RETAIL LEASING AT AIRPORTS

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Introduction

Leasing of airport concession locations has certain unique aspects. Many typical important issues in shopping centers such as exclusives, co-tenancy requirements, operation and maintenance of the common area, kiosk and RMU locations, parking and radius restrictions are not as relevant nor as important in airport concession programs. The following materials will address (i) the process of leasing at airports, (ii) issues which are unique to airport concession operations, and (iii) sample lease clauses for concession agreements.

Airport Concession Programs in United States

- Concessions were simply an afterthought, had a very small presence from a physical plant perspective and virtually no impact on revenues for airports.
- Consisted of generic non-branded "Coffee Shops" and "Newsstands" together with the airport chapel and USO and if lucky, a lousy restaurant!
- US industry began its transformation from these dull generic programs to more sophisticated branded programs in the 1990s.
- Programs have been expanded to become shopping "meccas" for the traveling public offering a wide selection of nationally and internationally recognized brands for specialty retail, news, bars, quick serve eateries and renowned restaurants featuring local celebrity chefs and services.
- Airports are creating their own "sense of place" and municipalities have begun to recognize the importance, as airports serve as the front door and gateways to their communities and, in many instances, is the first impression that tourists and business travelers have of the community.

Airport Concession Customer

- The average income of the traveling public exceeds the normal demographic averages for most metropolitan areas as these individuals typically have higher disposable incomes.
- The average dwell time is equal to or slightly higher than the average dwell time of shoppers in malls. Well over 60% of overall travelers use dwell time to spend money in concessions, with a higher capture rate for business travelers.
- Focus is on people boarding an aircraft (commonly referred to as "enplaning passengers" or "enplanements") as compared to people who are leaving the aircraft ("deplaning passengers" or "deplanements"). The spend rate per enplanement is substantially greater than the spend rate per deplanement.
- Concession operators also focus on and provide special incentives and promotions geared to the hundreds of employees who work daily in airports.

Airport Concession Program Models

There are three (3) primary airport concession program models. In almost all instances, rights to these programs are obtained pursuant to a public bidding/request for proposal (RFP) process. Airlines who lease entire terminals at various airports may be responsible under their unit terminal lease for concession programs and would typically pursue the latter two options.

Direct Leasing

- Some municipalities or airport authorities retain their own property/concession management staffs internally to handle all aspects of the leasing and management of the concession programs including lease negotiation and rent collection.
- RFPs are typically issued for each space (or in small packages).
- Direct leases are between the municipality/airport authority and each concession operator.

Prime Concessionaire

- A prime concessionaire is an entity that operates substantially all of the concessions in the airport or in the packages awarded.
- RFPs are issued for the operation of all or substantially all locations (may be split into larger packages of multiple units) in which one or a small number of larger prime concessionaires operate most of the concessions awarded.
- Leases are direct between the municipality/airport authority and the prime concessionaire
- These prime concessionaires either enter into joint ventures with ACDBEs or sublease certain locations to ACDBEs to meet the ACDBE participation requirements.
- Prime concessionaire responsible for all rent payments including those of any sublessee.

Developer/Manager Programs

- Awarded pursuant to a public RFP process for the development, leasing and management to companies which do not operate any of the concessions.
- Direct master leases or management contracts are entered into between the municipality/airport authority and the developer/ manager.
- The developer/manager in turn either subleases (master lease structure) or leases on behalf of the owner (management contract structure) to various concession operators for and is paid a fee by the municipality/airport authority for their development/management services.

Regardless of model, all leases and subleases are subject and subordinate to the master lease (prime concessionaire and developer/manager models) and any unit terminal or other ground leases.

The RFP Process

The public RFP process attempts to make the selection and award of locations as fair and as transparent as possible, with an objective to eliminate politics from the award process. The process is both time consuming and expensive for concession operators, prime concessionaires, ACDBEs and developers / managers. Each RFP has its own specific timing and requirement. The RFP process is being utilized more frequently in all airport concession program models (both governmental public entity solicitations and smaller private entity solicitations) to ensure the best opportunity for a completely fair, objective and transparent evaluation, selection and award process. Increasingly, concession awards are based in part on minority participation as a part of the RFP submission.

Airport Concession Disadvantaged Business Enterprises (ACDBEs)

Critical to operating in an airport and responding to a RFP is understanding the regulations that govern ACDBEs and joint venture partnerships with ACDBE partners. The following highlighted areas that must be addressed in this regard.

