

MEMORANDUM

TO: HONORABLE MAYOR & CITY COUNCIL MEMBERS
FROM: DENNIS McLEAN, DIRECTOR OF FINANCE & INFORMATION TECHNOLOGY 
DATE: MAY 4, 2009
SUBJECT: TERRANEA RESORT – REQUEST FOR FINANCIAL ASSISTANCE USING FUTURE TRANSIT OCCUPANCY TAX REVENUE
REVIEWED: CAROLYN LEHR, CITY MANAGER 

RECOMMENDATION

- 1) Consider the request made by Lowe Enterprises to provide financial assistance to the Terranea Resort;
- 2) If the Council is inclined, direct Staff to undertake a more complete legal, economic and financial review that may lead to a recommendation to develop a TOT loan agreement and/or ordinance for consideration by the City Council at a future meeting.

EXECUTIVE SUMMARY

Terranea is expected to immediately become the largest economic engine in the City, providing up to 500 jobs, thousands of new tourism customers in the area seeking services and paying taxes. Along with its management and investors, the City and the community have a significant opportunity to share from the success of Terranea. Terranea will become the largest single generator of tax revenue to the City, providing as much as \$8 million of tax revenue once it reaches stabilization.

Recent events in the US and local economy have significantly impacted the level and type

TERRANEA RESORT – REQUEST FOR FINANCIAL ASSISTANCE USING FUTURE TRANSIT OCCUPANCY TAX REVENUE

May 4, 2009

Page 2 of 7

of tourism and occupancy rates of hotels and resorts such as Terranea. The severe economic downturn coupled with tightening credit markets have created a severe challenge to all resorts across the world that was not anticipated when the financial strategy of Terranea was created.

The senior management of Lowe Enterprises (Lowe's) recently made a request that the City assign its transient occupancy tax ("TOT") that would be used to help fund start-up costs and operating losses of Terranea's operation. The initial proposal included an assignment of 50% of the City's TOT for 10 years (estimated to be about \$35 million) to provide a source for the direct repayment of \$15 million that Lowe's would borrow. The initial proposal included a repayment provision of the TOT based upon 3% of the net proceeds from the sale, refinancing or re-capitalization of Terranea.

Prior to submission of its initial proposal, Mayor Clark and Council member Wolowicz (the City Council sub-committee), Staff, and the City's Financial Advisor, Tim Schaefer of Magis Advisors, and the senior management of Lowe's met to discuss the request. The discussion provided Staff with a general understanding of the economic circumstances that led to the request and provided an opportunity to begin the process of learning about the organizational and financial framework of Terranea.

Upon receipt of the initial proposal and certain documents provided by Lowe's, an initial review was performed by Staff, the City's Financial Advisor, along with the assistance of Bruce Galloway, a real estate attorney with Richards, Watson and Gershon, and Hospitality Valuation Services (HVS), the City's resort consultant. Staff and its advisors conducted an intensive review that was sufficient to understand the fiscal impact of the initial proposal and reach a conclusion about its merits.

Staff, its advisors and Lowe's have worked expeditiously in a collaborative manner trying to develop a resolution that will help Terranea open successfully on time. Based upon discussions with senior management of Lowe's, Staff, and its advisors, and the City Council sub-committee, a framework was developed that could be memorialized in the form of a short-term TOT loan agreement that would include, but not be limited to provisions as follows:

- 1) The amount of the advances will not exceed \$8.0 million, or TOT revenues collected during the first twenty seven months of Terranea's operations, whichever occurs first. *Note: The amount of \$8 million requested by Lowe's is based on their estimate of the TOT they expect to collect during the initial 27 months of operations.*
- 2) The loan will be repayable not later than December 31, 2013. *Note: Although requested by Staff, and its advisors, Lowe's did not agree with the 2013 due date and have offered a 2020 due date.*
- 3) The City will have the right to be repaid from any sale, re-financing or re-capitalization of the project through receipt of 100% of the "net sale proceeds" or "net financing proceeds" as the case may be. If initial re-financings or re-

TERRANEA RESORT – REQUEST FOR FINANCIAL ASSISTANCE USING FUTURE TRANSIT OCCUPANCY TAX REVENUE

May 4, 2009

Page 3 of 7

capitalizations do not furnish sufficient proceeds, the obligation survives through all subsequent events until the loan is fully repaid. (Net proceeds are what are left after refinancing or repayment of the Corus loan, the mezzanine loan and the Turner loan – the “member loans” will be treated as equity.) *Note: Lowe’s requested that Staff advise the Council that its movement from 5% of net proceeds to 100% of net proceeds was significant. Staff believes it was essential to improve the security of repayment for the City.*

