

PORT OF SEATTLE
MEMORANDUM

COMMISSION AGENDA

Item No. 6d

Date of Meeting September 11, 2012

DATE: August 28, 2012

TO: Tay Yoshitani, Chief Executive Officer

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

SUBJECT: Lease and Concession Agreement for Duty Free Operations at Seattle-Tacoma International Airport (Airport).

ACTION REQUESTED:

Request Commission authorization for the Chief Executive Officer to negotiate and execute a lease and concession agreement with the proposer selected in the Port's current Request for Proposal process to operate three duty free/duty paid locations for a term of seven years. The draft lease (Exhibit A) is not necessarily the final version and is subject to negotiation within the stated parameters provided in the memorandum.

SYNOPSIS:

The Airport views the duty free business as one with significant non-aeronautical revenue growth opportunities. In 2011, the Airport's duty free business achieved record sales of \$12 million. This year's revenues are forecast to top \$14 million. This is the result of relatively strong international and domestic enplanements, primarily at the South Satellite, the increase in direct international flight services at the Airport, and upgraded merchandise and customer service. Prior to 2011, duty free sales were relatively stagnant.

Duty free operations at the Airport encompass more than just duty free sales of alcohol and tobacco to international travelers. Duty free shops also offer duty paid or 'travel value' priced merchandise such as cosmetics, perfume, luggage, handbags and other premium brand name products available for sale to savvy domestic travelers and even Airport employees. Additionally, Airport duty free shops offer local retail gift merchandise that appeals to both the domestic and international traveler such as jewelry and confectionary.

The Port issued a Request for Proposals (RFP) for a new duty free operator (on May 11, 2012) (additional detail below under "Background") to operate three new duty free stores located in Concourse A, Central Terminal and South Satellite (Exhibit B). The Port received proposals from five (5) well known, international duty free operators on August 2, 2012. In accordance

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with Port procedures, the evaluation of the proposals is being undertaken by an expert evaluation panel, and it is clear from initial reviews of the proposals that the Port expects to earn significantly higher revenues than the current operation has generated or historical trend lines would predict. In the Port's preliminary 2013 revenue budget, the Airport has assumed a conservative 25% increase in sales that, coupled with a more favorable rent structure, would ensure at least a 50% increase in revenue to the Port.

With three brand-new, modern duty free stores, totaling 6,925 square feet (nearly equivalent to current square footage), Airport travelers will experience a greater choice of products, more effective merchandising and promotional pricing. The minimum guarantees offered by the proposals, which represent baseline revenues guaranteed to the Port, promise a substantial increase over current revenue over the life of the seven year agreement. In addition, all operators' proposals project the ability to increase sales significantly over current levels, and with these increased sales, the duty free business will increase revenues to the Port as a percentage of sales, and create many new local jobs (beyond the approximately 60 jobs in the existing operations).

BACKGROUND:

Duty free and duty paid merchandise offerings to the traveling public were included in the operations under the Airport's master concessionaire agreement until January 1, 2005. The operator, HMS Host, was then awarded a non-competitive five year agreement for continued operation of duty free and duty paid stores at the South Satellite, North Satellite and in the Main Terminal (Concourse D). In mid-2009, due to a weak economic climate for an RFP issuance, HMS Host received a one-year extension through 2010.

The Port issued a RFP for duty free operations in spring 2010; however, the RFP was withdrawn before acceptance of proposals in late fall due to airline realignment uncertainty. HMS Host remained in month-to-month holdover status into 2011. At that point, HMS Host had exited the duty free business in the U.S., and the Airport opted to bring in a temporary operator of its duty free stores beginning on August 15, 2011. Operations under this new operator, HG Retail, a subsidiary of Hudson Group, have improved the Port's return on the duty free business significantly and drawn synergies from the news/gift and retail operations of Hudson Group at the Airport.

The Port reissued its RFP for the duty free business in May 2012. Five (5) well known, international companies submitted proposals on August 2, 2012. The evaluation panel is currently evaluating the proposals, all of which are very comprehensive. The evaluation panel consists of upper level professional staff in Aviation Business Development, Corporate Real Estate, Aviation Planning and Airport Operations. None of the panelists have any relationships with representatives from any of the proposer companies. Every effort has been undertaken to assure an unbiased and thorough evaluation of the proposals. The evaluation panel is expected to

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complete its scoring just prior to the anticipated award announcement date by the end of September 2012.

Evaluation Criteria

The duty free proposals are being evaluated based on the following criteria:

- Revenue to the Port:** 30 points
Based upon percentage of gross dollar sales proposed, the Minimum Annual Guarantee proposed, and the total amount of revenue the Port expects to receive under the proposal.
- Experience and Qualifications:** 30 points
Demonstration of experience and expertise in managing and operating multiple duty free concessions in an airport environment and capability to adapt to the unpredictable transportation environment.
- Specialty Retail Merchandise:** 25 points
Demonstration of ability to include specialty retail merchandise as part of the duty free operations that fits the demographics of the Airport domestic and international traveler, promotes quality and produces incremental sales.
- Design and Implementation:** 20 points
Design and features of the stores, efficient use of space to accommodate duty free and specialty retail merchandise and its ability to complete build-outs in a timely fashion.
- Financial Capacity:** 10 points
Demonstration of financial capacity to meet the requirements of the Agreement and the assurances in the submitted Proposal.
- Small Business/Community Commitment:** 10 points
Outline of efforts to support the local small business community through merchandise procurement and/or other strategic partnerships.

