Feasibility Assessment for a Master Lease Framework

KANOELEHUA INDUSTRIAL AREA PARCELS

Prepared for:

**State of Hawaii,
Department of Land and Natural Resources**

June 2015

MUNEKIYO HIRAGA

CONTENTS

K:\DATA\SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\Feasibility Assessment.docx

LIST OF FIGURES

Page

LIST OF TABLES

LIST OF APPENDICES

I. BACKGROUND AND ASSIGNMENT OVERVIEW

I. BACKGROUND AND ASSIGNMENT OVERVIEW

A. INTRODUCTION AND PURPOSE

As part of its contract for the Kanoelehua Industrial Area (KIA) project area located in Hilo, Hawaii, Munekiyo Hiraga (MH) has been requested by the State of Hawaii Department of Land and Natural Resources (DLNR) to assess the feasibility and desirability of placing management of the DLNR-owned properties within the KIA under a Master Lease for industrial, commercial, or other uses permitted by applicable zoning.

KIA is located in the urbanized region of Hilo in the vicinity of Hilo International Airport. See **Figure 1**. To the north of KIA are the Wailoa River State Park and the Waikea Pond with Downtown Hilo beyond. The Coconut Island Park is located to the east.

The State DLNR owns 79 parcels which total approximately 58.8 acres within the KIA. See **Figure 2**. Leases governing these parcels are set to expire between 2014 and 2044, with several leases operating on a month-to-month basis. In total, there are 70 leases which govern the 79 parcels owned by the DLNR (some leases cover multiple parcels). The geographic spatial relationship of the KIA parcels is presented in **Figure 2**. As shown, the State DLNR's lands at the KIA are clustered, and are not contiguous. These clusters of DLNR-owned land are distributed throughout the KIA.

The expiration of leases, many of which occur at concurrent lease termination dates presents an opportunity for the State to shift its management protocol from individual leases to a single lease managed by one (1) entity, which in turn would manage multiple tenants or sublessees. The purpose of this report is to assess the feasibility of this model of operation and the associated simplification of DLNR's oversight of State lands by allocating property management responsibility from DLNR to a managing entity.

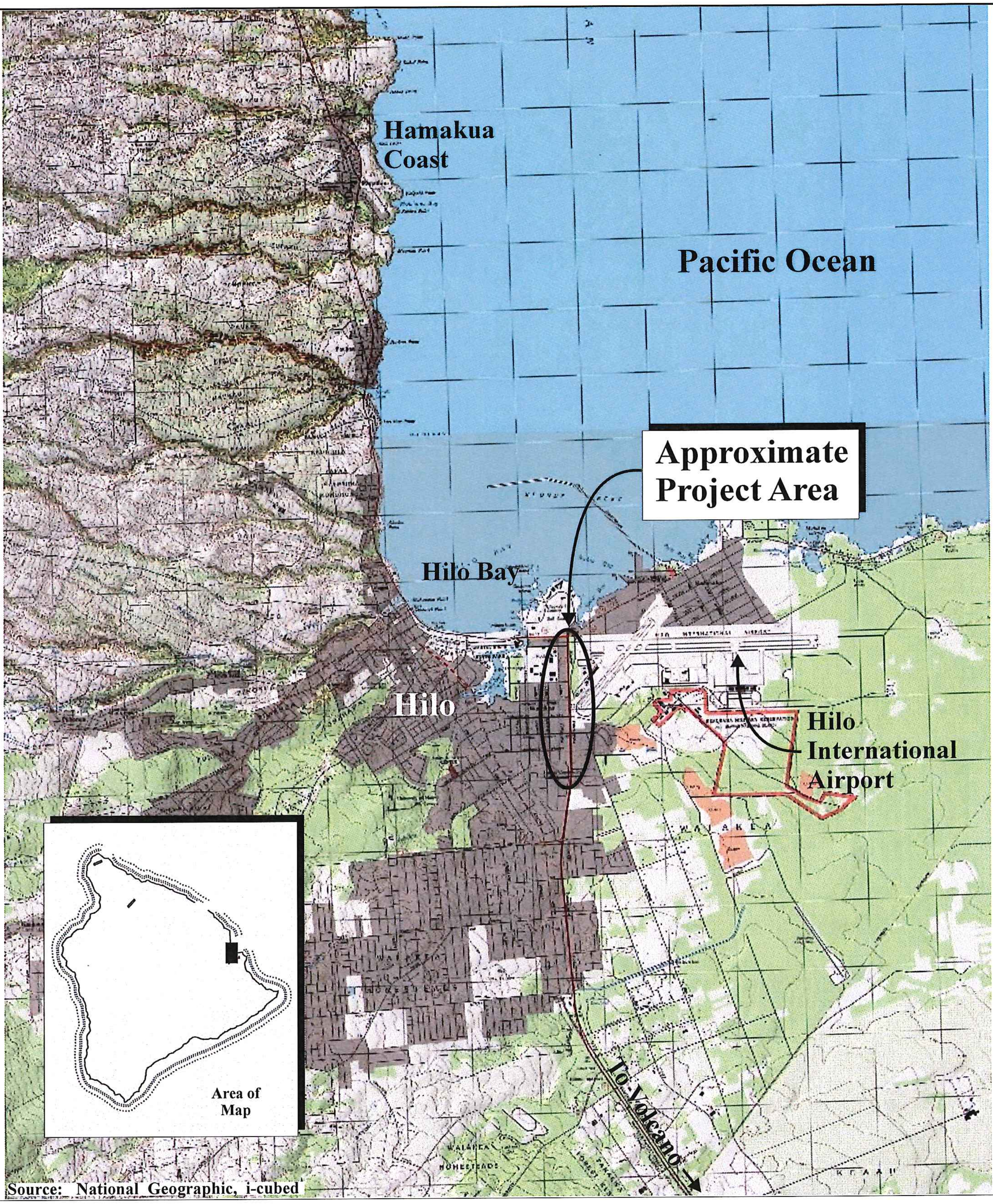
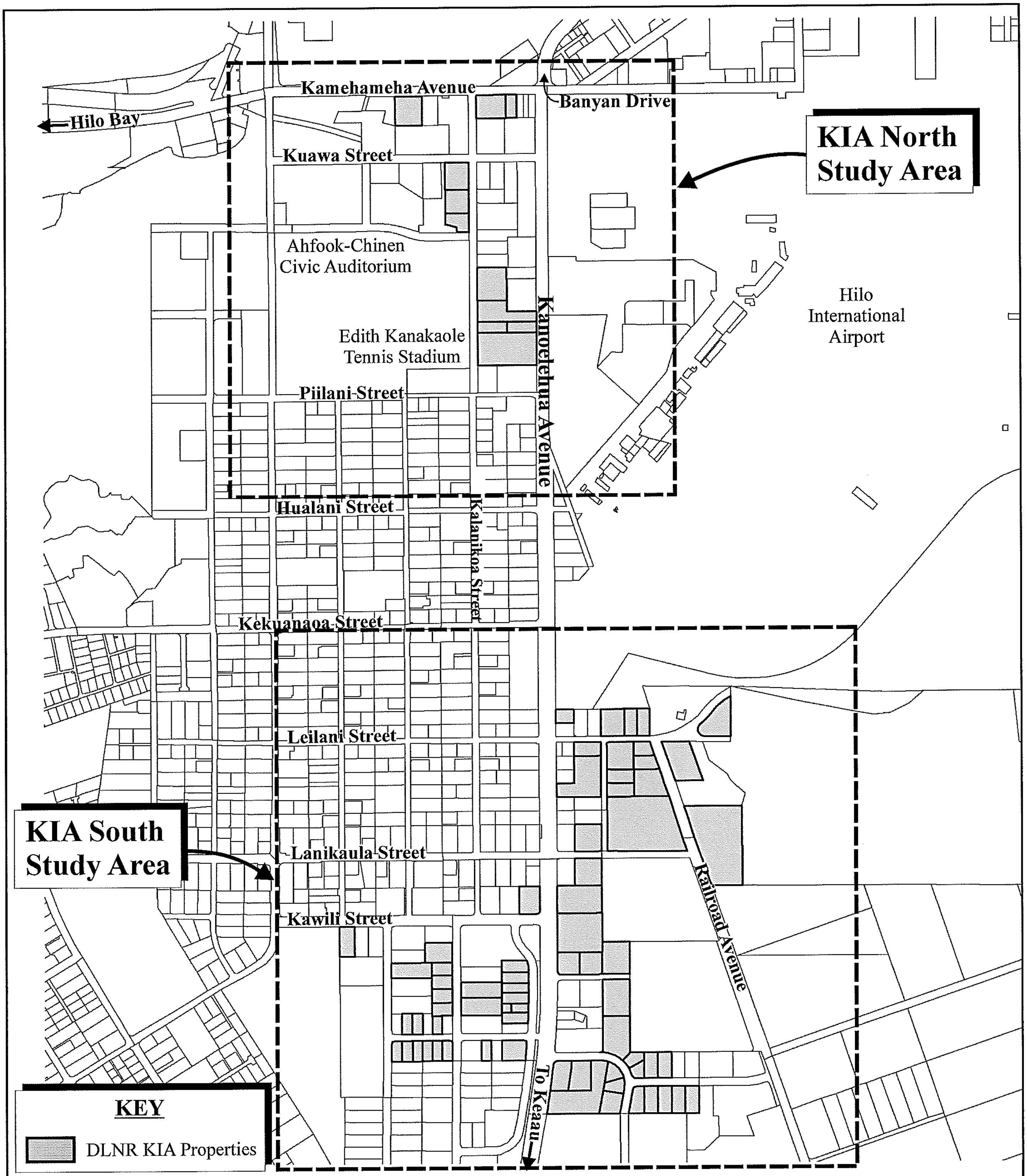


Figure 1 Kanoelehua Industrial Area
Regional Location Map

0 | 1,666.6675 | 3,333.335 | 6,666.67 Feet

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources



Source: County of Hawaii and Department of Land and Natural Resources

Figure 2 Kanoelehua Industrial Area
Overall Study Area

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\Overall Study Area ParcelsREV

Most of the DLNR leases at KIA were established pursuant to Act 4, Special Session Laws of 1960 resulting from the destruction of the Hilo Bay frontage caused by the 1960 tsunami. The water reached as far inland as Kilauea Avenue/Keawe Street through the entire Hilo downtown area and to Kekuanaoa Street near Kilauea Avenue. Act 207, Session Laws of Hawaii 2011 amends Section 171-36(b) of Hawaii Revised Statutes allowing tenants to extend or modify the lease period; provided that the aggregate of the initial term and any extension granted not exceed 65 years. Leases began expiring in 2015. There are a few leases that are on a month-to-month basis.

