TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Toni J. Taber, CMC
City Clerk

DATE: January 29, 2016

SUBJECT: Conventions Center Expansion Site at South Hall

RECOMMENDATION:

As recommended by the Community and Economic Development Committee on January 25, 2016, accept the report and approve Staff pursuing a Compensation Agreement with the Successor Agency to the Redevelopment Agency (SARA) Board to preserve two-thirds of the South Hall site for future Convention Center expansion and the remaining one-third for a high quality hotel development, and finalize the required agreement with the SARA taxing agencies.
TO: COMMUNITY AND ECONOMIC DEVELOPMENT COMMITTEE
FROM: Kim Walesh

DATE: January 11, 2016

SUBJECT: CONVENTION CENTER EXPANSION SITE AT SOUTH HALL

RECOMMENDATION

Accept this report and approve Staff pursuing a Compensation Agreement with the Successor Agency to the Redevelopment Agency (SARA) Board to preserve two-thirds of the South Hall site for future Convention Center expansion and the remaining one-third for a high quality hotel development, and finalize the required agreement with the SARA taxing agencies.

OUTCOME

Negotiate and execute a Compensation Agreement based on the principles outlined in this report.

BACKGROUND

The City of San Jose Redevelopment Agency acquired the 4.4 acres adjacent to the San Jose Convention Center between 1999 to 2001 in order to allow room for a future Convention Center expansion (the “South Hall Site”). The Convention Center Master plans calls for expansion to the north and south of the Convention Center in two phases. Phase I expanded the Convention Center to the north onto existing City property and was completed in October 2013. Phase II of the expansion was intended for the South Hall Site. The Phase II expansion would have created an additional 550,000 sq. ft. of space to be used for exhibit space, ballroom, meeting rooms, back of house support, and parking. Phase II expansion was not implemented, and the existing pavilion and parking were left in place. All net parking revenues (approximately $200,000 annually) are remitted to SARA.

As a former Redevelopment Agency property, the disposition of the South Hall Site (Attachment A) was required to be included in a Long-Range Property Management Plan ("Plan") that was ultimately approved by SARA’s Oversight Board and the State Department of Finance. Staff initially proposed that the South Hall Site be transferred to the City as a government purpose...
property. However, the final Plan designated the South Hall Site for future development and required that the Successor Agency and City negotiate a Compensation Agreement with the other taxing entities by March 2016. If an agreement is not reached by March 2016, the South Hall Site must be sold on the open market pursuant to a competitive solicitation process approved by the Oversight Board.

**ANALYSIS**

The property is zoned Public/Quasi Public (P/QP) and the General Plan designates the land as Public/Quasi Public. Staff recently reconfirmed with the City's hotel consultant, Convention, Sports & Leisure (CSL), that the South Hall Site is necessary for future Convention Center expansion. The Executive Summary of the study is provided as Attachment B to this report. Their conclusion is that 2/3 of the site is critical for future Convention Center expansion over the next 30 years (shown as Convention Center Expansion Site in diagram). Additionally, as part of their analysis, they found that significant hotel demand exists in the area and that a portion of this site is a prime location to build additional hotel inventory to support existing Convention Center demand (shown as Hotel Parcel in the diagram). Their recommendation is for a “high-quality, multi-story hotel” that could possibly serve as a headquarters hotel that provides much needed room blocks to support Convention Center bookings.

Initial conversations with County Board members and staff have begun with the City representatives emphasizing the need to protect the South Hall Site for future convention center expansion. While there is understanding of the importance of the site to the Convention Center, there is also strong interest in generating revenue for the taxing entities. As such, staff has prepared a draft Compensation Agreement based on the following principles:

a. Preserve 2/3 of site (3.0 acres) needed for the future convention center expansion within 30 years

b. Until built, continue to operate as parking lot until developed or sold. Net parking revenues flow to SARA (approx. $200K/year)

c. Sell the eastern 1/3 of site (1.4 acres) to locate a full-service, upper-scale nationally branded hotel (as defined by Smith Travel Research)

d. Issue RFP for hotel within 12 months after execution of Compensation Agreement

e. Site to be sold within 5 years after issuance of RFP

f. Value of 1/3 of the site used for a hotel (1.4 acres) will significantly exceed value of the entire site designated P/QP (4.4 acres).