- 4) The City Council would establish an ordinance that would contain provisions that the present owner and all future owners will be bound to these terms and conditions until the TOT loan has been repaid in full. Both the City and Lowe’s would continue to develop an agreeable mechanism to secure repayment of the TOT Loan.
- 5) Terranea will provide the following special discounts to residents of the City (who will register with Terranea and pay an annual fee starting at \$25 to receive the benefits):
 - a) Discount of 25% off the best available room rate for a comparable room on a comparable date;
 - b) Discount of 10% off fees for use of the spa and golf course; and
 - c) Discount of 10% off food and beverage costs other than alcoholic beverages.

Staff and its advisors expressed that a TOT Loan would also be subject to Lowe’s evidencing that it has sufficient funds in order to successfully transition into a viable hotel operation. Lowe’s initial proposal also suggested that Lowe’s would support an increase of the TOT rate from 10% to 12%; whereby, the incremental amount derived from such an increase would be used as a dedicated source of repayment to the City as well.

Although the following provisions have not been discussed with Lowe’s, it is the belief of Staff and its advisors that they are necessary provisions that should be discussed further and preferably agreed to with Lowe’s:

- 6) The City will receive the TOT revenues from Terranea and will return them to Terranea in the form of monthly loan advances within five business days of the City’s receipts of the TOT from Terranea.
- 7) Advances will be charged to the loan balance on the date the advances are remitted to Terranea. Advances will accrue interest at 3 month LIBOR plus a margin of X.X% and will be added to the loan balance quarterly (resulting in quarterly compounding). If paid on or before that date, the interest will be forgiven.
- 8) The ORIGINAL owner will have one, 1-year option to extend the repayment date to December 31, 2014.

TERRANEA RESORT – REQUEST FOR FINANCIAL ASSISTANCE USING FUTURE TRANSIT OCCUPANCY TAX REVENUE

May 4, 2009

Page 4 of 7

- 9) The project must be opened no later than January 1, 2010.

During a conversation with HVS, they advised Staff and its advisors that if Terranea did not commence operations, it would probably take as long as 18 months for the hotel property to work through proceedings that would lead to operating under new ownership. Accordingly, the possible loss of 18 months of TOT may be a reasonable benchmark to determine the value of providing a TOT Loan. Terranea has projected that it would collect about \$6 million of TOT during the initial 18 months of operations.

BACKGROUND AND DISCUSSION

Introduction:

Terranea is an oceanfront resort property situated on 102 acres of the Rancho Palos Verdes coastline. Terranea consists of a hotel, privately owned limited residency villas, a conference facility, a spa and fitness facility, a nine-hole executive golf course, and other amenities such as pools and food and beverage facilities. The project is in the final stages of construction, and is currently scheduled to open for business on June 1, 2009.

Additionally, Terranea is expected to provide significant amenities to the residents of the City including additional dining options, a golf course, and maintained public trails and beach access. In addition, Terranea is expected to generate a significant amount of tax revenue to the City. In addition to property tax, sales tax, business license tax, and golf tax, Terranea is expected to generate a considerable amount of transient occupancy tax (TOT). The City's municipal code imposes TOT of 10% of the room rent on persons staying up to 30 days in a hotel or other lodging facility. The TOT is an unrestricted revenue source that is deposited into the City's General Fund.

Overview of the Proposal:

Although Staff and its advisors have not had sufficient time to perform a thorough factual and legal due diligence review of Lowe's initial proposal, it has seriously considered the request, its financial impact on the City for the foreseeable future. The initial review included: a cursory review of abstracts, secured loan documents, 2007 audited consolidated financial statements for LDD Long Point Holdings, LLC (including the Terranea Resort), summary cash projections and investment solicitation documents. Staff, and its advisors, discussed the request with Hospitality Valuation Services (HVS), the City's hospitality consultant and a respected authority on the economics of the hospitality industry. HVS provided an overview of the current and future economic climate in the hospitality industry, answered questions posed and provided advice regarding the request made by Lowe's.