Understand the Certification Process

- The Certifying Agency.
- Why is the Applicant considered to be Disadvantaged?
- Personal Net Worth Requirements
    - Exclusions
- Management & Control
- Business Size Restrictions

The Certifying Agency

- Uniform Certification Programs
- Individual State Requirements
    - Different Agencies in States Can Certify
    - Determining Which Agency to Apply With
        - Domicile, Principal Place of Business
        - Authority Which With You Will Do Business
        - Any Certifying Agency Within the State

Determining the Applicant

- Application is in Name of Owner, Not Business
- Single Owner = Applicant
- Multiple Owners

- Applicant must have:
  - Disadvantaged Status
- Social & Economic
  - Majority Interest — at least 51% (49 CFR §26.69)
  - Management & Control Functions

<u>What Constitutes Disadvantaged?</u>

- ACDBE Applicants are Evaluated Under the Same Requirements as DBE Certification {49 CFR §26.31(a)}
- ACDBE Applicants Must be Both Socially and Economically Disadvantaged (49 CFR §26.67)
  - Social — Based on Gender, Racial/Ethnic Background
  - Economic — Based on Personal Net Worth

<u>Social Disadvantaged Status</u>

The following are Presumed to be Socially Disadvantaged (49 CFR §26.67)

- Women
- Black Americans
- Hispanic Americans
- Native Americans
- Asian-Pacific Americans
- Subcontinent Asian Americans
- Other Minorities found to be Disadvantaged by the SBA

<u>Economic Disadvantage Status / Personal Net Worth</u>

- ACDBE Applicant's Personal Net Cannot Exceed $750,000 (49 CFR §23.35)
- Personal Net Worth:
  - Excludes Ownership Interest in the Business
  - Excludes Equity in Applicant's Primary Residence
  - Contingent Liability Does Not Reduce and Applicant's PNW
  - Count Present Value of Assets (less taxes and distribution penalties) pension plans, retirement accounts, 401(k), etc.

<u>Management and Control</u>

- ACDBE must be an Independent Business (49 CFR §26.67)
- There cannot be any formal or informal restrictions which limit the customary discretion of the Applicant
- Applicant must possess power to make day-to-day operation, management and policy decisions
- Non-Disadvantage owners cannot disproportionately control business

Business Size Restrictions

- ACDBE Certification is limited to "small" businesses (49 CFR §23.33)
- Gross Receipts over the past 3 years cannot exceed $52.47 million
- Special Exceptions
  - Banks: $1 billion in assets
  - Car Rental Companies: $69.97 million
  - Pay Telephones: 1,500 employee

Certification Challenges

- Not all states use the Uniform Certification Application
- Different states require different documentation
- Certification is not currently reciprocal
- Certification is required in each state in which you want to do business
- There are pending regulation changes that may standardize and simplify the certification process

Structuring a Joint Venture (JV) for an Airport Concession Operation

- Old school ways of funding a JV that looks like a "front' will not work anymore
- JV Agreements need to be agreed to before bid Submission of the RFP
- JV Agreements govern the relationship between the prime concessionarie and the ACDBE
- Consequences appearing to be a "front"
  - Non-Conforming bid
  - De-Certification
- FAA's 2008 guidelines provide more scrutiny to JVs, including JVs that pre-date 2008
  - Changed the landscape of historical joint venture structure and operation
  - Increased benchmarks for participation by disadvantaged business owners
    - One of the factors considered by airport authorities when evaluating RFP submissions
    - Management
    - Recourse
      - No longer to ACDBE interests
    - Incentivize Separate Financing
- Drafting Approach
  - Form your JV assuming it will be audited
- Structuring JV's is in compliance with applicable regulations makes it more competitive

- Airport authorities enforce FAA Guidelines

Basics of an ACDBE Joint Venture

- Definition (per the guidelines) — an association of an ACDBE firm and one or more other firms to carry out a single, for-profit business enterprise, which the parties combined property, capital, efforts, skills and knowledge, and in which the ACDBE partner is responsible for distinct, clearly defined portion of the work of the contract and who shares in the capital contribution, control, management, risk, and profits of the joint venture are commensurate with its ownership.
- The joint venture cannot resemble a passive partnership
- What is a Passive Partner?
- Will not survive the scrutiny of an audit by an airport authority or any regulatory agency
- In the early planning stages the potential partners must think of the JV as a new business — the JV has no capital, no assets, no inventory, nor any management structure