It is noteworthy that existing tenants of the KIA are a part of the Kanoelehua Industrial Area Association (KIAA) which consists of members who operate businesses in the KIA and surrounding industrial properties, some of which are leased from the State Department for Hawaiian Home Lands. The KIAA membership includes businesses and organizations within specific Hilo and Keaau boundaries, with the goal of advancing commercial and community interests of its member companies. DLNR's 70 lessees are eligible for membership in the KIAA which represents a total membership of approximately 350 businesses.

B. REPORT FORMAT

This report examines opportunities for establishing a Master Lease model for the DLNR's KIA properties. To provide an organized and structured presentation of analysis, findings, and recommendations, the balance of the report is prepared in the following format.

- **Chapter II. Master Lease Concept.** This chapter discusses the general management and operating parameters of a Master Lease and management options. The information provided is intended to establish a framework for understanding the opportunities and constraints associated with a Master Lease.

- **Chapter III. Assessment Criteria and Evaluation Results.** This chapter discusses decision-making factors which should be considered in determining whether a Master Lease concept would be appropriate. This includes the analysis of criteria with the specific set of circumstances presented by the 79 parcels, as well as Master Lease management options.

- **Chapter IV. Analysis and Recommendations.** This final chapter summarizes key findings and recommendations arising from the assessment.

C. OVERVIEW OF DLNR LEASES

Towards establishing context for the assessment of feasibility and desirability of placing the subject parcels under a single consolidated Master Lease, relevant parcel data and information have been reviewed and summarized in this section.

For the purpose of this analysis, the KIA has been divided into a north and south study area. See **Figure 3** and **Figure 4**.

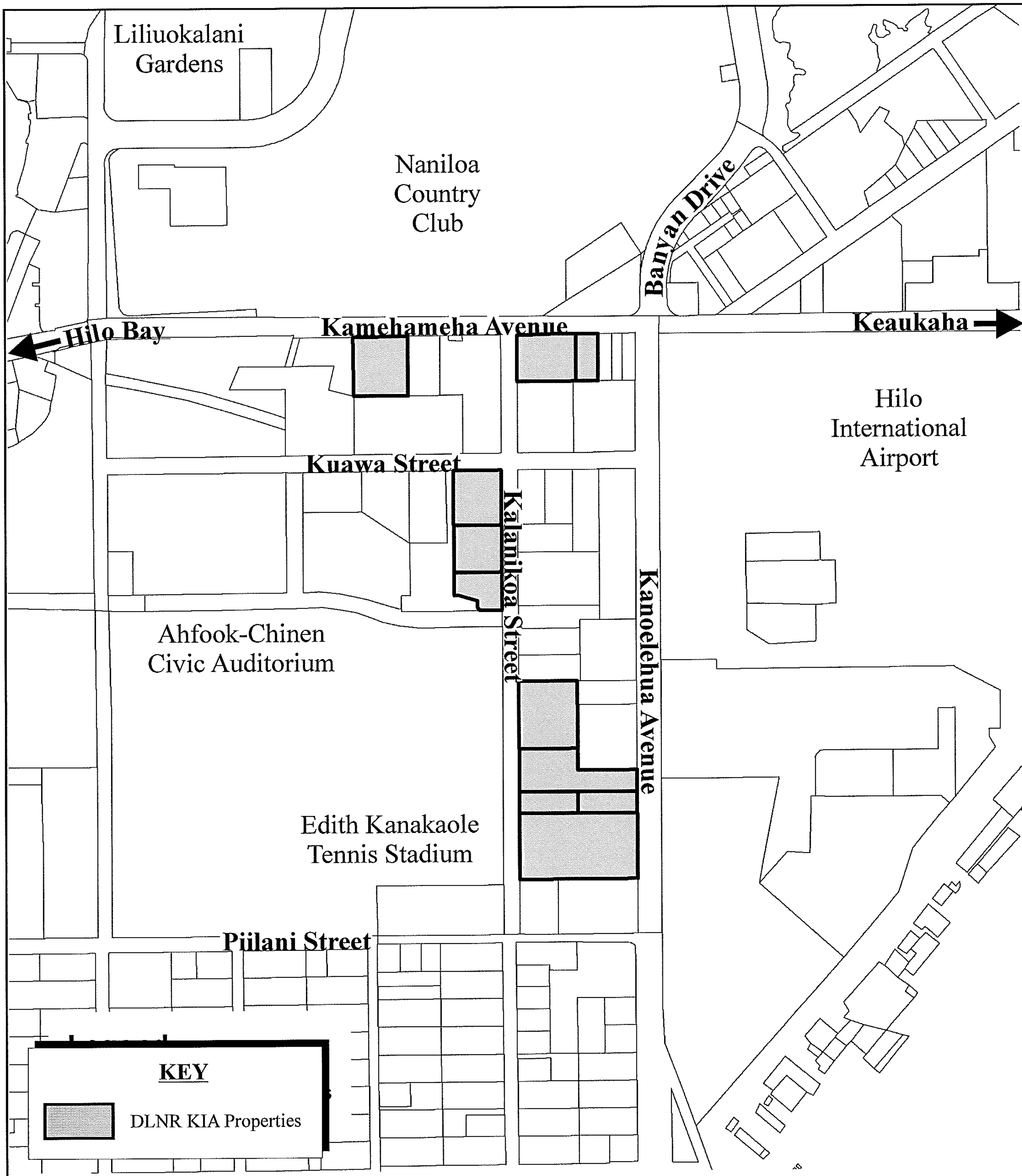
1. Existing Leases

As noted previously, the DLNR currently leases 79 parcels which are governed by 70 leases. These leases cover 58.8 acres and generate $2.1 million in annual lease revenue for the DLNR. **Table 1** presents a summary of the lease characteristics at the KIA. Leased area within the KIA range from 0.22 acre to nearly five (5) acres and average approximately 0.84 acre. The lease rates range from $8,280 per acre per year to $80,000 per acre per year, with an average rate of approximately $42,284.

Table 1. Summary of KIA Leases

DLNR Leases at Kanoelehua Industrial				
Number of Leases	70			
Number of Parcels	79			
Total Land Area (acres)	58.8			
Total Annual Lease Revenue	$2,125,989			
Lease and Property Characteristics				
	Minimum	**Maximum**	**Average**	**Median**
Lease Area (acres)	0.22	4.82	0.84	0.47
Lease Rate ($/acre/year)	$8,280	$80,000	$42,284	$43,594
Year Structure Built	1929	2005	1968	1966
Building Size (sq. ft.)	1,632	50,194	10,248	7,500
I/L Ratio[a]	0.12	6.91	1.10	0.96

[a] The "I/L Ratio" is a ratio of the assessed value of improvements (e.g., buildings) on a parcel to the assessed value of the land. An "I/L" ratio: less than 1.0 indicates that the land is more valuable than the improvements built on it.



Source: County of Hawaii and Department of Land and Natural Resources

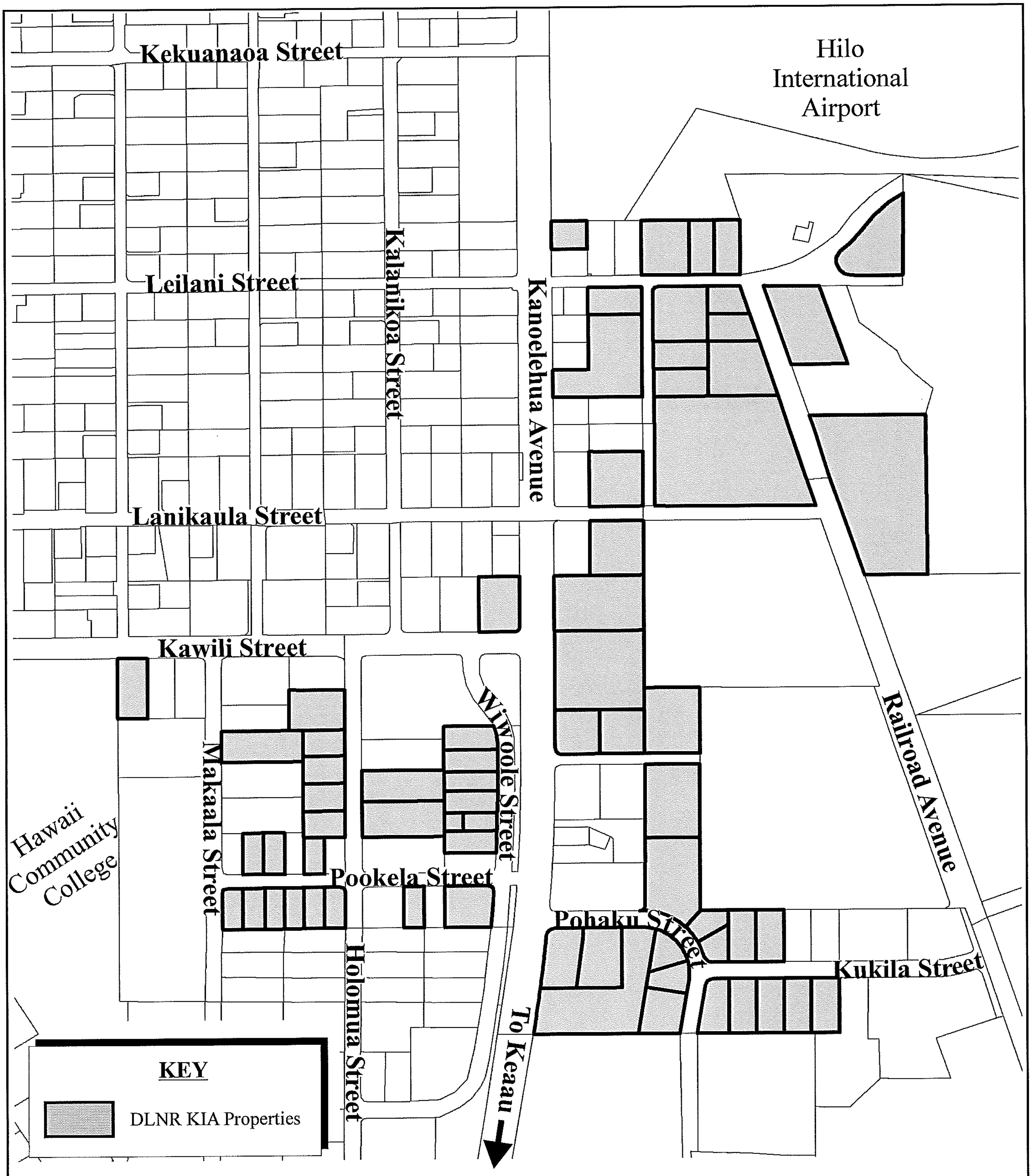
Figure 3 Kanoelehua Industrial Area
North Study Area Parcels

