PORT OF SEATTLE
MEMORANDUM

COMMISSION AGENDA — **Item No.** 6a

ACTION ITEM — **Date of Meeting** June 5, 2012

DATE: May 25, 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

ACTION REQUESTED:

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

SYNOPSIS:

On March 6, 2012, Airport staff requested approval to lease a vacant concessions unit on Concourse B, in close proximity to the Central Terminal and Airport's children's play area (Exhibit B: Map of Location), for a McDonald's restaurant. Consideration of the request was postponed by the Commission. Staff is returning to the Commission with this same request, but with significant new analysis in order to reaffirm that the local McDonald's franchise is the best available option for this space, that no other national or local hamburger chains are interested in the space, and that there exists more than sufficient passenger growth and demand to create incremental new sales and increase overall rent to the Port.

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. The nominal dollar value is estimated at $4.9 million.

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.

BACKGROUND:

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 and cannot meet current demand.

The McDonald's Proposal

The previously outlined parameters of the McDonald's proposal are:

- The prospective space has been vacant since turned back to the Port on March 31, 2006. Repeated attempts to garner interest in the space have been unsuccessful.

- The prospective space has not had any infrastructure improvements since 1994. It requires interior demolition and upgrades to supporting systems (plumbing, electrical, HVAC, etc.) before the unit can be built out as a new restaurant.

- McDonald's commits to a minimum investment of $2 million. This investment is supported both by McDonald's Corporation and the local franchisee Bob Comisky.

- The proposed term length is 12 years with percentage rent similar to rent paid by the other current quick-serve hamburger restaurant located in the main terminal.

Competitive Market Analysis

At the request of the Commission, staff returned to the marketplace to provide assurance that the McDonald's offer was the best possible for a hamburger restaurant in the location. In April, staff conducted a request for interest (RFI) process for this specific opportunity. The McDonald's proposal already was a commercially viable offer, and the purpose of the RFI was to determine if there might be other offers within a competitive range with McDonald's. The solicited operators received the same initial information on which McDonald's based its own pro forma analysis. In theory, McDonald's offer may have been at a competitive disadvantage because the terms of their offer are publicly well known.

Outreach Methodology to Local and National Hamburger Concepts

The Commission expressed an interest in considering both local and other national hamburger concepts. Previous direction from the Commission has also indicated a preference for local small business ownership and/or operation. For this reason, staff extended the reach of the RFI to both operators of local hamburger concepts and operators of locally franchised national concepts.

Local Hamburger Concepts

Staff sent materials about the opportunity to the four local quick-serve hamburger restaurants in the greater Seattle area with more than one street-side location. None of these local operators was interested in the opportunity, and with one exception, returned the written confirmation form (Exhibit A: Response Form). These operators either were not interested at all in operating in an airport, or deemed the required investment too high. One operator of a local hamburger concept with 14 locations did indicate future interest in operating at the Airport, but not in the proposed location.

National Hamburger Concepts

Staff looked at brand name market strength as the first criteria for determining which operators of national brand-name hamburger concepts to approach. An appropriate brand name for the Airport should be able to generate sales in the range of $3-3.5 million annually (the current hamburger concept in the Central Terminal generated $3.8 million in 2011). Such a brand name will have superior market strength in the national, local and airport markets. A brand may exist nationally, but due to the large share of resident travelers that use Sea-Tac, it is important that the brand also has a local presence. Additionally, it is important that the brand concept is established to some degree in airport venues, partly because travelers know which hamburger brands to expect and are willing to seek out in an airport, and partly because it shows brand experience with the unique airport environment.

This table summarizes the market strength of the ten largest national brand-name hamburger concepts. The four brand-name national hamburger concepts with the greatest strength in all three areas were McDonald’s, Burger King, Wendy’s, and Dairy Queen.

Market Strength of National Hamburger Concepts

Brand	National	Local	Airport
McDonald's	14,000	144	31
Burger King	7,750	62	47
Wendy's	6,576	42	35
Dairy Queen	5,050	54	1
Sonic (drive-in)	3,500	3	1
Jack-n-the Box	2,200	85	0
Hardee's	1,687	0	0
Carl's Jr	1,104	6	1
Checkers	800	1	1
Five Guys	735	8	4

The Port already has a proposal from McDonald's. Additionally, the Airport already has a very successful Wendy's in the Central Terminal, around the corner from the proposed location. For this reason, Wendy's was not approached as part of this RFI.

Dairy Queen operates many franchises in the Puget Sound area and also has a strong brand-name presence and some experience in airports. Dairy Queen offered the Airport opportunity to its locally based franchisees; however, none were interested. Nonetheless, Dairy Queen indicated an interest in future opportunities at the Airport. Burger King indicated initial interest in the Airport location. Staff provided a representative of Burger King a tour of the proposed space in early May, but they did not submit a proposal for the opportunity. At the conclusion of this process, staff determined that the McDonald's proposal, with local ownership interest and operation, was the only candidate for the proposed location.