Ultimately, the final form of a Compensation Agreement would need to be approved by the SARA Oversight Board, the County Board of Supervisors, the San Jose City Council and the SARA Board. Once approved, the Compensation Agreement would need to be approved and signed by each of the taxing entities.
Prior to any sale, an existing HUD lien would need to be released. This is feasible for a portion of the South Hall Site, but not the entire site. As the South Hall Site was acquired with tax-exempt bond proceeds, a sale of a portion of the site will likely trigger requirements to redeem a portion of the outstanding bond issue in order to maintain the tax-exempt status of the bonds.

**EVALUATION AND FOLLOW-UP**

Presuming negotiations with the SARA Oversight Board and related taxing entities are successful, staff would return to the City Council no later than March 2016 with a Compensation Agreement for Council approval.

**PUBLIC OUTREACH**

This memorandum will be posted on the City’s Council Agenda website for the January 25, 2016 Community and Economic Development Committee meeting.

**COORDINATION**

Coordinated with the Successor Agency to the Redevelopment Agency, and City Attorney’s Office.

**CEQA**

Not a Project, File No. PP10-069(a) Reports that involve no approvals of any City Actions.

/s/
KIM WALESH
Deputy City Manager
Director of Economic Development

Please contact Teri Killgore, Downtown Manager, with any questions at (408) 535-8102.

Attachment A: Map of South Hall Site
Attachment B: Draft Final Executive Summary of CSL Report
Attachment A: Map of South Hall Site
EXECUTIVE SUMMARY

Conventions, Sports and Leisure International (CSL) and Hotel Appraisers and Advisors (HAA) have completed a feasibility study for potential headquarter hotel development and long-term San Jose McEnery Convention Center (SJCC) space needs in San Jose. The purpose of this study is to evaluate market demand, financial and site features that will impact the near and long-term viability of the convention and hospitality industry in San Jose. In particular, we have developed findings that will allow the City of San Jose (City), Team San Jose (TSJ) and community stakeholders make decisions as to the future of parcels adjacent to or near the SJCC.

These studies provide an analysis of market demand, development program, financial feasibility and projected impacts associated with new headquarter hotel and event space development in San Jose. The primary components of this project could include the following:

- Between 600 and 800 rooms contained within a single property.
- Approximately 40,000 to 52,000 square feet of meeting and event space, including a 20,000 to 30,000 square foot ballroom.
- Recognized national brand with credibility in the convention industry.
- Sufficient contiguous site area to allow for eventual SJCC expansion.

Specific analysis steps undertaken included interviews with project representatives (hotel professionals, economic development officials and other individuals that could impact or be impacted by the project); extensive hospitality market research; review of local supply and demand characteristics and trends; review of event activity currently accommodated at existing hotels in the market; detailed analysis of event activity currently accommodated within the SJCC; analysis of local economic conditions impacting room demand; in-depth research of competitive and comparable facility/market product; and, the development of models to project financial performance and community-wide economic impact.

This summary outlines the key findings associated with the study. The full written report should be reviewed in its entirety to gain an understanding of the study's methods, limitations and implications.

Maintaining a Competitive Position

Reviewing the Need for Future Convention and Hotel Investment in San Jose

- There are approximately 2,300 hotel rooms within one-half mile of the SJCC. The San Jose Marriott (506 rooms) and Hilton San Jose (353 rooms) are the most proximate to the SJCC and typically act as headquarters hotel properties.
- Competitive markets such as Salt Lake City, Spokane, Portland and Austin are currently planning or have recently developed dedicated headquarter hotel properties. Fifteen other national markets have also either recently developed or are currently in various stages of planning to add one or more headquarter hotel properties.
- Relative to hotel inventory near competitive regional and national convention centers, the total number of hotel rooms within ½-mile of the SJCC is low.
- Similarly, the total sellable space available within the SJCC is comparatively low. There will eventually be a need for long-term investment in SJCC space and amenities in order to maintain market share, and this will require the use of parcels that are contiguous to the existing SJCC.
Given the strength of the corporate market in San Jose, there are significant limitations on the availability of rooms for conventions and tradeshows. The lack of committable hotel rooms is negatively impacting the SJCC's ability to attract nationally rotating events that benefit the state and city economically.