0 125 250 500 Feet

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\North ParcelsREV



Source: County of Hawaii and Department of Land and Natural Resources

Figure 4 Kanoelehua Industrial Area
South Study Area Parcels

0 125 250 500 Feet

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\South ParcelsREV

2. Land Use Designations

The majority of parcels are currently occupied by industrial and commercial uses, with limited office and utility uses occurring on DLNR's KIA lands. The County's Land Use Pattern Allocation Guide (LUPAG), a component of the Land Use Element of the County's General Plan, designates the lands underlying the KIA lease parcels as Industrial, Medium Density Urban, and High Density Urban. Consistent with the industrial character of the KIA, the majority of DLNR's lands in the area are zoned General Industrial and Limited Industrial. There are a few parcels zoned Neighborhood Commercial. Maps illustrating the existing land uses and land use designations are presented in **Appendix "A"**.

A description of the zoning districts underlying DLNR's KIA lands is provided below while a list of permitted uses by zoning district is presented in **Appendix "B"**.

- **Limited Industrial (ML)** – The ML district applies to areas for business and industrial uses which are generally in support of but not necessarily compatible with permissible activities and uses in other commercial districts.

- **General Industrial (MG)** – The MG district is intended for heavier industrial uses compared to the ML district. The MG district applies to areas for uses that are generally considered to be offensive or have some element of danger.

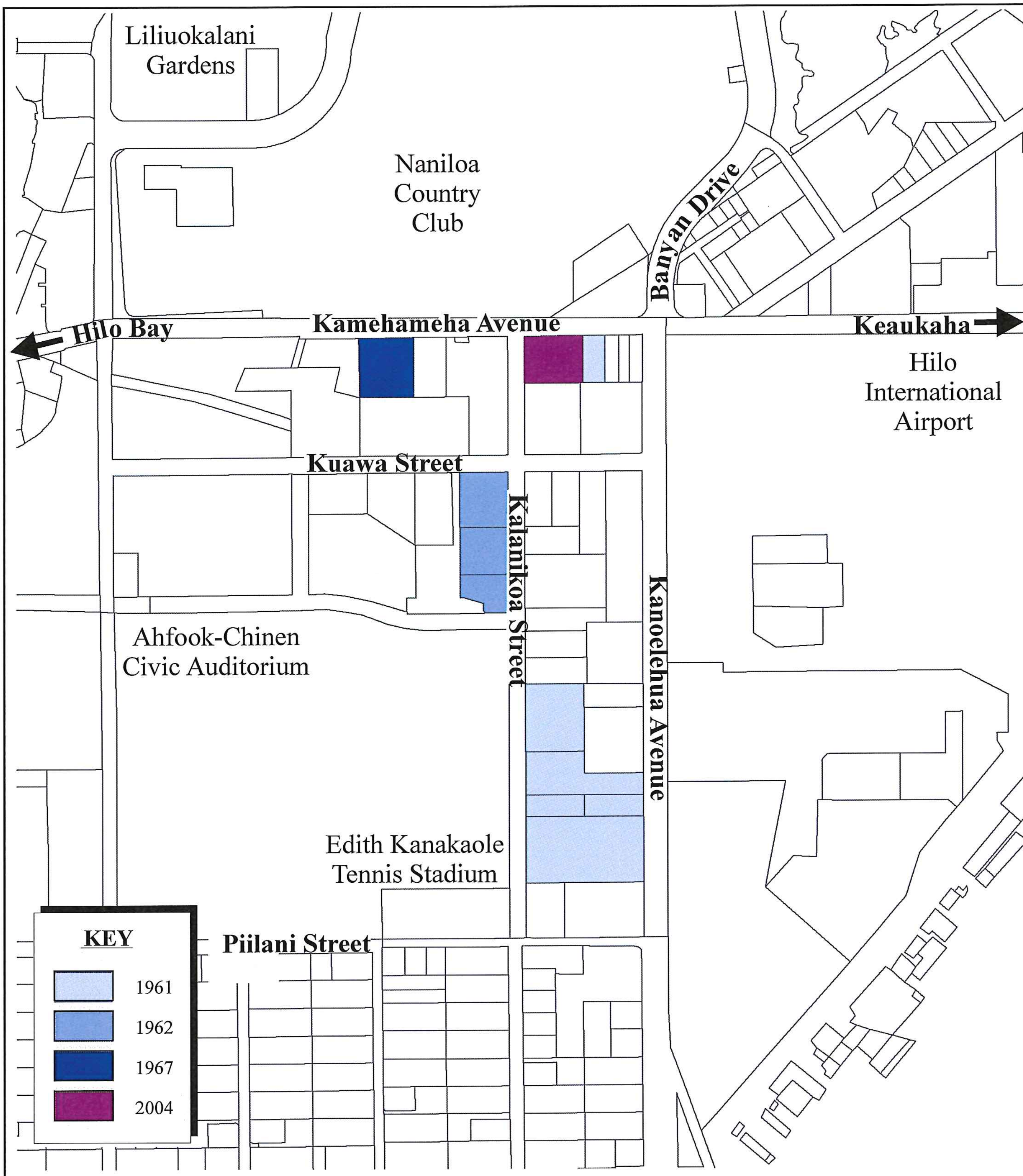
- **Neighborhood Commercial (CN)** – This zoning district applies to strategically located centers suitable for commercial activities which shall be of such size and shape as will accommodate a compact shopping center which supplies goods and services to a residential or working population on a frequent need or convenience basis. This district is distinguished from a central commercial district which provides general business and broad services to a city or region.

In general, the ML and MG districts allow for limited commercial uses such as bakeries, bars, restaurants, home improvement centers, laboratories, and storage facilities. Various manufacturing, repair, and storage uses are permitted in these zoning districts, with a greater variety of uses allowed in the MG district compared to the ML district. Examples of industrial uses allowed in both ML and MG districts include cleaning and dyeing plants, contractors' yards, food manufacturing and processing, heavy equipment sale, service and rental, publishing/printing plants, utility facilities, warehousing, and wholesaling and distribution. Heavier industrial uses only allowed on the MG district include bulk storage of flammable or explosive products, concrete or asphalt batching, freight movers, lumberyards, major repair establishments, saw mills, and automobile body and fender establishments.

It is noted that business services, commercial or personal services, offices, and general retail establishments are not permitted uses within the ML or MG districts. Only retail sales that are incidental and subordinate to permitted uses within the zoning district are allowed.

3. Duration of Lease Terms

In general, the DLNR's KIA leases have terms of 55 years, with varying lease start years and expiration dates. See **Figure 5**, **Figure 6**, **Figure 7**, and **Figure 8**. Certain leases have been extended as approved by the State Board of Land and Natural Resources, not to exceed 65 years. The earliest that leases begin to expire is in 2015. The lease with the longest duration remaining in its term expires in 2044. **Table 2** sets forth the existing leases for the subject parcels according to ascending expiration dates.