Essential Documents

I. Business Plan
   - New Businesses Require Planning -
     - Selection of the right business partner. There must be a good business fit between the Partners (Prime and ACDBE)
     - Assess what value can each partner bring to the new business
     - Consideration of all the business aspects for operation of a profitable airport concession business
     - Financial Metrics
     - Partners must analyze the projected cash flow for the business and consider what it will cost to operate concessions
     - Essential costs include:
       - Company formation
       - Legal and accounting
       - Inventory
       - Working capital
       - Construction rent
       - Minimal annual guarantees (MAG)
       - Security deposits
       - Training and hiring of employees

II. Joint Venture Agreement (IVA)
   - The blueprint to which your company will operate
   - The lens through which regulatory agencies will assess compliance with the FAA regulations and guidelines

- JVA will be your handbook on all operations issues

<u>Participation in a Joint Venture is Measured By</u>:

- Ownership/Capital Contribution
- Control
- Management

<u>ACDBE / Joint Venture Summary</u>

- Ask question up front. Take the time to understand the regulations or speak with someone who has a thorough understanding of the certification process and requirements.
- Be thorough. Carefully review both the ACDBE application and the instructions for completion and deliver an application that is deemed to be thorough and responsive.
- Because the burden will always be on the venture to demonstrate compliance with any and all FAA regulations, JV airport concessionaires do well by structuring and operating their companies as though they will be audited in the future.
- One day the concession operation will receive a notice of audit or subpoena from the local airport authority requesting all partnership agreements as well as operational records.
- If the structure is sound and the necessary systems and documentation are in place, this will save the JV partners a lot of anxiety on the back end and the company will have great confidence in demonstrating compliance to any regulatory inquiry.

Pre vs. Post Security Locations

- Following 9/11 and the creation of the TSA, it is far more critical for the majority of the concession program to be located in post-security sterile areas of the airport. The traveling public's first priority is to check in and get through the security checkpoints particularly if long delays are encountered.
- The vast majority of concessions developed since 9/11 are post-security.
- Therefore, fewer pre-security locations today (primarily limited to news/coffee combos, grab n go food & beverages and currency exchange or information booths), mainly located in the baggage claim areas or in central off-terminal rental car facilities. The majority of users are "meeters/greeters" as well as deplaning passengers.
- The evolution of pre-security locations versus post-security locations is leading to redevelopment opportunities at many airports.
- With the decline in landing fees and other airport users' rentals streams, concession revenues are becoming more and more important to municipalities, authorities and airlines to compensate for the shortfall in other revenue sources. Airports

are expanding the number of locations and designing specific areas for concessions including large, "mall-like" shopping concourses and multiple food courts to enhance the passenger experience and increase revenues.

- Although we all hate delayed or cancelled flights when we travel, it's a blessing in disguise for concession operators to have the captive audience which results therefrom. Food & beverage concessions honor airline vouchers provided to passengers in such situations and are reimbursed directly by the airlines.

Lease Terms and Deal Economics

Gross sales in airport locations, when measured in terms of sales per square foot, are substantially higher than the averages achieved in regional malls across the US. Millions and millions of passengers pass through US airports each year. Certainly, there are differences between shoppers and passengers whose primary purpose is travel, but brand awareness is especially important to retailers and provides instant visibility to millions of potential customers.

Lease Terms and Concession Size.

- Length of term is shorter than shopping center deals, news and specialty retail 5 years, fast food and other quick serve locations between 5 and 7 years and sit down restaurants between 7 to 10 years.
- Airport concessions have far heavier traffic, thus the finishes and fixtures wear out quicker than traditional retail venues.
- Shorter terms provide airports with more flexibility — allowing them to adapt to current popular concepts so programs remain fresh and appealing.
- Locations with terms longer than 5 years are typically required to perform a minimum refurbishment prior to the expiration of the 5^{th} year.
- Specialty retail is generally much smaller in size ranging from very small wall shops and 200sf kiosks, to inline locations ranging from 500 to 1500sf. Newsstands and news & gifts are slightly larger as they generate the most sales and have the greatest demand. Food & beverage locations are smaller than their traditional shopping center and street counterparts with the larger themed restaurants only occupying between 2500 to 3500sf in airports.