Limited access to adequately sized room blocks available at competitive rates has driven SJCC occupancy levels attributable to convention/tradeshow events down from approximately 29 percent in 2010 to just over nine percent in 2014. To maintain occupancy levels within the SJCC, building management has successfully increased conference/seminar and consumer show event activity.

However, this shifting in event activity has significant negative effect on state and city economic impacts generated by the SJCC.

**Value of the RDA Site Relative to the San Jose McEnery Convention Center**

- In the highly competitive market for rotating conventions and tradeshows, maintaining or enhancing market share requires occasional and strategic investment in space, amenities and hospitality infrastructure.

- Successful convention centers are typically located in urban areas to benefit from and to help support hotel, restaurant and entertainment assets. Convention centers typically represent the largest facility footprint in a downtown area.

- Numerous markets nationally are negatively impacted by land-locked convention centers, requiring significant expenditures to mitigate the lack of contiguous site area. This is currently the case in San Francisco, San Diego, Seattle and many other markets.

- Controlling parcels that are directly adjacent and connected to a convention center can be challenging, but is critical to maintaining long-term market share, and should be a key community priority.

- It is not possible to effectively sell small and mid-sized conventions on a non-contiguous facility. With modest but steady industry growth nationally, along with continuously evolving customer needs, the SJCC will need to respond, and this will very likely require added square footage on contiguous parcels.

- Full convention center expansions tend to provide for added space that can be roughly equivalent to 50 percent of existing sellable areas. For the SJCC, this would result in approximately 70,000 square feet of added exhibit space and a need for approximately 30,000 square feet of added meeting space. Preliminary planning should assume support space (lobbies, back of house, etc.) roughly equal to the added sellable space resulting in a total built square footage of approximately 200,000 square feet. While these totals will need to be verified through future market research, they represent viable preliminary planning goals.

- For site planning purposes, we can assume a stacked scenario that would require an expansion footprint of approximately 115,000 to 125,000 square feet, or approximately 62 to 67 percent of the existing 4.40 acre South Hall site (the only available site contiguous with the existing SJCC).

- An assessment of hotel properties in Bellevue, WA, Milwaukee, WI and Minneapolis, MN (all of which are under 287 feet tall) with room counts ranging from 730 to 820 suggest a footprint of between 49,200 square feet and 93,700 square feet (impacted by room count and sellable space). While this would result in a highly dense development, this preliminary assessment seems to indicate an ability to build a headquarter hotel and expand the SJCC on the RDA site, particularly if they are planned jointly. Alternatively, a smaller hotel property could be accommodated on the non-SJCC South Hall site square footage, with a headquarter hotel property developed on an alternative site.
Rating Location Options for Future Headquarters Hotel Development

CSL and HAA conducted a preliminary site/location analysis for the potential development of a headquarter hotel for the SJCC. After careful review of potential development locations throughout downtown San Jose, there were four potential sites considered, including:

- **South Hall (RDA Site)** - 4.40 acres in a rectangular configuration, located directly to the south of the SJCC on the same city block.
- **Boston Properties** - 4.35 acres in a somewhat rectangular configuration, located across Almaden Boulevard to the west of the SJCC.
- **Sobrato** - 1.60 acres in a rectangular configuration, located in the northeast quadrant of the Market Street and San Carlos Street intersection.
- **Valley Title** - 2.30 acres in a rectangular configuration, located a block and a half northeast of the SJCC along San Salvador Street between First and Second Streets.

To assist in the evaluation of each of the four potential sites specific site evaluation criteria were employed, consisting of 14 different criteria including characteristics such as:

- The ability to accommodate build-out of 600 to 800 rooms;
- Direct access to the SJCC;
- Proximity to restaurants, retail, nightlife, entertainment and other visitor industry amenities;
- The ability to leverage existing facility investment and/or infrastructure;
- Size, cost and ownership complexity of the potential site; and,
- Other such characteristics.