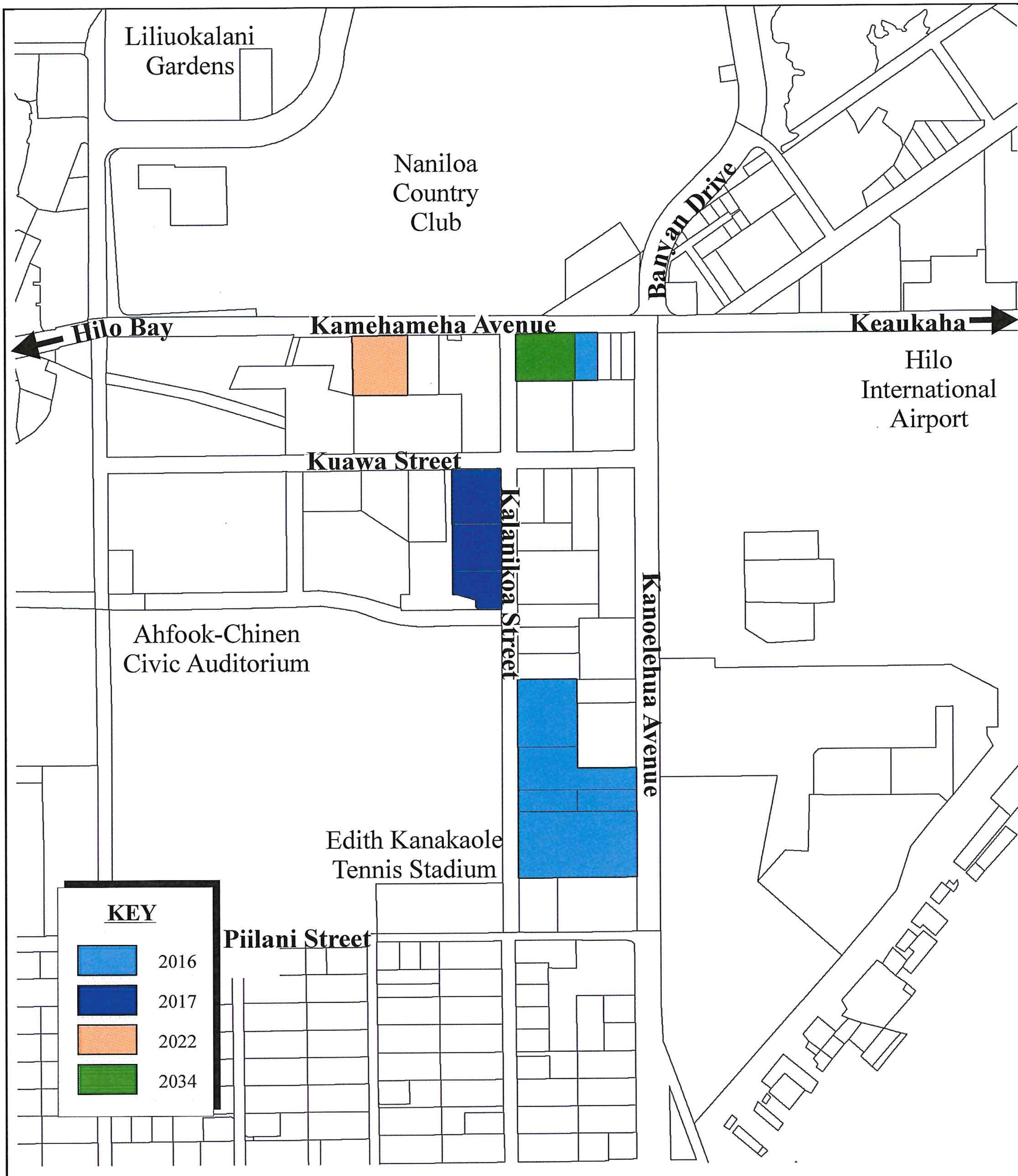


Source: County of Hawaii and Department of Land and Natural Resources

Figure 5 Kanoelehua Industrial Area
North Study Area Lease Start Year

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources



Source: County of Hawaii and Department of Land and Natural Resources

Figure 6 Kanoelehua Industrial Area

North Study Area

Lease Expiration Year

0 125 250 500 Feet

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\North LeaseEndREV

Source: County of Hawaii and Department of Land and Natural Resources

Figure 7 Kanoelehua Industrial Area

South Study Area Lease Start Year

0 125 250 500 Feet

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\South\South LeaseStartREV

Source: County of Hawaii and Department of Land and Natural Resources

Figure 8 Kanoelehua Industrial Area

South Study Area
Lease Expiration Year

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

Table 2. Lease Expiration

Expiration Year	Number of Leases	Cumulative	
		Number of Leases	% of Total
Month to Month	4	4	5.7%
2015	1	5	7.1%
2016	22	27	38.6%
2017	3	30	42.9%
2018	2	32	45.7%
2020	1	33	47.1%
2021	2	35	50.0%
2022	1	36	51.4%
2023	1	37	52.9%
2024	1	38	54.3%
2025	11	49	70.0%
2026	7	56	80.0%
2027	1	57	81.4%
2030	2	59	84.3%
2032	1	60	85.7%
2034	1	61	87.1%
2035	8	69	98.6%
2044	1	70	100.0%
Grand Total	**70**	**70**	**100.0%**

As shown above, the leases are set to expire over a 30 year period, with a large number of leases coming due in certain years. The largest number of leases are set to expire in 2016 with 22 leases terminating that year. Cumulatively, 27 leases, or 39 percent, will expire by 2016. Another 11 leases will expire in 2025. By 2025, 49 leases, or 70 percent of DLNR's leases in the area will expire. A total of 21 leases will expire after 2025.

4. Lease Revenue

As previously noted, DLNR collects approximately $2.1 million in lease revenue for the 70 leases within the KIA annually. The lease rates range from $8,280 per acre per year to $80,000 per acre per year, with an average rate of approximately $42,284. **Table 3** presents the sum of the annual rent for the leases by expiration year. As shown, the leases that currently operate on a month-to-month basis generate $35,520 in annual rent. The leases which expire by 2016, collectively generate $583,270 in total rent. From a revenue generation standpoint, the leases that are set to expire by 2016 represent 27 percent of the rent generated by the KIA leases. Leases expiring by 2025 comprise 66 percent of the total rent collected by DLNR in the area.

Table 3. Annual Lease Rent Revenue by Expiration Year

Expiration Year	Sum of Annual Rent	Cumulative	
		Sum of Annual Rent	**% of Total**
Month to Month	$35,520	$35,520	1.7%
2015	$16,100	$51,620	2.4%
2016	$531,650	$583,270	27.4%
2017	$160,280	$743,550	35.0%
2018	$61,650	$805,200	37.9%
2020	$19,200	$824,400	38.8%
2021	$57,200	$881,600	41.5%
2022	$29,640	$911,240	42.9%
2023	$10,960	$922,200	43.4%
2024	80,000	1,002,200	47.1%
2025	$390,070	$1,392,270	65.5%
2026	$192,120	$1,584,390	74.5%
2027	$14,280	$1,598,670	75.2%
2030	$171,625	$1,770,295	83.3%
2032	$16,000	$1,786,295	84.0%
2034	$28,534	$1,814,829	85.4%
2035	$291,360	$2,106,189	99.1%
2044	$19,800	$2,125,989	100.0%
TOTAL	**$2,125,989**	**$2,125,989**	**100.0%**

II. MASTER LEASE CONCEPT

II. MASTER LEASE CONCEPT

A. MASTER LEASE CONCEPT

The Master Lease concept is intended to simplify the management of public lands by allocating responsibility and authority of land and property management from the State of Hawaii to a third party, approved by the State Department of Land and Natural Resources (DLNR). For example, shifting management responsibility to a Master Lessee allows DLNR to allocate its staff and resources to other department needs. The Master Lease would contain all provisions required to protect the State's interest in the lands that would fall within the Master Lease. A similar model in the private sector is the use of a property management company to handle the affairs of a condominium homeowners association. The DLNR has employed this model for the Sand Island Industrial Park.

B. MASTER LEASE AUTHORITY

The Master Lease, prepared and executed in accordance with Chapter 171, Hawaii Revised Statutes (HRS) relating to the Management and Disposition of Public Lands, would address the roles and responsibilities of the parties to the Master Lease. Pursuant to Section 171-14, all dispositions of public lands shall be made at public auction after appropriate public notice.

Under the anticipated terms of a Master Lease, the lessor would be the State DLNR with the lessee taking the form of a managing entity (e.g. association).

C. GENERAL TERMS OF A MASTER LEASE

The Master Lease shifts the responsibilities of property management from DLNR to a third party entity. Terms of the Master Lease would conform to Chapter 171, HRS and shall address conditions of use, rent, improvements to be made, as well as identify restrictions and reservations to be held by the DLNR.

The Master Lease would also specify the lessee's overall management responsibilities of tenants (sublessees) under the Master Lease. Such responsibilities could include, but not be limited to, those described in **Table 4**.

Table 4. Master Lessee Responsibilities

Responsibility	Comments
Provision and maintenance of improvements to common areas to ensure the safe and functional use of all parcels falling under the Master Lease	The master lessee would be responsible for providing upkeep for those areas of the properties deemed to be "common" or shared areas providing benefits to all tenants. This responsibility is intended to ensure safe, functional, and code-compliant conditions for all areas deemed to be shared and in the common interest.
Payment of Lease Rent	The master lessee shall be solely responsible for payment of rents under the terms set forth in the Master Lease. In this regard, the master lessee, shall establish a management and accounting framework for collecting rents from each tenant or sublessee.
Collection and Management of Assessments	The master lessee shall be responsible for establishing and implementing a tenant assessment program which involves the collection from each tenant, fees for administration, common area improvements, debt financing (as applicable), and any other fees and assessments required to maintain the fiscal integrity of the master lessee and, therefore, the ability of the master lessee to meet its obligations under the Master Lease.
Establishment of Rules and Regulations Governing Tenant Responsibilities and Obligations	The rules and regulations would bind each tenant or sublessee to comply with the terms and conditions set forth in the rules and regulations to ensure that the master lessee will meet its obligations under the Master Lease. Such terms and conditions, for example, may address: • tenant rent or assessment payment delinquencies • tenant violations of a sublease agreement • tenants responsibility to maintain their respective properties in a clean, safe, and habitable condition.
Managing the Transfer of Tenants	The master lessee, in coordination and with approval of the lessor, shall be responsible for managing transfer of sublessees, in the event there is a change in tenant.
Overall Management Responsibilities	The master lessee shall be responsible for the overall management of its tenants and their respective subleased properties. In this regard, the master lessee shall have the authority to select and contract with vendors to provide services, such as garbage collection, common area landscape maintenance, insurance, and accounting.

While the list of responsibilities provided in **Table 4** may not be exhaustive, it is indicative of the role and authority anticipated to be granted to the master lessee, in order to ensure that the State's interest in the affected parcels are appropriately preserved and protected.

D. MASTER LEASE OPTIONS

This section discusses the Master Lease concept and its various operating considerations which may be applicable to the State's Kanoelehua Industrial Area (KIA) parcels.

1. The Association or Sand Island Business Association Model

For purposes of discussion of the Master Lease concept, the Association Model is characterized as a non-profit organization incorporated under Hawaii State law and registered with the State of Hawaii, Department of Commerce and Consumer Affairs. Membership of the incorporated Association consists of all eligible lessees of the State owned DLNR parcels within the KIA. The governance of such an organization would be in accordance with its corporate documents (e.g. Articles of Incorporation, Bylaws). The goal of such organizations is to provide value to members in the form of service or benefit (e.g. representation, advocacy, management activities). The act of incorporating creates a legal entity that is authorized to take action in a number of ways, including but not limited to:

- Purchase or lease, hold and improve real property
- Sell, mortgage, or lease any part of its real property
- Make contracts and secure a mortgage of any of its property
- Conduct its activities and locate offices
- Hire employees and agents of the corporation, define their duties and fix their compensation
- Impose dues and assessments upon its members
- Establish conditions for membership admission
- Carry on a business
- Do all things necessary or convenient that is not inconsistent with the law, to further the activities and affairs of the corporation

The corporation exists perpetually until there is an action to dissolve and terminate it pursuant to HRS Section 414D-52.

A Master Lease under this model offers DLNR the opportunity to establish a new non-profit Association with a membership that is limited to the tenants on the State-owned parcels in the KIA. The incorporation of an Association may be structured for the sole purpose of establishing an entity that is authorized with the power to enter into a Master Lease agreement with DLNR and undertake actions in order to meet its responsibilities under the Master Lease. To the extent the Association is a non-profit organization, its authorities, formation, and corporate governance are guided by HRS Section 414D-52.