Staff, the City Attorney, and the Financial Advisor participated in development of its recommendations and offer the following comments regarding the proposal requested by Lowe's:

TERRANEA RESORT – REQUEST FOR FINANCIAL ASSISTANCE USING FUTURE TRANSIT OCCUPANCY TAX REVENUE

May 4, 2009

Page 5 of 7

Limited Net Proceeds from Sale or Refinancing of Terranea is Only Source of Repayment

In the event the City enters into an agreement with Terranea to loan TOT, the City will share repayment risks similar to those of a commercial lender. The financial plan for the project includes the sale of casitas and villas to enable pay-down of the senior and mezzanine debt. In addition, the City assumes the risk of delayed repayment in the event the market value of Terranea is not sufficient to derive sufficient net proceeds to the City upon its sale, re-financing or re-capitalization. The proposed TOT loan would fall behind the senior, mezzanine debt and a trade note. It appears as though the viability of repayment of the TOT is dependent upon sales of the units as well as a significant improvement of the value of the property. Lowe's advised Staff and its advisors that their financial plan calls for sale of all units before the end of 2012. Staff, and its advisors, believes this may be difficult, at best, in this economic climate. There is no guarantee of repayment to the City. Mr. Lowe, CEO of Lowe Enterprises, declined the request for a personal guarantee suggested by Staff and its advisors.

Risks

In the event the City enters into an agreement with Terranea to loan TOT, the City will share repayment risks similar to those of a commercial lender. In addition, the City assumes the risk of delayed or no repayment in the event the market value of Terranea is not sufficient to derive sufficient net proceeds to the City upon sale or re-financing. Again, the proposed TOT loan would fall behind the senior, mezzanine debt and a trade note. There is no guarantee of repayment to the City.

HVS reports that the hotel industry is "re-setting itself" on economic terms; and that revenue per available room (a common measure of the industry's fiscal health) has dropped sharply from 2007 and may not fully recover to the prior level until 2013 or later. This decline has produced a corresponding reduction in the value of many hotel properties – in some cases by as much as 40%. If the market value of Terranea does not increase sufficiently to provide payment of net proceeds upon sale or re-financing, the City could receive little repayment from the refinancing or sale of Terranea on or before December 31, 2013 or in the near term thereafter.

HVS also expressed that if Terranea did not commence operations, it would probably take as long as 18 months for the hotel property to work through proceedings that would lead to operating under new ownership. Accordingly, the possible loss of 18 months of TOT may be a reasonable benchmark to determine the value of providing a TOT Loan. Terranea has projected that it would collect about \$6 million of TOT during the initial 18 months of operations.

Policy

The City has before never provided a developer with financial assistance like what has been requested by Lowe's. Although Staff understands the seriousness of the cash flow

TERRANEA RESORT – REQUEST FOR FINANCIAL ASSISTANCE USING FUTURE TRANSIT OCCUPANCY TAX REVENUE

May 4, 2009

Page 6 of 7

issues reported by Lowe's and its financial pressures as it completes construction of this resort, the City Council must weigh the "policy" and other fiscal considerations, including whether the proposed TOT Loan for a completed project is an appropriate use of public funds, whether to provide financial assistance to a commercial enterprise, whether the City will receive adequate compensation for the TOT Loan in light of the credit risk, and whether it's appropriate for the City to act in the capacity of a commercial investor or lender.

Financial Assistance Provided by Other Cities to Other Developers

The City may wish to provide Lowe's with the financial assistance and ensure that Terranea has sufficient cash resources to begin and sustain operations through this economic downturn. Lowe's provided some information about financial assistance provided by cities to other developers using TOT revenue.

Other cities have provided this type of assistance as a part of an inducement to build and operate a hotel with the resultant economic stimulus and revenue benefits to the city. These agreements or ordinances which provide for a TOT Loan to the developer are typically approved prior to construction of the project. Staff has researched similar policies and/or agreements, which other California cities have adopted. Staff has contacted the City's Financial Advisors, the League of California Cities and the California Society of Municipal Finance Officers (CSMFO) to gather research regarding these policies. Policies and/or agreements included in this analysis have been collected from seven California cities and have been summarized in Attachment B. The analysis includes the amount of the assignment provided to developers, the length of the assignment agreement and the conditions upon which the assignment was approved.

Potential Opportunity Loss

Although not included in the budget for FY09-10 and FY10-11, future TOT from Terranea was expected to become a possible source of funding the City's Capital Improvement Program ("CIP"). If enacted, the TOT Loan as proposed would cause deferral high-priority projects that could be funded with TOT during FY09-10 and FY10-11. Additionally, the federal government is currently in a period of providing stimulus funding. In order to secure this type of assistance, it is often necessary for the City to contribute a portion of funding to the project, usually referred to as a matching requirement.