Supportability/Competitive Analysis

When proposed earlier this year, the need for an additional hamburger concept was illustrated by the high sales volumes in the Central Terminal, and specifically Wendy's 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. 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 other four quick-serve restaurants also achieve high sales per square foot and face similar pressures on capacity.

The issues associated with insufficient seating capacity in the Central Terminal provide further justification. At times, it is nearly impossible for customers to find a place to sit and dine. 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, and it is not possible to add any more furniture to the space. The new McDonald's location will offer seating for 40 patrons and relieve some pressure on the Central Terminal.

Passenger Research

For more than a decade the Airport has periodically conducted surveys of enplaning passengers. The purpose of these surveys is to collect accurate and detailed information about passenger characteristics, passenger experiences, and terminal facility use. In the previous presentation of the McDonald's proposal, staff referenced the passenger survey conducted in August 2006, which showed that 25 percent of all travelers made no purchase (retail or food) at the Airport. This finding suggested that there exists ample room for additional capture of sales among passengers who make no purchases.

The 2011-2012 Enplaning Passenger Survey is being conducted over a full calendar year to better understand seasonal variation in the wide range of passenger characteristics and behaviors, including concessions purchases. New survey data collected monthly from 500 to 800 randomly selected passengers during July 2011 through March 2012 has just recently become available. The data provide more detail than previous surveys specifically regarding food and beverage purchases. This data showed that 39 percent of travelers make no food or drink purchase at the Airport. Of those who do make a purchase at the Airport, the largest share, 31 percent, purchase from a casual dining alternative. These results suggest that the capacity to increase sales among travelers who currently do not make any food purchases represents a significant marketing and revenue opportunity.

Competitive Analysis

Due to remaining concerns that shifting of sales away from existing concessions would reduce the benefit to the traveling public and the Port, staff engaged its recently hired concessions consultant firm to conduct a new financial analysis. For the analysis, staff settled on a conservative to pessimistic view of the changes that could result from the new McDonald's. The analysis looked at present-day conditions and did not take into account efforts by concessionaires to increase their overall capture rate among the share of travelers who currently make no food purchases. Previous experience from the earlier concessions program transition proved the power of increased competition to raise overall sales for nearly all concessionaires.

The analysis also did not take into account the additional enplanements that will move to the main terminal in early 2013 as a result of the airline realignment and the continuing strong growth of the number of passengers using the Airport. Since 2009, when the number of passengers dipped almost 970,000 from the year before to 31.2 million, passenger numbers have steadily rebounded. In 2011, 32.8 million passengers arrived or departed from Sea-Tac. So far in 2012, the number of passengers is up 2.8 percent compared to 2011.

Based on an analysis of the sales productivity of McDonald's in three other U.S. airports, the analysis projected that the proposed Sea-Tac McDonald's will achieve between $3.0-$3.6 million in sales in its first year. This estimate is consistent with the staff estimate, and McDonald's pro forma estimate of $3.5 million. This estimate was the basis of the initial financial analysis placed in relationship to the expected increase in sales overall and the percentage rent projected from the new operation. The consultant analysis verified the sales projection while accounting for differences in the location of the restaurant in the airports used for comparison. Additionally, the analysis summarized a number of case scenarios to determine at what point loss of sales at other restaurants would make the addition of McDonald's a neutral or net loss for the Port in terms of increased sales and revenue.

The exact effect of increased competition is difficult to predict because operators respond differently to the pressure of new competition. Therefore, any estimates on possible sales loss are approximate, and in reality, could be better or worse. Generally, previous Airport experience is that the first 8-12 months of a new concept or new concessions offerings may cause significant – but not permanent – swings in customer behavior. This is due to the large share of Puget Sound area residents who frequent the Airport, and for many local resident travelers the opportunity to visit an Airport McDonald's will be appealing because it is new. Eventually, however, the newness wears off and sales/customer behaviors settle into a new normal, and also based on experience, at an overall higher sales level than previously.

In any scenario, the analysis confirmed that the two closest full-service restaurants, Seattle Tap Room and Casa del Agave, which both achieve a majority of their sales via alcoholic beverages, will not be negatively impacted. No such impact should be anticipated on other full-service dining in the Central Terminal area, particularly those selling alcohol.

Despite the Central Terminal quick-serve units being at or over capacity already, one pessimistic scenario assumed a 5 percent loss of sales at the four non-hamburger concepts and that Wendy's Hamburgers' sales could be negatively impacted by 15 percent. The analysis even hypothesized a possible small 2.5 percent impact to the two small Starbucks Coffee units on Concourse B. The analysis also assumed that the greatest potential impact may be to the two other quick-serve brand names on Concourse B: Sbarro (pizza) and Quiznos (sub sandwiches). Those two units could lose 25 percent of their current business without making efforts to compete with McDonald's. Quiznos, as a strong national brand and the only branded sub sandwich concept in the Airport, should have better possibilities to compete with McDonald's than Sbarro. The Quiznos brand is aggressively supported with local advertising campaigns and there are more than two dozen Quiznos locations in the Puget Sound region. Sbarro is an older concept in airports and has no local street-side presence in the Puget Sound region. Additionally, there is a local pizza favorite, Pallino Pastaria, in the nearby Central Terminal. In 2011, Quiznos sales were significantly higher than Sbarro.