The roles and responsibilities of the parties will be established according to the terms of the Master Lease, including but not limited to, those described in **Table 4**. The parties to the Master Lease would be the State of Hawaii, DLNR as lessor and the new association which is membership based and conducts its business via its board of directors. The business association will serve as a property managing entity over the State owned parcels in KIA.

This Model allows an Association to enter into a Master Lease agreement with the State DLNR. An example of this Model is found in the Sand Island Business Association (SIBA), a non-profit entity which is currently in a Master Lease arrangement with DLNR. The SIBA was incorporated in 1989 for the purpose of negotiating and entering into a Master Lease agreement with the State DLNR, in order to manage the Sand Island Industrial Park leases. The SIBA Model includes 91 members and 111 leased lots, with some tenants holding multiple leased lots. Staffing to support the SIBA started with one (1) person. Currently, the SIBA operations is supported by two (2) personnel and includes a position responsible for bookkeeping and property management and an Executive Director position responsible for administrative functions, including attendance at the SIBA's Board of Directors meetings. SIBA's current expenses include the cost of staffing, outsourcing for certain functions, as needed (e.g., accounting services), real property tax for the lot upon which the staff office is located, landscape maintenance, insurance and security service. SIBA operations are supported solely by monthly assessments collected from tenants in the form of a management fee. Under the SIBA Master Lease arrangement, tenants are responsible to pay for trash pickup, utilities, and maintenance on their respective lots. In terms of infrastructure in the Sand Island Subdivision, roads, landscaping, and sidewalks are intended to remain under private (i.e., non-dedicated) ownership for the purpose of having security services provided by the SIBA.

2. Other Lease Management Considerations

While the Association Model is viewed as the appropriate mechanism for framing a Master Lease arrangement for KIA, other management options may also be considered. These options are not viewed as advantageous as they do not provide a management framework nor State oversight capacity desired for management of the KIA parcels.

a. Third Party Vendor Model

The Third Party Vendor model is not a Master Lease concept but is noted here as it is an option that shifts responsibilities for property management of commercial leases via a contract to a third party vendor. In this contract arrangement, the third party vendor agrees to be responsible for managing the leases on behalf of the lessor. This model involves the procurement of services by the lessor State DLNR, by entering into an agreement with a commercial property management company pursuant to the terms of a contract. The roles and responsibilities of the services provided by a commercial property management company would include, but not be limited to, those described in **Table 5.**

Table 5. Third Party Vendor Responsibilities

Responsibility	Comments
Collection and Management of Lease Rent	The vendor establishes a management and accounting framework for collecting rents from each tenant or sublessees. The rental amount collected includes amounts to manage the maintenance of common areas. The vendor shall be solely responsible for transmitting the rent collected in accordance with the terms of its management contract. Vendor's fee for service is paid for by the lessor (State DLNR).
Managing the Transfer of Tenants	The vendor assists the State DLNR with lease renewals or marketing the property for new tenants.
Management Responsibilities	Vendor responsibility is governed by the contract with the State DLNR. Generally, vendor responsibility covers the collection and management of Lease Rent and management of the leases on behalf of the lessor State DLNR.
Operational Functions (e.g. trash, maintenance)	While vendor's responsibility is to collect fees from lessees to cover operational costs, the vendor may not desire to assume the responsibility entering into these contract for services in which case the lessor (State DLNR) or lease tenants are responsible for executing these contracts.

An assessment of the Third Party Vendor Model is provided in Chapter IV of this report.

b. **KIAA Collaboration Model**

As noted, there is an existing non-profit Association for the KIA. The Kanoelehua Industrial Area Association (KIAA) was established in 1968 and membership includes the business entities that lease parcels from DLNR and non-State owned parcels within the KIA. According to the KIAA website, the goal of the organization is to advance commercial and community interests of the membership. The KIAA is a membership based non-profit organization and the board of directors are elected and conduct its business on behalf of its membership via regular meetings. Management of the 79 State-owned parcels may be considered via a collaborative operating agreement with the KIAA. While there have been no discussions with the KIAA on this approach, it is noted herein because the KIAA is an existing non-profit membership based organization which may be viewed as a vehicle for master leasing purposes. An assessment of this option is provided in Chapter IV of this report.

III. ASSESSMENT CRITERIA AND EVALUATION RESULTS

III. ASSESSMENT CRITERIA AND EVALUATION RESULTS

As noted previously, the purpose of this report is to assess the feasibility and desirability of placing the management of the 79 subject parcels under a Master Lease for uses permitted by applicable zoning. To establish a logic and method for undertaking the assessment, the following assessment criteria have been formulated.

- Do uses covered by the Master Lease provide value warranting a Master Lease framework?
- What are the perceived risks and benefits to a potential master lessee and its tenants?
- What are the operational tradeoffs with the Master Lease concept?
- What are the implementation considerations associated with establishing a Master Lease framework?

A. DO USES TO BE COVERED BY THE MASTER LEASE PROVIDE VALUE WARRANTING A MASTER LEASE FRAMEWORK?

The Kanoelehua Industrial Area (KIA) parcels are currently occupied by a variety of industrial and commercial uses, with more limited office and utility uses. As previously noted, the parcels are primarily zoned by the County of Hawaii for limited industrial and general industrial uses with a few parcels classified within the neighborhood commercial zone. The highest and best use of the lands is generally defined by the parameters established by zoning.

Each existing State lease specifies a particular use (e.g., commercial, transportation, body and fender repair, retail, automotive supply). For the highest and best use of the parcels, in the future, the State leases may contain general provisions that would allow for all uses permitted by zoning, rather than restricting the lots to particular uses.

The uses permitted by zoning enable a broad range and mix of possible future tenants, within a framework of commercial and industrial uses as a foundation. Given this context, the management of the KIA properties under a master lease appears advantageous, when compared to a more diverse range of uses (e.g., resort, residential) which may involve varying management objectives making the master lease option more difficult from an operational standpoint.

B. **WHAT ARE THE PERCEIVED RISKS AND BENEFITS TO A POTENTIAL MASTER LEASE AND ITS TENANTS**

The appeal of the Master Lease concept to potential tenants and a potential master lessee is anticipated to be based on risks and benefits associated with this model. From a potential master lessee and/or tenant's standpoint, considerations and issues, likely to arise are summarized in **Table 6.**

Table 6. The Master Lease Model – Tenant/Master Lessee Considerations

Issues/Considerations	Risk or Benefit	Master Lessee or Tenant Concern	Comments Regarding KIA Applicability
Identifiable common areas to be managed	Benefit	Tenant	The 79 parcels are separate parcels with some contiguous parcels. Each tenant is responsible for improvements, repairs, and maintenance of their respective parcels. There currently does not appear to be identifiable KIA common areas for which tenants share repair and maintenance responsibilities.
Obligations and risks in the event of payment default by a tenant.	Risk	Master Lessee and Tenant	The operations of the master lessee shall be funded by assessments paid by each tenant or sublessees. As the number of tenants to be covered by the Master Lease involves 79 parcels, the nonpayment of assessments by one or more of the tenants may not adversely affect the financial capacity of the master lessee to conduct its business when compared to a Master Lease arrangement with a fewer number of tenants.
Incremental costs of subleasing through a master lessee	Risk	Tenant	This issue/consideration relates to the perceived and real benefits of working through a master lessee as opposed to entering into a direct lease with the State. If added costs are anticipated via the Master Lease model, such added costs may affect overall lease rents and assessments. However, having 79 parcels in the Master Lease, allows added costs to be distributed and shared among a greater number of tenants.

Issues/Considerations	Risk or Benefit	Master Lessee or Tenant Concern	Comments Regarding KIA Applicability
Sufficient economies of scale	Benefit	Master Lessee and Tenant	The 79 parcels to be managed will form the basis for the management oversight by the master lessee. As the management oversight includes operational expenses for the master lessee, the question is one of economies of scale as it relates to the master lessee's cost of assuming management responsibilities and cost to the tenants. Lease rent and assessments based on 80 parcels appears to provide sufficient economies of scale that appeals to the master lessee and tenants.
Consolidation of Operational Functions (e.g., security, maintenance, insurance, improvements)	Benefit	Tenant	Under a Master Lease, the management of selected operational functions would be consolidated as a responsibility of the master lessee. Such functions may include, but not be limited to, trash collection, insurance coverage, and off-site infrastructure (e.g. roads, sidewalk, utilities) improvements.

C. WHAT ARE THE OPERATIONAL TRADEOFFS WITH THE MASTER LEASE MODEL?

This question considers the value created under a Master Lease model versus that provided by a traditional general lease model that is utilized in the existing leasing arrangement of the State-owned parcels.

The risk-benefit considerations described in Section III.B, and the management and oversight of 79 parcels via a Master Lease, suggest there are advantages of this model over individual leases. Refer to **Table 6**. Identified common interests (e.g., security and infrastructure) are typically assumed by an Association, with the tenants having shared responsibility via monthly assessments.

Consolidation of operational functions via the Master Lease may also provide opportunities to negotiate and contract for services that is a cost benefit to the tenants due to the economies of scale based on a sufficient number of parcels. The economies of scale presented by the potential revenues generated by 79 parcel leases allows operational costs to be shared among the tenant/members under a Master Lease. Under the Master Lease model, added cost can be spread among many tenants and equality of that distribution can be achieved by calculating assessments based on lot size. Recurring costs such as for refuse service, insurance coverage, and landscape maintenance can be recovered by the master lessee via monthly assessments on tenants. Non-recurring expenses such as specific capital improvement projects (e.g., off-site road, utilities) can be recovered via special assessments paid by tenants. What is perceived as a risk to the tenant due to a few tenants bearing financial obligations, turns into a benefit when the tenant base increases to a sufficient number of leases that generate revenues and assessments.

There is a perceived risk that if the number of tenants or leases is not sufficient to generate funding to support the Association, the Master Lease obligations will be difficult to fulfill. As a corollary, when the tenant and lease numbers are sufficient to generate revenues, the risk turns into a benefit as pro-rata assessments is the Association's mechanism to equitably distribute the expenses on its members. Under these circumstances, the Association is in a position to manage the risk from tenant default of payments and continue servicing the greater tenant group as an overall benefit to its members.