Suggestion to Increase TOT Rate from 10% to 12%

Lowe's initial proposal included a suggestion that the City should increase the TOT rate from 10% to 12%. Lowe's stated that they would support the City in an effort to secure voter approval for an increase of City's TOT rate from 10% to 12% for a period extending through the date on which the total TOT Loan has been repaid in full from all sources. The TOT attributable to the increased tax rate shall be applied to repayment of the total TOT Loan.

TERRANEA RESORT – REQUEST FOR FINANCIAL ASSISTANCE USING FUTURE TRANSIT OCCUPANCY TAX REVENUE

May 4, 2009

Page 7 of 7

Proposed TOT Rate Increase to 12% Requires Majority Vote of the Residents

The increase of the TOT rate from 10% to 12% would require a majority affirmative vote of the registered voters during a municipal election. The City Council could act to place a ballot measure on the November 2009 ballot. The cost of submitting the ballot measure and providing public information prior to the election is unknown at this time.

Incremental TOT Resulting From Rate Increase for Holdings Benefit

Notwithstanding whether the voters would approve an increase, the incremental 2% increase of the TOT would be retained by the City and applied to repayment of the TOT Loan. It's important to note that the incremental TOT (and repayment of the TOT Loan) would be funded by taxpayers, not Terranea. For every incremental dollar of TOT paid by taxpayers staying at Terranea, Holding's TOT Loan from the City would be reduced by the same dollar. If there is no timely sale or re-financing of Terranea, Staff estimates that it would take about 16 years of an increased TOT rate to repay the TOT Loan provided to Terranea.

Staff understands that Lowe's has requested that the proposal be enacted prior to June 1, 2009, the targeted date for commencement of operations of Terranea. Staff and its advisors believe that there may be sufficient time for the City to perform to provide the Council with a framework of terms and conditions of an agreement with Lowe's, and prepare draft documents for the City Council meeting scheduled for May 19, 2009.

Attachment:

Financial Assistance Provided by Other Cities to Other Developers

Financial Assistance Provided by Other Cities to Other Developers

City	Amount/Length of Rebate	Conditions of Approval	Other Notes
Palm Springs, CA	First Class New Hotels receive a rebate amount equal to 50% of the Adjusted Tax Rate for 20 years, up to \$50 million. New Quality Hotels receive a rebate amount equal to 50% of the Adjusted Tax Rate for 10 years, up to \$25 million. Existing Hotels receive a rebate of 50% of TOT for 10 years, up to \$25 million.	The purpose of their Ordinance is to enhance the tourist and travel experience for visitors, maximize the use of the City's newly renovated and expanded Convention Center, and assist the City in achieving its tourism goals.	Palm Springs adopted an ordinance which applies to the development of First Class Hotels, Quality Hotels, and Qualified Renovation Projects. These agreements and feasibility studies are completed prior to construction. The Adjusted Tax Rate is applies to a tiered approach to collecting TOT revenue under their Hotel Performance Incentive Program.
Elk Grove, CA	Developers will collect the 12% TOT and upon receipt of the remittance to the City, the City will review and send rebate payments to the developer on a quarterly basis. For years 1-10 of Hotel operation, the City will remit 50% of the TOT revenue back to the developer, and for years 11-15, the City will remit 33% of the TOT revenue.	The rebate is provided to address certain challenges unique to the project site which negatively impact economic feasibility of the project. Reasons stated include: redevelopment of blighted sight, new investment into main corridor of the City, new tax-generating use and new permanent jobs.	The project is a 98 room Marriott TownePlace Suites Hotel. The City's TOT rate is 12%. The agreement was made through adoption of a Resolution. This agreement was adopted prior to construction of the hotel.
Anaheim, CA	One hotel received a 50% rebate on TOT revenues for up to approximately \$12.9 million during the first 15 years. Another hotel received a rebate of 50 percent of sales tax revenues generated by the project, up to \$11.5 million and 50 percent of TOT revenues generated by the project, up to \$7 million (the length of time was not specified in the report).	The subsidies were provided to support the City's tourism industry.	The City of Anaheim provided subsidies to the Doubletree Hotel and the Anaheim Garden Walk.
Los Angeles, CA	As part of a multi-facet agreement, the City waived all remittance of the TOT collected by the hotel for 25 years, and this money would ultimately be transferred back to the hotel developer to be used for improvements benefitting the hotel. The amount of TOT revenue would be approximately \$62 million over 25 years.	The report noted that the LA Convention Center has not been able to attract large scale conventions and events due to its lack of a Headquarters Hotel, so the agreement was to incentivize the developers to construct a 1,100 room hotel.	This agreement was adopted for the development of a Convention Center Headquarters Hotel for the surrounding L.A. Live Project.