Total: 125 points

In addition, the financial projections are being analyzed for reasonableness by the Port's concessions consultant, AirProjects, Inc.

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Potential Risks

The successful conclusion of the duty free RFP process with an award to a new operator by the end of September 2012 is critical to the Airport's ability to provide a new duty free offering for passengers in time for the peak summer travel season in 2013.

The majority of international departures take place at the South Satellite, and this new location will generate the highest sales. The issuance of the duty free RFP earlier this year was carefully timed to dovetail with the construction work at the South Satellite that is needed to create the new vacant shell space for the selected operator. There are many challenges to this schedule due to the constrained space of the satellite and high passenger volumes during peak seasons. The construction of the new duty free shell is slated to take place in the fall of 2012, at the same time as the current duty free store remains operational. The space constraint created by this construction is only operationally feasible during the slower time of the year, not in the peak summer months. The South Satellite shell space is scheduled for completion in early 2013. The future operator will have approximately 16 weeks to build out the shell space, and open for business before the 2013 peak season beginning in June 2013. If the Airport is unable to award the duty free business expediently, the consequence will be a one-year delay in construction and a necessary re-phasing of the project so that construction of the shell would take place in the fall of 2013 instead. While difficult to estimate precisely, another consequence would be a loss of additional projected revenue to the Port due to an inability to take advantage of much better lease terms in a new duty free business.

There is also a risk of proposer protest, which is inherent in an RFP process for a coveted new business opportunity. Most recently, duty free awards were challenged in Atlanta, Orlando and Los Angeles. Although there have been no instances where an evaluation panel decision was reversed due to a protest, nonetheless, there is the risk of airport staff time required to defend such a protest, which could challenge the schedule further.

PROJECT JUSTIFICATION:

Approval of this lease will allow the Port to dramatically improve its offering of duty free/duty paid merchandise to the Airport's domestic and international travelers. After the realignment of air carriers in early 2013, this lease will provide for the offering of merchandise in new locations in proximity to international departures.

Project Statement:

- Negotiate and execute a Lease and Concession agreement for three new duty free stores in Concourse A, Main Terminal and at the South Satellite to commence business in June 2013.

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Project Objectives:

- Improve non-aeronautical revenues significantly from the duty free operation at the Airport
- Place duty free offerings in new locations to meet airline realignment schedule
- Create the world-class duty free offering that travelers expect at a major international airport
- Reinforce a desired ‘sense of place’ with new duty free store design
- Maintain the Airport’s competitive position as an airport of choice for new international airlines and routes

PROJECT SCOPE OF WORK AND SCHEDULE:

Scope of Work and Schedule:

<i>Milestone</i>	<i>Schedule</i>
Commission Approval	September 11, 2012
Contract Award	September 2012
Execution of Agreement	October 31, 2012
Design Approvals Complete	February 28, 2013
Construction – South Satellite	March – June 2013
Construction – Concourse A	March – June 2013
Construction – Main Terminal	March – June 2013

** Schedule assumptions based on no protest delay*

LEASE TERMS:

The lease term will be seven years with no option to renew. The Minimum Annual Guarantee (MAG) and rent will be negotiated with the winning proposer.

FINANCIAL IMPLICATIONS:

The initial non-competitive lease term awarded to Host International at the end of the master concessionaire era maintained a rent level of 16%. Sales achieved during the five year term and subsequent one year extension ranged from \$8.5 million to \$11 million. The highest level of sales achieved was in 2008. At this sales level, annual Port revenues reached a maximum of \$1.7 million. The minimum annual guarantee was 90% of the previous year’s rent payments to the Port, typically in the range of \$1.1 to 1.6 million.

Under the temporary operation by HG Retail, the Port was able to negotiate more favorable rent terms, despite the short lease term and start-up costs associated with Customs requirements. HG Retail pays 18% of gross sales up to \$10 million, 20% up to \$15 million and 21% over \$15 million. With only one duty free operator for nearly 50 years, it has been difficult to estimate the potential to increase sales in the Airport’s duty free business. Under a new operator for the last year, there has been a strong increase in sales to a record level of \$7.5 million in 2012 year-to-

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date through July. The Airport estimates that this operation will reach year-end sales of \$14.4 million. With this forecast, the Port will earn an estimated \$2.6 million in revenue from the duty free business. The increase in sales is remarkable due to the outdated and worn store locations and severe construction impacts in front of the main South Satellite duty free store during the peak travel season (April – September). Evidence from this past year bolsters the Airport's confidence in being able to achieve significantly higher sales in the new duty free operation.

