

CITY COUNCIL STAFF REPORT

MEETING DATE: June 26, 2024

PREPARED BY:

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APPROVED BY: City Manager

AUTHORIZE THE CITY MANAGER TO ENTER INTO AN AGREEMENT WITH HOTEL MOHI BY APPELLATION FOR A TRANSIENT OCCUPANCY TAX AND SALES TAX SHARING AGREEMENT

RECOMMENDATION(S)

Authorize the City Manager to prepare and execute a Transient Occupancy Tax (TOT) and Sales Tax Sharing Agreement for the Hotel MOHI by Appellation project based on the Draft Deal Points as memorialized by KMA.

COUNCIL PRIORITIES, GOALS & STRATEGIES

City Council Ongoing Priorities

Enhancing Public Safety

Maintaining and Enhancing Infrastructure

2024-2025 Strategic Priorities

Fiscal Sustainability

Economic Development and Tourism

Guiding Documents

Economic Blueprint

Morgan Hill 2035 General Plan

REPORT NARRATIVE:

Policy Consideration

Should the City of Morgan Hill provide a Transient Occupancy Tax (TOT) and Sales Tax Sharing Agreement to support the upgrade of the hotel brand and the range of offerings of the Downtown boutique hotel to increase the City's share of TOT and Sales Tax revenue?

Background:

The City of Morgan Hill's 2017 Economic Blueprint identifies tourism as one of four key industries the City should prioritize to further economic development opportunities. During the 2024 City Council Goal Setting Session, the Council added tourism to the Economic Development Strategic Priority within the City's 2024-25 Sustainable Morgan Hill Strategic Priorities to strengthen the City's focus on supporting efforts that advance the City's goals for tourism.

Hotel Inventory & Future Product Development

One of the most substantial impacts the City can have on positively impacting its tourism strategy is to grow and diversify its lodging options both in quality and quantity. Currently, the City of Morgan Hill does not have a full-service hotel. A full-service hotel is a mid-priced, upscale, or luxury hotel with a wide range of amenities, including (a) restaurant(s), meeting spaces, and, in some cases, exercise rooms, spas, and concierge service. Full-service hotels generally offer food and beverage services, special events, and minimum service levels like valet parking, bell service, and room service. Most of the existing hotel inventory is older and needs re-investment. Currently, the City of Morgan Hill is losing corporate, group, and leisure travelers to nearby cities due to the lack of a full-service hotel or the lack of high-quality and newer hotel products. These travelers often stay at full-service hotels in San Jose, Los Gatos, Palo Alto, or the Monterey Peninsula.

Economic Conditions

Before the COVID-19 pandemic, the City of Morgan Hill hotel industry was experiencing record occupancy and solid average daily revenue (ADR) rates. However, while leisure travel has experienced a significant rebound post-pandemic, the business travel sector, which the City of Morgan Hill and the greater Silicon Valley has historically benefited from, has not rebounded as quickly. More importantly, post-pandemic, the costs of new hotel construction have skyrocketed. The cost of materials, labor, supply chain issues, and high interest rates all make the construction of a new hotel increasingly difficult. Many hotel projects have seen their construction costs increase 30 to 40 percent, making it difficult for projects to secure lines of credit and bank financing. At least three (3) very high-profile, well-financed developers have delayed plans to build new full-service hotels in Cupertino and Santa Clara until the economic conditions improve. To support hotel development, in 2022, the City created a [Hotel Incentive Policy](#) (HIP) that allows the City to use hotel revenue to incentivize new hotel development and/or upgrade existing hotels to more upscale brands. The HIP offers for a hotel rebate program for up to 50% of the costs associated with offsite/public improvements such as roadways, sidewalks, utility undergrounding, and other offsite improvements required for a new hotel in a greenfield development. During the development of the HIP, the City Council encouraged City staff to pursue full-service hotel development. The opportunity with Appellation furthers the Council's direction and provides for the development of a full-service luxury hotel brand.

Hotel MOHI Project History and Status

In 2016, Downtown Boutique Hotel developer and owner Frank Leal (Developer) received a Design Permit and a Conditional Use Permit approval from the Planning Commission for a 60-room Downtown Hotel. The approvals included a new 67,940 square foot, four-story building with restaurants, bars, retail, banquet hall, and a hotel lobby with guest rooms, services including valet parking and amenities. The Conditional Use Permit allows for an outdoor green event space, banquet rooms, and ancillary prep kitchens with one main kitchen to serve the hotel. The hotel also included a pool with an outdoor lounge area. The City Council approved the project on May 18, 2016, and construction commenced in March 2019.

