a 24-hour operation in 1,212 square feet. It cannot increase its capacity further.

The space available for seating in the Central Terminal atrium cannot accommodate the passenger demand. At times, it is nearly impossible to find a place to sit. On the positive side, strangers do share tables with each other. On the negative side, passengers often take trays with food from one of these restaurants into other restaurants with more seating and into gate areas where they leave behind trays and garbage. In the past two years, the Airport has purchased more furniture for the atrium area, but it is not possible to add more furniture to the space. The new McDonald's location will offer seating for 40 patrons and relieve pressure on the Central Terminal.

Costly Facility Improvements

The specific intended location for this franchise is a 2,900 square foot unit at the front of Concourse B, which was vacated by a food and beverage tenant in 2005. The condition of the unit is very poor and the infrastructure systems supporting the unit do not meet current building codes and Port requirements for operation of a food and beverage location. In 2007, Port staff estimated that the unit would require approximately $350,000 in Port investment in order to make the unit leasable for a new food and beverage tenant. While design was completed in 2008, staff did not request final construction authorization because the location did not have broad market appeal due to its relatively poor sight line at the bottom of a ramp, and large square footage that would require significant investment to build out even after Port improvements. For these reasons, it is highly unlikely any other tenant will be interested in this location. McDonald's is willing to invest in the Port infrastructure systems outside of the tenant lease line – waste lines, HVAC, increased electrical service – in lieu of the Port upgrading these systems. Additionally, McDonald's understands the interest of the Airport to maintain a Pacific Northwest character to all of its concessions, even if the brand name is a national concept. The company is committed to developing a design in accordance with the Airport's aesthetic standards and design its storefront look to reflect a Northwest look and feel.

McDonald's is one of very few Airport concepts that does not require a "perfect" location because travelers will seek it out. This concept can be placed on a concourse and thrive if it has adequate directory and wayfinding signage. The proposed Airport location is in proximity to the children's play area, but not in the immediate vicinity of another quick-serve restaurant. The closest food and beverage concession is a restaurant/bar (with alcohol service) which should not suffer any loss of patronage to a family-themed restaurant such as McDonald's.

Investment and Lease Terms

McDonald's has committed to a design and construction investment of $2 million. This investment would become the largest amount ever invested at the Airport for a quick-serve food location, and second only to the $4.2 million investment in Anthony's Restaurant in 2005.

The lease term proposed for this McDonald's franchise is 12 years. This term length is consistent with the term of the four current food and beverage prime concessionaires (which were granted two year term extensions in 2005). However, it is two years longer than an industry-typical airport food and beverage lease. The justification for this specific term length is that it enables the Airport to receive a comparable rent to other operators despite the unusually high initial investment. The McDonald's agreement would reflect a tiered rent structure, which has proven to be successful with the Central Terminal leases. With the achievement of higher sales levels, McDonald's will pay higher rent to the Port (see Financial Implications).

The investment model used by McDonald's has great advantages for the Port. McDonald's, a multi-billion dollar company, will be responsible for funding the investment and the construction of the unit. McDonald's also will hold the lease agreement. McDonald's has conducted an internal competitive selection process and has selected a local franchisee that currently operates another McDonald's in the local community near the Airport. The franchisee is a small business that meets the Small Business Administration standard for "limited service" fast food.

Anticipated Customer Behaviors and Sales Growth

The traveler demographic of the Airport is dominated by 'origination and destination' passengers, with a large share as residents of the Puget Sound area. Airport staff believes that a McDonald's in the Airport is a long-awaited addition and will be much appreciated by many travelers. Particularly with its location near the children's play area, staff anticipates that McDonald's will be a very strong draw. Many travelers will want to eat at the Airport McDonald's because it is an opportunity they did not have before. While McDonald's initially will experience very high sales volumes and likely will result in some sales loss at nearby quick-serve alternatives in a similar price category, staff is confident that the Airport will experience an overall increase in food and beverage sales. In addition, the planned airline realignment is anticipated to add another 100,000 annual enplanements to the Concourse A and B areas. The Airport also stands to gain sales among the 25% of Sea-Tac travelers who make no purchases at all when traveling due its strong brand recognition and appeal to price-sensitive travelers.

PROJECT JUSTIFICATION:

- There is demonstrated capacity for another quick-serve hamburger concept in the main terminal without risk of a decline in concessions sales.
- The Port has the opportunity to avoid costly expenditure to upgrade a concessions unit with limited market appeal, but is very appropriate for McDonald's.
- The Port has the opportunity to increase non-airline revenues by an estimated $323,000 in the first year. Over the life of the lease, Port revenues would likely exceed $3 million (net present value).
- McDonald's is a proven success in airports, such as Denver International, Salt Lake City International, Los Angeles International and John Wayne/Orange County Airport.
- The business structure of this proposed lease offers the Airport the financial stability and secure backing of McDonald's, while creating a small business franchise opportunity for a local operator.
- This lease will create new jobs in the community both directly and through the local sourcing of products for the restaurant.

PROJECT STATEMENT AND OBJECTIVES:

Project Statement:
Open a new food and beverage concept, McDonald's, in the Concourse B unit known as CB-07 by October 31, 2012.