From a benefit standpoint, the number of tenants covered by a Kanoelehua Industrial Master Lease, is a mechanism that provides a financial advantage to the master lessee in the form of organizational and management stability. As a corollary, the advantage also works in the favor of a group of tenants as the Master Lease may serve as a vehicle to create a stronger organizational "voice". This may be an advantage, for example, in negotiating off-site issues affecting the Kanoelehua Industrial properties. This organizational or advocacy strength provides tenant representation on issues such as those relating to improving roadway conditions or utility infrastructure improvements.

The context for a Kanoelehua Industrial Master Lease, suggests advantages similar, for example, to what may be observed in the Sand Island Industrial Park Master Lease which covers a total of 111 separate parcels. The economies of scale created by the 79 parcels in KIA suggest there is incentive for the creation of a master leasing association entity given the risk-benefit considerations described herein.

D. WHAT ARE THE IMPLEMENTATION CONSIDERATIONS ASSOCIATED WITH ESTABLISHING A MASTER LEASE FRAMEWORK?

1. Non-Contiguous Area

As previously noted, the 79 parcels are clustered in a non-contiguous pattern and are distributed throughout KIA. Implementing the Master Lease via an

Association may be perceived as easier if the 79 State-owned parcels were contiguous. For example, in the context of infrastructure improvements, having contiguous parcels may offer a better advantage for the Master Lessee to negotiate off-site improvements (e.g., roads, sidewalks, landscaping) and the associated costs. The non-contiguous parcel groupings may not have a common shared interest in terms of improvements needed. Even assuming that shared interests may not be the same for each non-contiguous tenant group, the Master Lease is a feasible and desirable mechanism due to the overall value it provides to the State, the Master Lessee, and tenants. See Section III. C.

2. <u>Lease Expiration Distributed Over 30-Year Period</u>

Leases for the 79 parcels expire over an approximately 30-year period, and the opportunity for a new lease for the Master Lease will arise as each lease terminates. As noted previously, by 2016 approximately 39 percent of the leases are up for new leases, with approximately 70 percent expiring by 2025. Determining the point in time that the Association is a viable entity turns on the economies of scale. In other words, when is the number of tenants adequate to govern via the Association's Board of Directors? And at what point are the revenues generated from the leases under the Master Lease sufficient to financially sustain the Association's operations? These are considerations that go to the basis of decision making as to the options for implementing the Association Model as discussed in Section IV.C.

3. <u>Lot Consolidation</u>

Separate from this Master Lease assessment, the State DLNR is requesting determination of the potential for consolidating the existing parcels. While the DLNR's property within the KIA is not contiguous, there are clusters of parcels located adjacent to each other. Many of these parcels are smaller, averaging less than one (1) acre in size. Lot consolidation may be advantageous to the DLNR and prospective tenants as it would allow for more flexibility and efficiency in site planning, as well as the development of larger buildings. The greater development opportunities afforded by lot consolidation could result in higher rent revenue and assessments potential for the lands.

As noted earlier, there are currently 79 parcels governed by 70 leases within the KIA. Does lot consolidation impact the feasibility and implementation of a Master Lease framework? In otherwords, are there economies of scale to consider? A lot consolidation effort may reduce the number of parcels, and as a result, the number of sub-lessees or tenants, within the governing association. From the financial standpoint, lot consolidation may not significantly reduce revenues, as revenues are based on lot size. A lot consolidation does not reduce or add to the existing total square footage under the ownership of the State.

The lot consolidation analysis identified 17 potential opportunities for parcels to be consolidated into larger lots. It is noted, however, that there are various factors that influence whether the lots will actually be consolidated, including tenant needs and market conditions. There are also various ways in which the lot consolidation can be implemented. DLNR could take the initiative to consolidate the parcels prior to putting them out to lease. Alternatively, provisions could be written into the lease to allow tenants to go through the process of consolidating parcels if they so desire.

IV. ANALYSIS AND RECOMMENDATIONS

IV. ANALYSIS AND RECOMMENDATIONS

A. APPROPRIATENESS OF THE MASTER LEASE CONCEPT

The objective of this assignment is to assess the feasibility and desirability of placing management of the subject 79 parcels under a Master Lease from the State of Hawaii for commercial, industrial or other uses permitted by applicable zoning.

The key element which drives decision-making on the question of Master Lease feasibility and desirability is one of economies of scale. Economies of scale presents cost advantages that is derived from the number of leases that generate revenues. The benefit to tenants is derived from the distribution of costs (e.g., operational and capital improvement) over a sufficient number of tenants.

The Master Lease model would ultimately consolidate the management of 70 leases to a single responsible entity. The subject parcels have a shared and common interest in being supported by services via the consolidation of operation functions described in **Table 6**. The services are supported through revenues collected from tenants under the Master Lease. The sharing of costs by many tenants means that the operations and programs can be sustained by the Association which is a benefit to the master lessee. Another benefit is that the model allows the master lessee to coordinate and negotiate capital improvements on behalf of the tenants, including but not limited to obtaining a loan to finance such improvements. The economies of scale presents cost advantages to pay for the improvements, as the capital cost is shared by a greater number of tenants, rather than a few in the form of a special assessment. This model makes improvements more affordable and desirable, in that the unit cost per tenant decreases with a sufficient number of leases. Overall operational and capital costs are subject to economies of scale, a benefit to both the master lessee and 70 tenants.

The decision to utilize the Master Lease model should be based on the following considerations: (1) is there sufficient incentive for a master leasing entity to be organized; and (2) will such a model limit tenant interest in the subject parcels (when compared to the traditional general lease model). Included in the decision making process are considerations as to what is involved in the process of implementing the Master Lease model over time as well as DLNR's assessment of cost savings and management efficiency by allocating property management responsibility of State-owned lands to an Association.

B. THE MASTER LEASE MODEL

1. The Preferred Scenario

Chapter II addressed the operational parameters of the Master Lease concept, including that of the Association or Sand Island Business Association (SIBA) Model. Under this concept, a non-profit organization is established and would enter into a Master Lease agreement with the State Department of Land and Natural Resources (DLNR). The Association would sub-lease the DLNR-owned parcels and serve as a property managing entity for these lands.

The Association Model is viewed as an appropriate mechanism for framing the Master Lease agreement for Kanoelehua Industrial Area (KIA). As previously noted, this option involves a non-profit organization for the purpose of organizing a membership of tenants for a common and shared goal. In this model, the shared goal is to establish a property management mechanism to ensure the safe and functional use of all parcels through the establishment of rules under the Master Lease as well as the responsibility of the master lessee in the delivery of basic services to the tenants (e.g. garbage collection). The Association Model assumes a direct management agreement between a non-profit entity and the State DLNR.

In order for the State DLNR to enter into a Master Lease agreement with a new entity, a non-profit association would need to be incorporated. The eligible members of the new entity would be limited to the lessees on the State-owned 79 parcels in the KIA.

The sole purpose of the incorporation of the new Association would be to manage the subject parcels via a Master Lease agreement with the State DLNR. This Master Lease model sees that responsibilities go towards a single entity to manage DLNR's tenants. The new entity represents the interests of these similarly situated tenants and assumes the responsibility of property management. The process of shifting the property management responsibility to the non-profit entity involves action on the part of Association members and board of directors to negotiate and enter into a Master Lease based on a common interest that is focused on the State-owned parcels (i.e., tenants share operational costs for trash, maintenance improvements, tenants benefit from economies of scale). Refer to **Table 6**.

Should in the future, there be a need for Association improvements (i.e, infrastructure or other "common area" improvements) the Association can obtain development loans and assess its members to satisfy the loan amounts to the extent provided by its Articles of Incorporation and Bylaws. Consolidating the operational services for 70 leases and having a single Association manage the State owned parcels, offers a practical method of advancing the Association's objectives.

As the representative of the 70 tenants, the new entity may also collaborate with the existing KIAA in order to create greater opportunities for improving the KIA for both the State lessees and other tenants who conduct business in the area.

2. Other Management Scenarios

While the Association Model is considered appropriate for the State's Kanoelehua parcels, other options were examined to ensure that a full range of management considerations were addressed as part of the master lease feasibility process. This section discusses two (2) other options which were assessed, the "Third Party Vendor Model" and the "KIAA Collaboration Model".

a. Third Party Vendor Model

This model serves as a vehicle for the State DLNR to shift some management responsibilities of the leases to a third party vendor. In this concept, the State DLNR remains the owner/lessor of its parcels and the management of its leases is contracted to a third party vendor such as a commercial real property management company. The vendor primarily acts on behalf of the property owner to monitor leases, collect lease rent, renew leases, and market leases. Refer to **Table 5**.

There is no representative acting on behalf of the interests of the tenants, and each tenant represents their own interests via the direct lease agreements with the State DLNR. From the tenant's perspective, the third party vendor model maintains the status quo, as each tenant will represent their respective, individual interests, with no advantage of collective advocacy. As such, from the perspective of the tenants, this may be a less desirable option.

In this scenario, the State DLNR would negotiate a fee for service by the third party out of the revenues generated from the leases. Commercial management companies do not have the mechanism to levy direct assessments against the tenants, and payment for property management services would be the responsibility of the State DLNR.

b. **KIAA Collaboration Model**

The Kanoelehua Industrial Area Association (KIAA) has 350 members, including the 70 tenants of the State-owned parcels. The stated goal of KIAA is to advance the business and community interests of its membership in the form of business advocacy, health plans, scholarships, and community events.

Though there is an existing KIAA, the organization does not appear to currently include a property management function or have authority to implement a Master Lease concept. Should such function exist as part of KIAA's organizational structure, the question is whether it is feasible and desirable that the KIAA enter into a Master Lease arrangement and assume a property management responsibility for the subject State DLNR owned parcels.

While there may be value to the State DLNR to enter into a Master Lease with an already existing entity such as the KIAA, the separation of governance responsibilities and management objectives would potentially be disadvantageous to the State's interests. As the KIAA membership and board of directors represents the entire KIAA, the interest and goals of the State-owned parcels would be subject to an existing governance system that includes lessees of all 350 parcels. The Master Lease would place responsibility and risk on the KIAA which may not be perceived as desirable by the entirety of the organization and its members. In order for this model to be implemented, the KIAA membership and board of directors would need to take action to extend its organization's purpose and responsibility to negotiate and enter into a Master Lease with the State DLNR for the subject parcels. Refer to **Table 6**.