In March 2020, the COVID-19 pandemic halted construction and decimated the hospitality and lodging industries. The project, which completed all underground and utility work and two floors of foundation work, became a popular pop-up restaurant while the developer pursued additional construction financing. To complete the project, the developer requested the addition of a partial fifth story to gain an additional thirteen (13) new guest rooms.

On November 15, 2022, the City Council approved a Zoning Map Amendment allowing for the additional 5th floor. As a condition of approval, the City required the developer to enter into a [Memorandum of Understanding \(MOU\)](#) to further define the parties' expectations, parameters, and project timeline moving forward, including commencement of construction and completion of the hotel rooms. To date, the conditions of the MOU have been met, and the project is back under construction. It is important to note that the hotel and restaurant project, initially budgeted to cost \$16 million in 2016, went up to \$40 million by 2022 and is now expected to cost over \$75 million. This represents an increase of over 87% in total development costs since 2022. Due to the current economic environment, the rising costs of construction, and the state of the capital markets – the subject property is at risk of meeting the levels of investment metrics required to successfully achieve full capitalization and completion of development.

Opportunity

While the construction costs have increased significantly, the developer is committed to meeting the terms of the MOU and completing the hotel rooms by December 2025. The purpose of this staff report is to present the City Council with a unique opportunity to partner with the developer to attract the investment and partnership of a hotel and restaurant brand that will elevate the Downtown hotel, increase projected TOT and Sales Tax revenue, and cement the City's place branding as a tourist destination.

For several years, the City's Economic Development team has been pursuing brands that would increase the City's profile on the culinary and hospitality front. Charlie Palmer is one of these brands. Charlie Palmer is an American chef, hospitality entrepreneur, hotelier, and author. He is best known for Aureole, his flagship restaurant in New York City, which earned 13 Michelin stars and two James Beard awards. Chef Palmer is credited with having earned over 20 Michelin stars. Charlie Palmer and Christopher Hunsberger are co-founders of Appellation Hospitality. Chef Palmer and Mr. Hunsberger started working together on their first hotel 20 years ago and, after five dozen hotels, have launched the [Appellation Hospitality brand](#), which is focused on culinary excellence with access to world-class artisans and offering an accessible luxury experience with a sense of place and community.

There is a unique opportunity to support the union of Hotel MOHI with Appellation Hospitality to upgrade the Downtown Boutique Hotel offerings with an upgrade in brand and recognition with a world-renowned chef, create a state-of-the-art restaurant in Downtown Morgan Hill, and upgrade the lodging experience. The developer has negotiated with Charlie Palmer and the Appellation Hospitality Group and has

collectively identified a unique opportunity to re-brand and upgrade Hotel MOHI to Hotel MOHI by Appellation. The new hotel development group has approached the City with the opportunity to support this project that will benefit the City in name recognition, revenue, and amenities. The project requires financial assistance in the form of a TOT and Sales Tax Sharing Agreement to support the increased costs--some of which are directly associated with the upgrade and build-out required by the Appellation Hospitality group. To evaluate the opportunity, the City engaged the services of Keyser Marston Associates, Inc. (KMA), a financial consultancy firm.

Hotel MOHI by Appellation Scope

1. An approximately 76-room boutique hotel (assumes 3 more rooms than currently designed);
2. Food and beverage service areas totaling approximately 14,000 square feet of gross building area (GBA);
3. Event space totaling approximately 11,000 square feet of GBA;
4. An approximately 2,100 square foot spa; and
5. A swimming pool and pool deck area.

Project Review

KMA was asked to identify the project financial gap, projected revenues from the upgraded hotel and restaurant, and a financial package that secured increased financial gain by the City while limiting its financial risks. KMA performed the following tasks as part of the project analysis:

1. Reviewed the development plans for the Proposed Project;
2. Prepared a comparative cost analysis for constructing the proposed development scope versus the cost associated with constructing a typical limited-service hotel;
3. Compiled market data to assist in projecting the achievable room rates; and
4. Prepared a 15-year projection of the transient occupancy tax (TOT) and sales tax revenues that could potentially be generated by the Proposed Project under current market and financial conditions.

KMA Financial Analysis

The KMA financial analysis showed that the hotel, as a limited-service hotel, has a gap of approximately \$3 million. The Hotel MOHI by Appellation shows a total project gap of approximately \$9 million. The estimated development costs of the project are \$75.75 million. These development costs include the previous investment of nearly \$20 million. The analysis assumes an increased hotel room rate from \$170 per night for a limited-service hotel to \$296 per night for the proposed luxury boutique hotel. The rates are projected to increase at a 3% average annual rate. The commercial operation of the Proposed Project assumes revenue that ranges between \$600 to \$950 per square foot of areas associated with the food and beverage, meeting and event space, and spa.

Financial Assistance

Based on those assumptions, KMA is recommending that the following assistance package be provided by the City:

1. The City's assistance to the Proposed Project will be measured in terms of the TOT

and sales tax revenues generated by the Proposed Project.