Based on our analysis of these characteristics, the South Hall (RDA) site was identified as the preferred site for headquarter hotel development, followed by the Sobrato site and the Boston Properties sites. Due largely to its distance from the SJCC (among other considerations), the Valley Title site was identified as the least preferable option.

With respect to future SJCC enhancements, the South Hall site represents the only option for adding contiguous event space to the existing SJCC footprint.

Market and Financial Feasibility Analysis for Headquarters Hotel Development

- The headquarters hotel room demand, occupancy, average rate and other statistics generated as part of this study have been used by HAA to prepare a detailed forecast of income and expense for the proposed hotel. The full report, prepared by HAA under separate cover, should be read in its entirety to gain a full understanding of the assumptions and limitations used in preparing this forecast.
- There are several sources of potential room nights for a new San Jose headquarter hotel. These include induced room nights (new demand attracted to the market due to the new hotel); unaccommodated room nights (existing demand that is pushed outside the downtown area due to lack of room inventory); and absorption demand (room nights that will be attracted from existing downtown hotels).
Hotel occupancy levels among competitive area San Jose hotel properties have exceeded 70 percent, while average daily rate (ADR) has increased faster than the rate of inflation.

San Jose experiences strong mid-week demand patterns, with occupancies on most Tuesday and Wednesday nights consistently exceeding 90 percent from February through November. These patterns are indicative of significant volumes of unaccommodated demand during certain periods of the year. While new hotel room supply will likely have some negative effect on overall market occupancies, the significant volumes of unaccommodated demand detected is expected to moderate the impact of new supply on existing competitors.

Based on the subject property's new construction, upper-upscale amenities, full-service nature, national branding, and adjacent demand generators, we expect its ADR will stabilize above the market average. Due to its large room supply, we expect its occupancy to be positioned below the market average. As a result, the subject property's RevPAR (revenue per available room) penetration is projected to be among the highest within the competitive set of San Jose area hotels reviewed.

Based on the research conducted as part of this project, a new 800-room headquarter hotel is estimated to achieve a stabilized occupancy level of 74 percent, and a stabilized average daily rate of $227 (in 2015 dollars).

The estimated net income for the property is projected to range between $17.7 million in the first year of operation, to $28.0 million in year ten.

Assuming an order-of-magnitude construction cost of approximately $400,000 per room, an 800-room hotel would cost approximately $320.0 million, not including the cost of land acquisition. It should be noted that these costs are based on industry average cost-per-room data, and should not be considered to be a project-specific or site-specific assessment of costs. Detailed costing analysis will be necessary in order to make fully informed decisions as to the future of the project.

Assuming an overall capitalization rate of 9.0 percent, the value of the ten-years of forecasted hotel net income plus a terminal value after year ten is approximately $250.0 million.

Based on this analysis, there is a gap between the potential costs for the subject property and the value of the hotel of approximately $70.0 million. This gap will vary if the hotel room count changes.

Potential Funding Alternatives Analysis

Virtually all convention center headquarter hotel projects nationally have faced a financing gap. This includes large hotel projects in Denver, Dallas, Houston, Baltimore, Charlotte, Indianapolis, Nashville, San Antonio, St. Louis and numerous other markets.

There are two broad mechanisms under which these projects have been financed. In markets such as Dallas, Denver, Sacramento, Baltimore, Austin and Houston, a public sector entity has issued tax exempt bonds to fund a project, with the bonds backed by a series of revenue streams and resources including hotel net operating income, project reserves and debt service guarantees, and oftentimes some form of public revenue stream as a final backstop to the debt. Given the lower interest rates on tax exempt debt as compared to the cost of capital for a private developer, the hotel net operating income will go much further in financing the project. The lower cost of capital can minimize any necessary up-front public sector contribution.
• Alternatively, in markets such as Indianapolis, Los Angeles and Nashville, the project financing involves selecting a developer to finance, construct and potentially operate a new headquarter hotel. Under this financing method, there is typically a gap (as described above for a potential San Jose hotel project) given the net operating income and corresponding costs associated with the project. Some form of public support is required to fund this gap.

• Additional analysis will be needed to determine the most viable funding mechanism to develop and sustain the operations of a potential headquarter hotel at the SJCC.