Minimum Annual Guarantee (MAG).

- MAG rents are generally higher per square foot in airports than in traditional shopping center, street and office building locations.
- Annual MAG increases are generally tied to either increases in enplanements or by paying a specified percentage (85 to 90%) of

the prior year's "effective rent" (MAG plus Percentage Rent) as the new MAG.

- Most of these structures do not provide for adjustments below the initial year's annual MAG, even in the event of a decline in enplanements, as most deals are approved by public boards and compliance with the board approved total term MAG revenues is required. Concession operators should try to negotiate some equitable relief in the event of substantial enplanement declines.

Percentage Rent.

- Percentage Rent rates in airports are slightly higher as well.
- Key difference is the timing of percentage rent payments, which in most airports are paid on a monthly basis and then reconciled at the end of each year, rather than when gross sales have exceeded either a quarterly or annual breakpoint.
- Rates may be structured to be increased as sales thresholds are achieved each year or deals may be structured to provide for different rates for different types of products.
- Newsstands typically pay a lower rate on news and sundries as the margins are lower on these items as compared to gifts and souvenirs.
- Restaurants pay a higher rate for alcoholic beverages as compared to food and non-alcoholic beverages.
- Retail Display Allowances almost always included in gross receipts.

Additional Charges. Additional Charges vary from airport to airport but typically include the following:

- Storage. Some airports charge rent while others provide storage at no charge. Size is small and limited in airports. Wet storage usually at a higher rate if rent charged.
- Utilities. Varies among airports. Some charge all concessions, other airports only food & beverage and a few provide at no cost. Excludes telephone and data.
- Taxes. In some jurisdictions, ad valorem or PILOT taxes are charged to businesses located in airports but at a majority of US airports, concession operators are not required to pay any traditional real estate or personal property taxes on either the common areas or the concession locations themselves because its located on governmental property or otherwise specifically exempt.
- Logistical Support. In most airports, some sort of logistical support charge is imposed for such items as deliveries, use of loading docks, trash removal, commissary services, and vehicle escort services (if airside access is involved). Rates charged are based on both the type of concession and frequency of services needed for the different concession uses.
- Food Court Operating Expenses. Food court operators typically

pay for a proportionate share of expenses to clean and maintain the public seating areas in food courts, centralized grease trap cleaning and maintenance and any tray washing operations. This is in addition to logistical support charges.

- Marketing Fund. Typically based on half percent of monthly gross sales. Some airports cap annual amounts. Certain services may pay flat annual fee (foreign currency exchange, for example).

Construction Allowances

- Construction allowances for concession operators' build-outs are very rare in airport venues and generally are only given to smaller concession operators such as certified ACDBEs or local "Mom & Pop" businesses to create that "sense of place" but allowances even for ACDBEs or locals are not common occurrences. Concession operators more likely to receive this form of assistance in developer/manager or prime concessionaire models.

Plan Approval and Build-Out Process

The plan approval process and construction process is more complex in airports than in traditional retail shopping centers or office buildings.

- Design criteria must be complied with, may impact a company's prototype.
- Approvals are required from both the airline/airport authority and local building inspectors and code officials in many instances.
- Design criteria may be more restrictive and provide less visibility than other retail venues. Most airports in the US are public buildings and many have historical significance which will further impact the design criteria and storefronts, additional costs and time may be incurred.
- Resolution of design and aesthetic issues may be subjective and may result in unanticipated delays.
- The design process usually takes between 4 and 6 months to obtain all approvals required. Key is to start the design process early.
- In most instances, concession space delivered AS IS so may have to factor in demolition as part of overall costs.
- Payment and Performance Bonds are normally required in amounts equal to the penal sum of the construction contracts. Additional cash construction security deposits may be required from both the concession operators and their contractors.
- If the unit is located post security, an additional layer of requirements must be followed.
    - All materials, equipment and supplies must be properly screened, and the contractor and subcontractor

employees must be fingerprinted, pass background checks and properly badged so that they may access the site.

  - o Each day a log must be maintained with respect to all tools brought into sterile areas and all tools, machinery and equipment must be properly stored and locked each day.

- Time periods during which construction activities may be undertaken and also restricted as the nosier and more disruptive construction activities may be required to be performed at night when the airport is not conducting aeronautical operations. Materials being brought to the site are also typically required to be delivered during the airport's non-operating hours.