2. The City's assistance will be provided for a 15-year term, commencing in the first year of the Proposed Project's operation.

3. Before any funds are distributed to the Proposed Project, the City will receive the following share of the TOT and sales tax revenues generated by the

Proposed Project:

a. A \$282,000 base will be applied in the first year of the Proposed Project's operation; and

b. The base will be increased by 3% annually.

4. During the 15-year term, the City assistance will be structured as follows:

a. An amount equal to 100% of the TOT and sales tax revenue generated by the Proposed Project above the base level will be provided to the Proposed

Project each year until the Proposed Project has received \$6 million measured in net present value terms.

b. After the developer receives \$6 million in assistance in net present value terms, the City assistance will be reduced to 50% of the TOT and sales tax revenue generated above the base level until the end of the 15th year of the Proposed Project's operation.

5. In the event the developer defaults on any of the development scope and/or operational standards imposed by the City assistance agreement, and that default is not cured within a defined time period, the City assistance payments to the Proposed Project will terminate.

Economic Impact

The KMA analysis shows the economic benefit of partnering to secure the delivery of the Hotel MOHI by Appellation project. The benefits include:

1. Increase in TOT and Sales Tax generation;
2. A lifestyle luxury hotel that receives a rating of four stars or greater;
3. A Charlie Palmer restaurant;
4. Commercial and event spaces that are compatible with a luxury lifestyle hotel; and
5. Increased brand recognition

Ultimately, delivering a full-service hotel and high-end restaurant in Downtown Morgan Hill would be transformative for the City and business community, especially the Downtown district. In addition to the direct financial impact described above, the subject property would also directly contribute to a broader multiplier effect of economic growth in the City of Morgan Hill and elevate the City's overall appeal and reputation as a destination market. The addition of Morgan Hill's premier hotel offering and the association with Appellation Hotels and celebrated restaurateur and hotelier Charlie Palmer will undoubtedly be a defining moment for the City of Morgan Hill.

Conclusion

TOT and Sales Tax sharing agreements can help improve a project's viability. Many local jurisdictions have used these types of agreements to ensure a project is completed, and it is financially viable during its multiple-year start-up period. The City of Morgan Hill has used Sales Tax rebate programs to help attract and assist in developing several businesses, including Target, The Ford Store Morgan Hill, Honda of Morgan Hill, and Morgan Hill Chrysler Dodge, Ram & Jeep. These businesses have

ultimately exceeded the anticipated Sales Tax revenue generation and positively contributed to the City's General Fund.

The City developed a Hotel Incentive Program to support construction and upgrade of existing hotels. The opportunity to partner with Appellation Hospitality and deliver a full-service hotel is consistent with the previous direction of the City Council. The proposed financial package by KMA limits the City's financial risk while supporting a project that will be catalytic for Morgan Hill. KMA's recommended TOT and Sales Tax Sharing Agreement secures an enhanced revenue of \$82,000 annually (above the previously anticipated \$200,000) plus a 3% annual increase capped at 15 years with a reduced share of 50% split above base after \$6 million. The financial assistance package will cease if the project defaults on the development scope and/or operational standards of a four-star hotel.

Staff recommends the City Council authorize the City Manager to execute a Transient Occupancy Tax (TOT) and Sales Tax Sharing Agreement for the Hotel MOHI by Appellation project based on the attached Draft Deal Points parameters.

COMMUNITY ENGAGEMENT:

This report serves to inform the community of the proposed agreement.

ALTERNATIVE ACTIONS:

Alternatively, the City Council could decide to provide an alternative incentive or no incentive for the project.

PRIOR CITY COUNCIL AND COMMISSION ACTIONS:

In 2016, the developer received a Design Permit and a Conditional Use Permit approval from the Planning Commission for a new 60-room Downtown Hotel. The project was approved by the City Council on May 18, 2016, and construction commenced on March 2019.

In August 2022, to encourage new hotel investment and reinvestment, the City Council adopted a Hotel Incentive Strategy & Program (HIP). The intent of the HIP was to provide rebate incentives to encourage the construction of new hotel development and the rehabilitation and upgrade of existing hotels.

On December 7, 2022, the City Council adopted Ordinance No. 2339, approving a Zoning Map Amendment for a Planned Development Combining District on the site, to allow for the additional 5th floor.

FISCAL AND RESOURCE IMPACT:

The proposed TOT and Sales Tax Sharing Agreement poses no financial risks to the City and secures added revenue of \$82,000 annually above previous projections. If the project meets its financial targets, the City anticipates increasing the TOT and Sales Tax revenue from the project.

CEQA (California Environmental Quality Act):
Not a Project as a governmental fiscal activity.