COUNCIL AGENDA: 10-23-12
ITEM: 2.11

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Edward K. Shikada

SUBJECT: **FAIRMONT HOTEL CONSENT AGREEMENT**

DATE: October 18, 2012

Approved [signature] Date 10/18/12

RECOMMENDATION

Approval by the City Council to the contribution of additional cash equity by certain partners of the Fairmont Hotel ownership group and that the contributing partners will be entitled to the return of such cash equity and a preferred return pursuant to the terms of that certain Operation, Ownership and Participation Agreement dated March 28, 1996, as amended.

OUTCOME

Approval of the recommended action will allow the ownership of the Fairmont Hotel to proceed with a loan modification and extension that will enable continued investment in this flagship community asset while retaining a participation interest for the City in the property.

BACKGROUND

Prior to the dissolution of the former San Jose Redevelopment Agency ("Agency") and in consideration of assuming certain reimbursement obligations of the Agency related to the funding of improvements for Montague Expressway, the Agency assigned to the City all of the Agency's interest in an Operation, Ownership and Participation Agreement (OOPA) with Light Tower Associates, LP, Light Tower Properties I, LLC, and Light Tower Associates, Sub LLC, collectively, the ownership ("Owner") of the Fairmont Hotel ("Hotel"). Pursuant to the OOPA, the City is entitled to receive 1/6th of any distributions made to the partners under the Light Tower Associates, L.P. partnership agreement. From its inception in 1996, the OOPA has generated approximately $9,200,000 in participation payments to the Agency. Under the OOPA, the City has no obligation to fund the operations of, or any expenses related to, the Hotel. Upon a sale of the Hotel, the City would also receive 1/6th of any net sales proceeds after the repayment of any existing debt and closing costs. Upon a sale of the Hotel, the City may or may not receive a participation payment, depending upon the net sales proceeds available for distribution. Furthermore, the OOPA, and the City's right to receive participation payments, terminates upon a sale of the Hotel by Owner.

The Owner is working to modify and secure a roughly two-year extension to a maturing $100,000,000 loan on the Hotel. As part of the loan modification and extension, MetLife ("Lender"), has agreed to extend their loan but is requiring approximately $14,600,000 be reinvested into the Hotel, consisting of (i) a reduction of the outstanding principal amount of the loan in an amount no less than $9,400,000, (ii) additional debt service reserves, and (iii) additional capital improvements to the Hotel. After exploring alternative capital sources, several of the partners decided to invest cash equity into the partnership to fund the items necessary to finalize the loan modification and extension.

Under the OOPA, the City's express written consent is required to increase the aggregate amount of cash equity. The Owner's representative, Maritz, Wolff, & Co., has requested that the City consent to treating the additional cash equity of $14,600,000, together with an additional $3 million in equity that was invested in 2011 by the Owners for capital improvements to the Hotel, consistent with the Owner's original investment in the Hotel. The Owner's original investment was subject to an eighteen percent (18%) preferred return on investment. This additional cash equity investment into the Hotel partnership would total approximately $17,600,000. The Owner would assume all risks associated with this investment, and there would be no General Fund nor other City funds at risk.

ANALYSIS

In evaluating this request from the Owner, staff has reviewed information provided by the Owner and consulted with a hotel consultant retained by the City. Staff evaluated options for the City in the context of the existing relationship with the Owner under the OOPA and the ability to maximize the City's financial position.

One option is that the City consent to the terms as proposed. This option would allow the Owner to finalize the loan modification and extension and will provide for additional funds to be used to make improvements to the Hotel. By consenting to the increase in cash equity with a preferred return of eighteen percent (18%), the City will retain its participation interest in the Hotel, although the City will not receive future participation payments under the OOPA until the Owner's additional cash equity and its preferred return have been repaid to the Owner. To the extent the loan modification is adding equity to replace existing debt (at least $9.4 million), the effect of this change on the City's position is essentially the difference in rate of return between the preferred rate and a commercially available rate. At the same time, the City's interest is positively affected by the Owner's improvements to the Hotel.

In addition, any distributions made to the partners are at the sole discretion of the Owner; there is no obligation under the partnership agreement to distribute retained earnings. While approval of the consent agreement may impact the amount and frequency of distributions, the revenue generated by the Hotel in transient occupancy taxes, sales taxes and Convention Center Facilities

District taxes provide critical revenue to fund services to the community and pay debt service on the Convention Center expansion project.

A second option is for the City not to consent to the terms as proposed. The Owner's representative has indicated that a preferred return of eighteen percent (18%) is necessary to obtain the additional cash equity from the partners. The Owner's representative has also provided evidence that additional financing to fund the additional cash requirements, although not readily available, was short term financing in excess of eighteen percent (18%). As such, the City's disapproval of this request would likely cause the Owner to terminate the pending refinancing. Under that scenario, it is uncertain how the Lender would proceed, and could lead to a foreclosure and sale of the property thereby terminating the OOPA. It is unclear at this time if the net sale proceeds would result in a distribution to the City; the Owner has indicated that the value of the Hotel today is at or below the debt, leaving the City with no distributions from a Hotel sale if this is correct. Additionally, the negative impact to the revenue generating capacity of the Hotel after a sale is unclear.

A third option is that the City request additional time to negotiate an improved position relative to the Owner's equity investment. The owners have indicated that such a delay would likely cause the termination of the pending loan modification and extension. The Lender agreed to delay the loan closing on the condition that the Owner make immediate progress in obtaining the City's consent. It is unclear whether the Lender will extend further if negotiations further delay closing. Once again, the Lender may consider forcing an immediate sale of the Hotel. Depending on the timing and proceeds generated from a sale, a number of potential negative effects could occur, including loss of the planned investment into the Hotel as well as potential proceeds from the City's interest in the property.

Staff also contacted the City's hospitality consultant for validation of the requested preferred rate of return. The City's consultant concluded that a preferred return of 12% would be more typical but 18% is not unreasonable under the circumstances. It should also be noted that the transfer by the Agency of its interest in the OOPA to the City is currently under review by the Office of the State Controller in connection with the dissolution of the Redevelopment Agency. This adds further uncertainty to the prospect of the City realizing future stream of revenue from the Hotel under the OOPA. While the proceeds from any sale of the City's interest would likely flow back to the Successor Agency to cover Enforceable Obligations, as noted above the value of this interest is difficult to gauge given it is influenced by numerous factors. While the transfer is under review, the City believes the transfer is appropriate.

Based on the options as presented, staff recommends approval of the requested consent agreement.

EVALUATION AND FOLLOW-UP

No further action by the City Council is anticipated to be necessary.

PUBLIC OUTREACH/INTEREST

☐ **Criteria 1**: Requires Council action on the use of public funds equal to $1 million or greater.
(Required: Website Posting)

☐ **Criteria 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**

☐ **Criteria 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

This report will be posted for the October 23, 2012 City Council meeting.

COORDINATION

This report has been coordinated with the City Attorney's Office.

CEQA

Not a project. Public Project number PP10-066.

EDWARD K. SHIKADA
Assistant City Manager

For questions please contact Edward K. Shikada, Assistant City Manager, at (408) 535-8190.