The Airport is still in the evaluation stage of proposal review; however, all of the financial proposals are significantly more favorable to the Port than the current terms. In the Port's preliminary 2013 revenue budget, the Airport has assumed a conservative 25% increase in sales that, coupled with a more favorable rent structure, would ensure at least a 50% increase in revenue to the Port.

ECONOMIC IMPACTS AND BUSINESS PLAN OBJECTIVES:

This lease and concession agreement will contribute to the achievement of the Airport's business plan objectives of "maximizing non-aeronautical net operating income" by generating new non-aeronautical revenues. 2013 revenue budgets will be built upon the assumptions of significant additional revenue generated by the Airport's duty free business.

STRATEGIC OBJECTIVES:

The approval of these lease and concession agreement meets the following Airport concessions strategic objectives:

- Maximizes financial performance by meeting current customer demand as well as spurring new incremental spending with an upgraded offering, including duty paid and local retail.
- Elevates the duty free offering to a level expected by international travelers in a major U.S. airport by bringing in a worldwide operator of duty free with experience from major duty free markets in Europe, Asia and South America.
- Supports the economic vitality of local businesses with locally procured specialty retail merchandise.
- Reinforces a desired local "sense of place" with new, updated store designs consistent with Airport design guidelines that provide direction to architects and designers on Pacific Northwest design characteristics.
- May provide opportunity for proposed new ACDBE joint venture partners.
- Creates new job opportunities for employment in the new, expanded duty free operation.

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ENVIRONMENTAL SUSTAINABILITY AND COMMUNITY BENEFITS:

The current duty free locations, including materials and supporting infrastructure, are very outdated. The new locations will be energy-efficient and built with materials durable and well-suited for an airport environment.

The current temporary duty free operator, HG Retail, hired 18 additional employees when it assumed management of the duty free operation last year, in addition to retaining all of the existing sales associates and support staff. This investment in personnel has led to record sales levels for duty free operations in Seattle. The more recent hires, as well as the employees present during the HMSHost tenancy, are a valuable asset to an incoming operator. Although not required by the Port, staff believes that a new operator is very likely to retain experienced employees. All proposals outline extensive employee benefit, training, and incentive programs to create an attractive workplace that can attract and retain skilled, customer service-oriented employees.

TRIPLE BOTTOM LINE:

The 2011 concessions stakeholder process examined the concessions program from a triple bottom line perspective. Stakeholders reinforced the value of a concurrent pursuit of positive financial, social equity and environmental stewardship outcomes in the selection of new concessionaires. The evaluation criteria for the duty free opportunity are clearly consistent with these values.

ALTERNATIVES CONSIDERED AND THEIR IMPLICATIONS:

1. **Delay Approval:** The Port stands to lose significant revenue if approval of the agreement is delayed, and preliminary 2013 revenue budget assumptions would need to be revised downward. Duty free operations will continue at the South Satellite and Main Terminal locations; however, duty free operations at the North Satellite will cease in 2013 due to the relocation of United Airlines. The new Concourse A location will not be available to serve those passengers and to generate additional sales. Remaining duty free operations would continue at the existing (lower) rent levels. Costs to the Port will be incurred in the delay of the construction project at the South Satellite as the contract for construction has been awarded and scheduled for starting this fall. Additionally, there is significant risk of exposure to lobbyist and/or legal efforts by unsuccessful duty free proposers in order to influence/change the RFP process outcome if lease approval is delayed until after the award announcement by the end of September 2012.

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2. **Do Nothing:** Failure to award a contract has the same implications as delay indicated above. The current short-term agreement with HG Retail transitioned to month-to-month status on its one-year anniversary on August 15, 2012. Business will continue where duty free operations remain needed in current locations. However, the need will still exist to identify a long-term solution. The Port's RFP process has been widely publicized in the travel retail industry, and failure to award a contract after a completed process with multiple reputable proposers may damage the Airport's long-term industry reputation as a viable business partner.
3. **Approve Lease and Concession Agreement:** Approval will make it possible to meet the schedule to open the most critical duty free shop at the South Satellite by summer 2013. The Port also will begin to realize a much greater financial return on the duty free business in 2013 if this alternative is selected. **This is the recommended alternative.**

OTHER DOCUMENTS ASSOCIATED WITH THIS REQUEST:

Exhibit A: Draft Lease and Concession Agreement

Exhibit B: Map of New Duty Free Locations

Exhibit C: Power Point Presentation

PREVIOUS COMMISSION ACTIONS OR BRIEFINGS:

- March 8, 2011 – South Satellite Concessions Project (CIP#C800412), authorization to design.
- March 27, 2012 – Staff Briefing about Interim Concessions Leasing, 2012-2014.
- June 5, 2012 –South Satellite Concessions Project (CIP#C800412) authorization to advertise for construction bids (combined with CIP#C800466).
- July 24, 2012 –South Satellite Concessions Project (CIP#C800412) Authorization for additional funding and award of construction contract (combined with CIP#C800466).