General Operating Requirements

Operating concessions in airports is more complicated and expenses in comparison to traditional retail venues.

- Operating hours are much longer, with some locations open as early as 5 a.m. and closing as late as 10 p.m. Standard operating hours are tied to the first and last departures daily.
- Concessions are open 365 days a year, including all national and other holidays.
- Additional costs are incurred for product deliveries, screening and storage.
- Employee fingerprinting, background checks and security ID badging are required. Training classes on airport security must also be taken.
- Use clauses may be more restrictive.
- Street pricing policies must be complied with. These policies vary from airport to airport, with on-airport prices compared to either the same brand if locally operated in an off-airport location; or to an average of other similar types of stores (usually average of 3 to 5) being operated in the local market. The airport price cannot exceed the street price.
- Labor harmony clauses are important as all labor in an airport must work in harmony with one another and the growing trend in airports is to require evidence of a labor peace agreement between the concession operators and a. union to prevent boycotts, strikes or lockouts on airport property.
- Employee parking is not provided free of charge, adding additional costs (many employers reimburse their employees for the monthly parking).
- Compliance with additional legal and regulatory requirements.

Relocation and Early Termination Rights

- Almost all concession leases provide the landlord entity (whether a municipality, airport authority, airline, prime concessionaire or developer/manager) with the unfettered right to relocate or reduce the location if needed for airport or airline operational issue or for public health and safety considerations.

- Also have rights to terminate a concession operator's use and possession if needed for airport or airline operational considerations. Reimbursement limited to the unamortized investment in the original leasehold improvements.
- These rights are almost always non-negotiable.

Insurance and Indemnity

Insurance and indemnity provisions are similar to those contained in more traditional retail venue leases.

- Liability limits typically higher than in shopping centers.
- Property insurance must be maintained at 100% replacement value level.
- Automobile liability insurance is substantially higher if airside access is required (typically in the range of $10M to $25M).
- Very unlikely to get a mutual waiver of subrogation from a municipality or airport authority, and unlikely to obtain one from an airline landlord.
- Indemnity provisions are usually much broader (including environmental) and are generally non-negotiable.

Subordination and Non-Disturbance Agreements (SNDA)

- Airport authorities and airlines do not typically provide SNDAs to concession operators, even if the Prime Concessionaire or Developer/Manager models are utilized. On rare occasions, SNDAs have been provided to a large national tenant by an airport authority but this is not the norm.
- Airports may provide waiver letters for equipment leasing and equipment financing but the letters are very restrictive and do not provide the lessor or lender many rights other than removing the collateral in a very supervised manner and during a limited time period (typically midnight to 5 a.m.). If the locations are located post-security, then escort privileges must be obtained in order to even access the collateral!

Exclusives, Radius Restrictions and Co-Tenancy

Exclusives and co-tenancy provisions are rarely if ever given in an airport concession program.

- To the contrary, most airport concession programs like to foster competition among similar retail and food & beverage concession operators and in some instances cluster similar types of uses so that the operators will provide a superior customer experience to all patrons.
- Programs try to maintain a proper tenant mix by not permitting substantial duplication of use clauses from operator to operator.
- Co-tenancy provisions tied to other stores is irrelevant in this

venue as the loss of any stores or groups of stores has little if any effect on the success of the other operators. To the contrary, should some locations go dark, it tends to benefit the other concession operators rather then result in a decline in business.

Enplanement Protection and Early Kick Outs

- Protection from decreases in enplanements is very difficult to obtain, and even if so obtained, it is typically of a more catastrophic type of protection and not a benefit for smaller decreases that may occur from time to time. Enplanement protection provisions are very difficult to negotiate.
- Concession Operators may consider the right to kick after a specified period of time if sales are not sufficient to continue operation; however, the pitfall is that these kick out clauses are usually mutual if granted.

Other Issues

- Office of Foreign Asset Controls — federal agency which administers and enforces economic sanctions against countries and groups of individuals, such as terrorists and narcotics traffickers. OFAC publishes a list of these individuals (Specifically Designated Nationals or SND) and US persons and companies are generally prohibited in entering into business transactions with any SDNs.
    - o Before entering into any lease transactions, landlords should perform the required due diligence pursuant to the USA Patriot Act and regulations issued thereunder.