With the McDonald's forecasted first year sales of $3.5 million, and using the assumptions above, the Airport could see a combined increase of 4.34 percent in sales and 2.5 percent in rent revenue from Concourse B and Central Terminal. The Net Present Value to the Port based on these assumptions would be approximately $2.0 million.

In the event that loss of sales among the Central Terminal quick-serve tenants is greater, and if the loss of sales at Wendy's is as much as 20 percent, paired with as much as a 30 percent loss in sales on Concourse B, the addition of McDonald's becomes a neutral proposition from a financial standpoint (Net Present Value). Staff sees this scenario as unlikely because the Central Terminal tenants are well established and patronized, competition-minded, and do not have the capacity to keep pace with anticipated passenger growth.

Efforts to Support Existing Small Business

There is currently another small business operator of a national franchise concept on Concourse B, Quiznos Subs, mentioned above. This business is certified as a minority-owned, disadvantaged business (ACDBE) and is a subtenant of HMSHost. All businesses at the Airport are expected to be competitive with other operators, but staff also recognizes that this particular tenant does not have the same economies of scale as a prime concessionaire such as HMSHost, which controls all of the other surrounding concessions. Therefore, staff is committed to assisting this tenant to the greatest degree possible in increasing its ability to be competitive.

As part of ongoing efforts to support small operators, Airport staff devotes resources to help drive concessions sales. For example, wayfinding signage is being refreshed at the head of both Concourses B and C in order to support the smaller operators on those concourses. Within the Concourses, some pillars are already covered with colorful directional signage for concessionaires and more pillars are in production. Concessions staff also is committed to providing on-going sales analysis, operational support and marketing expertise to operators. Staff hosts annual tenant seminars for small operators and meets one-on-one to discuss operational challenges. With its industry-wide knowledge, staff can propose improvements or product additions that drive additional sales. For example, most airport Quiznos locations nationally also serve beer and staff believes that the sales of beer at the Concourse B Quiznos would help that location compete with the Casa del Agave restaurant next door.

It is not the intent of the federal ACDBE program to provide concessionaires shelter from competition; rather it is an opportunity for small minority-owned businesses to learn to operate a business in an airport as a step toward eventually graduating from the program and operating street-side retail or restaurant businesses. The Port has a common interest with its tenants in maximizing the competitiveness and customer appeal of every concession. At the same time, tenants must expect that vacant units may be leased to new operators when it benefits the traveling public and the Port. .

PROJECT JUSTIFICATION:

- There is demonstrated capacity for another quick-serve hamburger concept in the main terminal without probable risk of an overall decline in concessions sales.
- The Port has the opportunity to avoid costly expenditures 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 from the McDonald's operation would likely exceed $3 million (net present value). With assumptions of some degree of sales shift from other restaurants, this net present value is estimated at $2 million.
- McDonald's is a proven success in airports, such as Denver International, Salt Lake City International, Los Angeles International, Reagan National 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 at the Airport and 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 in the first quarter of 2013.

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	June 2012
Design approvals	July – October 2012
Pre-construction demo	August 2012
Construction	December 2012-February 2013
Open for business	March 1, 2013

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	March 1, 2013
Investment from Lessee	$2 million
Term Length	12 years (2013-24)
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 non-aeronautical revenues of $3 million for a term of 12 years. With assumptions of some degree of sales shift from other restaurants, this net present value is estimated at $2 million.

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. Current 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 offers a varied menu from the classic Big Mac and fries to salads and yogurt parfaits.
- 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, which leads to a hiring wave even outside the Airport in the nearby community.
- 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: Not approve the proposed lease and concession agreement. Allow the concessions unit to remain vacant as it has been for the last six years. 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: As a result of the recent outreach to the market to solicit interest in the proposed space, staff is reinforced in its belief that it would not be a prudent investment by the Port to upgrade this unit in the hope of generating future tenant interest. Nonetheless, staff could return to the Commission to request authorization of funding to upgrade 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. This is not the recommended alternative.

OTHER DOCUMENTS ASSOCIATED WITH THIS REQUEST:

Exhibit A: Response Form
Exhibit B: Map of Location
Exhibit C: PowerPoint
Exhibit D: Fact Sheet about Local Concessionaire's Wages and Benefits
Exhibit E: Draft Lease Agreement

PREVIOUS COMMISSION ACTIONS OR BRIEFINGS:

- March 6, 2012: Postponement of request to negotiate and execute a Lease and Concession Agreement for a McDonald's restaurant at Seattle-Tacoma International Airport.

- March 27, 2012: Staff Briefing about Interim Concessions Leasing 2012-2014.

- April 10, 2012: Staff Briefing by Mark Reis, Managing Director, Aviation Division on proposed request for interest process for a quick-serve hamburger concept.