In this alternative, KIAA actions under the Master Lease would be subject to the decision-making of the KIAA membership and its board of directors. While the State leases represent only a portion of the total KIAA membership, the KIAA board of directors may not include a representative member from the group of State DLNR tenants. As such, the desires of the greater KIAA membership, having the greater "voice" may not align with the desires of the State DLNR and this may result in management actions which may not benefit State tenants.

Economies of scale may translate into affordability for improvements (e.g., offsite infrastructure), in that the Association may seek capital improvement loans and assess the entire KIAA membership to satisfy the loan amounts. In the event of any future need for off-site improvements to serve the KIA, economies of scale may produce benefits that may be perceived as weighing either in favor of the KIAA or the state tenants. The benefit derived is in the form of cost sharing for improvements via assessments levied on the entire general membership of 350 members, versus a group of 70 members. Membership perception as to whether the distribution of cost benefits their respective interests, will be influenced by whether the improvements are viewed as serving their property.

Again, while collaboration opportunities with the KIAA may be useful, from a management standpoint, consideration of this option would also involve establishment of a separate financial management and auditing processes to ensure distinct fund allocation and utilization policies for the State-leased parcels only. While such a financial management framework may be implementable, from the State's standpoint, accountability would be better achieved through an entity solely responsible for managing State-leased parcels under a Master Lease arrangement.

C. IMPLEMENTATION OPTIONS FOR A MASTER LEASE FRAMEWORK UNDER THE ASSOCIATION MODEL

The process of implementing the Master Lease option with a new Association involves an assessment of several factors. Most notably, the expiration dates of existing leases play an important role in determining when leases can be renewed, and terms and conditions related to the Master Lease framework can be instituted. As leases are set to expire over an approximately 30 year period, the membership in a new Association would not be complete until all leases have expired in 2044 and new leases are negotiated.

For the new entity to become fully functional, having a critical mass of membership is key towards implementing the Master Lease and sustaining the new Association. This critical mass is achieved when revenues provide a sufficient base for an Association to draw upon for its operational expenses and having an adequate number of tenants that is perceived as sufficient to govern an Association. In other words, the critical mass may be viewed as a stage that an entity can viably function and conduct its business.

Identifying what is needed for an Association to operate forms the basis for developing a budget, and it is the budget which influences the level of tenant assessments. The SIBA model serves as an example. Current operational costs for the SIBA fluctuates from $80,000 to $100,000 per month and its budget includes costs for personnel, outsourcing contracts for service, landscape maintenance, insurance, security service, and real property tax for the SIBA office. It is noted that the lease rent revenues do not contribute towards the SIBA assessment amounts received from tenants, pursuant to the terms of the Master Lease agreement. As such, the SIBA assesses tenants at a rate of $0.05 per square foot (sq. ft.) based on lot size. Assessments are expected to fully support the operational costs of the SIBA. The SIBA model is viewed as desirable in that revenues to support the Association's operations is entirely drawn from separate assessments levied on the lots. In this Model, all rent revenues generated by the leases benefits and is directed to the State. Allowing the funding of the Association's operation via the sharing of rent revenues by the Association and State is a management option, though is not viewed as advantageous to the State.

The discussion that follows illustrates factors that influence the implementation of the Master Lease Framework. The factors include assessments that may be collected from tenants and the operating expenses of the Association in order to perform its responsibilities.

1. Association Revenue via Assessments

Table 7 illustrates the range of assessment rates that lessees would pay. Three (3) scenarios are presented based on a low ($0.0075/sq. ft./mo.), medium ($0.01/sq. ft./mo.), and high ($0.02/sq. ft./mo.) assessment rate. As shown in **Table 7**, the average tenant leases 0.84 acre, or 36,590 square feet. This average tenant would pay a monthly assessment between $274 under a low rate to $731 per month under a high rate. Annually, this would translate to a total assessment for the average tenant ranging from $3,292 under a low rate to $8,777 under a high rate.

Table 7. Range of Assessment Rates (Based on SIBA Model)

	Minimum	Maximum	Average	Median
Lease Area (acres)	0.22	4.82	0.84	0.47
Lease Area (sq. ft.)	9,757	210,090	36,572	20,321
Monthly Assessment				
$0.0075/ft./mo.	$73	$1,576	$274	$152
$0.01/sq. ft./mo.	$98	$2,101	$366	$203
$0.02/sq. ft./mo.	$195	$4,202	$731	$406
Annual Assessment				
$0.0075/ft./mo.	$878	$18,908	$3,292	$1,829
$0.01/sq. ft./mo.	$1,171	$25,211	$4,389	$2,438
$0.02/sq. ft./mo.	$2,342	$50,422	$8,777	$4,877

Table 8 illustrates potential assessment revenue based on leases that have expired by a particular year for the three (3) scenarios. The analysis assumes that assessments are only collected by the Association for leases that have already expired by that particular year for example. This is because it is assumed that the expired leases would be re-negotiated under the master lease model and the terms of the lease would include payment of an assessment by the tenant to the Association. Leases that have not yet expired would continue to operate under existing lease terms with the State DLNR and do not provide requirements for payment of an assessment as these tenants are not members of the Association. As such, assessment revenue would not be collected from leases that have not yet expired as renegotiation to include these tenants in the Association has not occurred. To illustrate the analysis presented in **Table 8**, the potential assessment revenue in 2016 is discussed. By 2016, leases covering 796,886 sq. ft. will have expired. Assuming that all 796,886 sq. ft. are negotiated to bring these tenants under a Master Lease framework, assessments on this land would generate between $71,220 ($0.0075/sq. ft./mo.) and $191,253 ($0.02/sq. ft./mo.) annually in revenue for the Association.

Table 8. Potential Association Assessment Revenue[a]

Estimate of Potential Assessment Revenue			Annual Revenue ($0.0075 / sq. ft. / mo.)		Annual Revenue ($0.01 / sq. ft. / mo.)		Annual Revenue ($0.02 / sq. ft. / mo.)	
	Leased Area (Sq. ft.)	Cumulative Sq. Ft.	Total	Cumulative	Total	Cumulative	Total	Cumulative
Month to Month	48,395	48,395	$4,356	$4,356	$5,807	$5,807	$11,615	$11,615
2015	14,418	62,813	$1,298	$5,653	$1,730	$7,538	$3,460	$15,075
2016	734,073	796,886	$66,067	$71,720	$88,089	$95,626	$176,177	$191,253
2017	138,390	935,276	$12,455	$84,175	$16,607	$112,233	$33,214	$224,466
2018	106,243	1,041,519	$9,562	$93,737	$12,749	$124,982	$25,498	$249,965
2020	13,242	1,054,761	$1,192	$94,929	$1,589	$126,571	$3,178	$253,143
2021	70,001	1,124,762	$6,300	$101,229	$8,400	$134,971	$16,800	$269,943
2022	43,037	1,167,799	$3,873	$105,102	$5,164	$140,136	$10,329	$280,272
2023	20,647	1,188,447	$1,858	$106,960	$2,478	$142,614	$4,955	$285,227
2024	111,731	1,300,178	$10,056	$117,016	$13,408	$156,021	$26,816	$312,043
2025	445,924	1,746,102	$40,133	$157,149	$53,511	$209,532	$107,022	$419,065
2026	176,070	1,922,172	$15,846	$172,995	$21,128	$230,661	$42,257	$461,321
2027	17,990	1,940,162	$1,619	$174,615	$2,159	$232,819	$4,318	$465,639
2030	251,211	2,191,372	$22,609	$197,224	$30,145	$262,965	$60,291	$525,929
2032	38,986	2,230,359	$3,509	$200,732	$4,678	$267,643	$9,357	$535,286
2034	35,284	2,265,642	$3,176	$203,908	$4,234	$271,877	$8,468	$543,754
2035	280,831	2,546,473	$25,275	$229,183	$33,700	$305,577	$67,400	$611,154
2044	13,591	2,560,064	$1,223	$230,406	$1,631	$307,208	$3,262	$614,415
Grand Total	**2,560,064**	**2,560,064**	**$230,406**	**$230,406**	**$307,208**	**$307,208**	**$614,415**	**$614,415**

[a] 2015 dollars

To remain competitive within the industrial market, the level of assessments levied on tenants of DLNR properties must be compared against the benefits provided by the master lessee to the tenant. Tenants will assess the value provided by the master lessee, such as consolidated security services or better trash collection service rates negotiated by the Association, against the cost. If the perceived benefit provided by the Association is less than the added cost of the assessments, DLNR may also need to consider partially offsetting the lease rate to subsidize the assessment. This balancing act is necessary to ensure that the master lease framework and the associated assessment does not inadvertently create a competitive disadvantage for DLNR properties. From DLNR's perspective, any partial reduction in lease rates to offset a portion of the assessment, if necessary, would need to be weighed against the management efficiencies provided to the department by transferring property management responsibilities from the department to the master lessee.

2. Association Operating Expenses

To be functional, an entity would be expected to establish systems to perform property management duties and to meet its responsibility under the Master Lease. The Association would either hire staff or contract with a commercial property management vendor. The SIBA currently has two (2) staff positions. The SIBA administrator is an Executive Director who performs a range of day to day operational activities, including implementing organization decisions made by the Association's Board of Directors. The Executive Director is hired by the Board of Directors. Support staff includes a position responsible for bookkeeping and property management and is hired by the Executive Director.

For discussion purposes only, the budget to support an Association's operations assumes a staff of two (2) personnel and operational expenses that include outsourcing (e.g., accountant, insurance, security, etc.), and real property tax. **Table 9** is an illustration of an Association Budget.

Table 9. Illustration of Association Budget

		Annual Expenses
Association Staff	Executive Director	*$84,500 ($65,000 salary)
	Book Keeper/Property Management	*$45,500 ($35,000 salary)
Association Office	Lease Rent CAM Fees	**$15,225
	Miscellaneous Office Expenses (supplies, equipment)	$5,000
Outsourcing	Accountant (tax preparation)	$10,000
	Total	**$160,225**

* Salary plus 30% fringe benefits. Note that the salary for non-profit Executive Directors may vary widely ($40,000 to over $100,000).

** Assumes an average commercial rent ($20/sq. ft./annual) in Hilo and Common Area Maintenance (CAM) expenses ($1.75/sq. ft./annual) based on a 700 square foot office. CAM expenses are negotiable and may include expenses for repairs, insurance, property maintenance, real property tax and utilities.