Project Objectives:

- Provide local business and employment opportunity
- Meet the needs of the traveling public
- Increase revenues to the Port
- Eliminate financial burden on the Port to renovate a unit in poor condition.

Project schedule:

Execution of agreement	March 2012
Design approvals	May 2012
Construction	June-October 2012
Open for business	October 31, 2012

PROPOSED LEASE TERMS

Standard lease term lengths and rent levels are well-established in the airport concessions industry. Lease term lengths are directly connected to the level of required investment and anticipated volumes for different types of businesses. Specialty retail requires the least initial investment, and lease term lengths typically range between 5-7 years. The longest lease term lengths are granted for quick-serve and full-service restaurants, which require significantly more investment than any other type of concept, and such terms are typically 10 years. The extremely poor condition of the proposed space justifies the additional term in light of high investment requirements.

Also, the 12-year lease term places the term expiration in 2024, well beyond the major redevelopment phase in 2015-17. A greater staggering of lease term expirations is a goal for the concessions program. The tiered percentage rent proposed between 9-13% is consistent with typical rent terms in the Central Terminal for this type of concept.

FINANCIAL IMPLICATIONS:

Financial Analysis Summary:

This location is not currently generating any revenue for the Port. The summary below outlines the financial return expected from the operation.

Terms	McDonald's franchise (Food)
Store Open	October 31, 2012
Investment from Lessee	$2 million
Term Length	12 years (late 2012-24)
Est. 2013 Sales	$3.5 million
% Rent	9% of gross sales from 0 to $2,780,000 11% of gross sales from $2,780,001 to $3,630,000 13% of gross sales exceeding $3,630,001
Minimum Annual Guarantee (MAG)	$280,000 in Year 1, thereafter 85% of the previous year's rent payments to the Port
Marketing	0.5% of gross sales to joint concessions marketing fund not to exceed $24,000 annually.
Storage	400 square feet of storage at $7.75 per square foot
Year One Port Rev.	$323,000

ECONOMIC IMPACTS AND BUSINESS PLAN OBJECTIVES:

This lease and concession agreement will contribute to achievement of the Airport's business plan objective of "maximizing non-aeronautical net operating income" by generating increased non-aeronautical revenues of $3 million for a term of 12 years.

STRATEGIC OBJECTIVES:

The approval of this lease and concession agreement meets the following Port strategic objectives:

- Maximizes financial performance by meeting customer demand.
- Provides compelling customer and community value by bringing a locally-franchised and internationally known brand concept into the Airport.
- Develops a new business opportunity for a proven local small business restaurant operator to be successful in a new venue.
- Provides additional opportunities for new employees and suppliers to this business.

ENVIRONMENTAL SUSTAINABILITY AND COMMUNITY BENEFITS:

- The location for this concession is in very poor condition. Materials are not likely to be appropriate for reuse. However, the new construction in the space will bring the infrastructure systems up to the latest standards for efficiency as well as use materials (lighting, paint, floor and wall surfaces) that live up to the highest standards in environmental sustainability.
- McDonald's is known for its practice of using locally sourced products for their restaurants. From bread and produce to meat and potatoes, this McDonald's will source most of its purchases in the local area.
- McDonald's at Sea-Tac will employ approximately 60 full- and part-time employees. These will be completely new jobs created at the Airport. Initially, many of these employees will be experienced McDonald's employees who currently work for the franchisee at another local location.
- McDonald's holds high standards for employee compensation and training. Employee benefits include medical and dental insurance, paid vacation, 401K retirement plans and college tuition assistance. McDonald's is known world-wide for its "McDonald's University" where the company cultivates employees for advancement in the company. Most McDonald's franchisees began their careers as front line staff.

TRIPLE BOTTOM LINE:

The recently completed concessions stakeholder process examined the concessions program from a triple-bottom-line perspective. Stakeholders reinforced the value of a concurrent pursuit of positive economic, social equity and environmental stewardship outcomes in the selection of concessionaires. The proposed concessionaire selection is a choice consistent with these priorities.

ALTERNATIVES CONSIDERED AND THEIR IMPLICATIONS:

- Alternative 1: Approve the proposed lease and concession agreement. For the reasons stated above, **this is the recommended alternative.**
- Alternative 2: Allow the concessions unit to remain vacant. This is the likely outcome if McDonald's is not selected as a tenant. The investment needed is too high for other operators. Few other concepts have the same ability as McDonald's to make a less than perfect location profitable. Staff does not see any likely interest in this space by another operator in the foreseeable future, even with investment made by the Port in its infrastructure. This is not the recommended alternative.
- Alternative 3: Invest Port funds to prepare the unit for a future tenant to be determined by the concessions program leasing agent. Staff could return to the Commission for authorization of the funding for previously designed upgrades to the space. These costs

would likely be higher today than the $350,000 budgeted initially in 2007; perhaps as much as $400,000-450,000. Even in this event, it is unlikely that the concessions program leasing agent will be able to find a tenant other than McDonald's with interest in the space. This is not the recommended alternative.

OTHER DOCUMENTS ASSOCIATED WITH THIS REQUEST:

Exhibit A: Power Point
Exhibit B: Map of Location
Exhibit C: Draft Lease Agreement

PREVIOUS COMMISSION ACTIONS OR BRIEFINGS:

None.