3. Implementation Options

The analysis presented above illustrates that an Association would require assessment revenue of approximately $160,000 per year to fund operations (refer to **Table 9**). Based on the assessment rate of $0.0075 per square foot per month, annual assessment revenue would not exceed $160,000 until 2026. An assessment rate of $0.01 per square foot per month, generates an annual assessment revenue that would not exceed $160,000 until 2025. An assessment rate of $0.02 per square foot per month, generates an annual assessment revenue that would not exceed $160,000 until 2016 (refer to **Table 8**). It is noted that by 2016, a sufficient amount of leases have expired and can be negotiated to include these tenants under a Master Lease Framework (refer to **Table 2**). As mentioned earlier, the budget of $160,000 is presented as a sample budget for discussion purposes only. The Association's budget can be established to be higher or lower, depending on organization staffing and operational needs. For example, the initial annual budget of the Association may be lowered if staffing requirements can be reduced to manage the smaller initial membership base. Furthermore, the budget could be scaled up or down as the Association's membership profile and needs change. Regardless of what the Association's budgetary requirements are, it is assumed that the revenue generated by the monthly assessments would need to reach a certain threshold in order to fully fund the Association's operations. Assuming a decision to implement the Master Lease Framework in 2016, an initial assessment of $0.02 per square foot per month, would enable the Association to become fully funded. This monthly assessment can be reviewed in the future to determine if the assessment amount can be reduced based on the anticipated increase in Association membership.

Based on the Association's illustrated budgetary requirements and projected assessment revenue, there are three (3) options to implement the Master Lease framework, as discussed below.

a. **<u>State Initiatives Formation of Association</u>**

The first Master Lease implementation option involves the State DLNR initiating the formation of an Association. Through 2015, a total of five (5) leases would be available for Master Lease consideration. Refer to **Table 2**. From a budgetary standpoint, implementing the Master Lease framework with an initial membership in the Association of five (5) tenant members may not be sufficient to govern the organization. For these years, the State DLNR may consider options for its involvement as discussed in this Section, until such time the tenant membership grows to a number that is perceived as adequate to govern the Association.

As the incorporator of the new entity, the State DLNR designates the initial board of directors, of which a minimum of three (3) directors is required (Hawaii Revised Statutes (HRS) Section 414D-133). State DLNR would establish a new corporation by preparing the required incorporation documents and filing these with the State of Hawaii, Department of Commerce and Consumer Affairs. The organizational structure allows the State DLNR to make decisions and act on behalf of the new business entity, during the initial startup period. During the initial phase, the DLNR would manage the new leases, until the membership of the new entity reaches a critical mass in order for the Master Lease to be negotiated and executed. The parties negotiating the Master Lease would be the State DLNR and the new association.

As there are varying expiration dates, inclusion of new members into the association is expected to occur in phases. As existing leases expire, new leases will be issued making the tenants eligible for membership in the newly formed association. **Table 2** shows that 27 leases, or 39 percent of the leases, will expire by 2016 and 32 leases, or 46 percent of the existing leases, will expire in 2018.

By 2016, the number of new members suggests there is a critical mass for the organization at this stage. Subsequently, from 2018 to 2026 the new membership significantly increases and begins reaching 80 percent of the total DLNR leases at KIA.

As the critical mass needed to operate in terms of membership is likely to be achieved by 2016, the new membership can install its board of directors via the process provided in its corporate documents. With a board of directors, the State DLNR would begin negotiating a Master Lease with the new entity in lieu of direct leases as provided by State law, HRS Section 171-141(a)(5).

During the time of membership growth, the State DLNR may consider retaining one (1) seat on the board of directors and its membership for a period of time and relinquish its seat and membership once the Master Leasing entity is deemed to be fully functional and operational. The following **Table 10** illustrates a process for the implementation of the Master Lease:

Table 10. Illustrative Implementation Timeline

2015-2017	30 leases expire; State DLNR issues new leases with provisions that these leases will be included in a Master Lease and lessees are eligible for membership upon the incorporation of the new association. The leases should include a provision that addresses the assessment levied on new lessees upon membership in the new association
2017	State DLNR establishes a new association via the preparation of incorporation documents (e.g. Articles of Incorporation, Bylaws) and files documents with the State Department of Commerce and Consumer Affairs. State DLNR designates initial board directors and is a member of the new association. The three (3) leases that expire in 2017 become eligible members of the new entity. The new association hires staff or contracts a vendor to meet the requirements of the Master Lease. State DLNR initiates negotiations with the new entity to enter into a Master Lease.
2018	Master leasing entity functional
2018-2026	24 leases expire and new members represents 80 percent of the projected total membership.
2027-2044	The remaining 14 leases expire.

Again, the foregoing timeline is illustrative only, and is intended to provide a generalized framework for defining progressive and reasonable milestones for implementation.

As membership in the Master Leasing entities grows, annual revenues will increase and assessments can be stabilized or reduced over time. As illustrated in **Table 8**, the revenues generated with membership growth will likely create revenue stream in excess of the funding needs of the non-profit Master Lessee. Adjustments in assessment, depending on annual budgets and capital reserve requirement will be made over time to ensure that income requirements are in line with the entity's non-profit objectives.

b. Alternative Funding Source for Association's Initial Years of Operation

Achieving a membership that is sufficient to support the operations of the Association is not expected to occur until 2016. Implementing sooner than 2016 requires identification of an alternate funding source. Though not perceived as desirable, an alternative source to initially support the Association's operations may be drawn from a portion of the revenues generated by the leases that fall under the Master Lease. This, however, would be undesirable for DLNR, as it would reduce the amount of lease revenue that is flowing to the Department to support its programs. It is noted that current lease provisions at KIA stipulate that lease rates be redetermined every ten (10) years and as a result, lease rates can lag market rates towards the end of the ten-year periods. Thus, when DLNR negotiates new leases, it is likely that the new lease rates will be higher, when they are adjusted to market rate, and the revenue flowing to the State will be increased. Thus, the higher lease revenue from the new negotiated leases under the Master Lease may allow for a portion of the revenue to partially fund the Association until a sufficient membership level is reached and still allow DLNR to collect the same amount of lease rent or more from the properties.

As previously noted, a funding source for the Association's operation budget that depends entirely on assessments levied on the tenants is the SIBA model. As the SIBA does not draw from the lease revenues, tenant assessments are a separate expense and in addition to the base lease rent. It is noted that the SIBA initially funded its operational costs by securing a loan and requiring its tenants to contribute towards satisfying the loan via monthly assessments. Securing a loan to fund Association operational costs is another alternative funding source that could supplement assessment revenue in the early years.

c. **<u>Renegotiating Existing Leases Ahead of Current Expiration Date</u>**

To ensure a full range of management considerations, this section discusses an option which may have limitations or constraints due to factors, such as the willingness or ability of parties to agree to enter into negotiations for new lease terms prior to the expiration of existing lease agreements.

While the assessments may support the Association's operations by 2016, there may be a perception that it is more desirable to have a larger membership base (rather than 27 tenants) for purposes of governing the Association. There may be opportunity to create a more robust critical mass in terms of membership base in the initial years that leases are expiring. This option involves the State DLNR entering into negotiations with all tenants for the existing leases for the purpose of seeking an agreement that would bring as many of the existing 70 leases under the

Master Lease, sooner than the current expiration date. The Association benefits from the creation of the critical mass, as this generates lease revenues and assessments sooner, allowing the Master Lease model to be implemented.

While renegotiating existing leases to increase the membership of the Association may be seen as beneficial to the Association to achieve a critical mass, there are considerations for both the State and tenants that may make this scenario less desirable, as both parties would need to be willing to negotiate new lease agreement terms. From the State's standpoint, renegotiating an existing lease results with DLNR continuing to lease to the current tenant. If DLNR is interested in changing the character of use at a given property, it may be more difficult to negotiate these terms in a new lease with the existing tenant. On the other hand, if the DLNR were to wait until the leases expire, this allows an opportunity for competitive bidding by anyone interested in a lease on terms which the State is seeking (e.g. changing the property use). The State would be able to enter into a lease on different terms with the highest bidder, who may or may not be the current tenant at the property.

From the tenant's perspective, renegotiating the lease may be perceived as creating an opportunity for the DLNR to increase the lease rate. As mentioned previously, the current lease terms at KIA provide that lease rates are redetermined every ten (10) years. The tenant would need to feel that there is a benefit to entering into negotiations with DLNR that could offset or outweigh the possibility of an increase in lease rent. Tenants may perceive there is an incentive to renegotiate their leases if there is an opportunity to extend their current lease expiration date on terms that are deemed favorable to them. For example, this opportunity to lock in rates for a longer duration than is provided in their lease may be an incentive to tenants. Note that without legislative amendment, current law allows for lease extension and modifications such that the aggregate of the initial term and any extension granted not exceed 65 years. Extending leases beyond this may require amendments to current legislation governing the leases.

Beyond extension of lease term, potential benefits to tenants may include:

- The opportunity to consolidate parcels for higher tenant use (e.g., site development, buildings)

- Infrastructure improvements (e.g., offsite roads, utilities, landscaping) coordinated by an Association

- Consolidating services (e.g., trash collection, insurance, maintenance) and managing by an Association

As previously noted, the renegotiation of leases prior to the current expiration date may be advantageous for the formation and stability of the Association, but there may be challenges and limitations from the perspective of DLNR and tenants.

V. CONCLUSION

V. CONCLUSION

The State's leases at Kanoelehua Industrial Area (KIA) expire over a 30-year period, allowing Department of Land and Natural Resources (DLNR) to consider implementing a Master Lease Model to manage the State-owned parcels. The expiration of leases, which begins in 2015, presents an opportunity for DLNR to shift its management protocol from individual leases to a single lease managed by one (1) entity. The Master Lease Model simplifies the management of State lands by allocating the responsibility of property management from DLNR to a managing Association. The Master Lease would contain provisions that protect the State's interest in lands that are within the agreement.

The discussion of different management scenarios in Section IV.B of this report suggests that a Master Lease agreement via the creation of a new entity based on The Sand Island Business Association (SIBA) Model is the most appropriate mechanism for the KIA. Incorporating a new non-profit organization to serve as the property managing entity over State-owned KIA parcels, results in a legal entity that has the authority to enter into a Master Lease agreement with DLNR and to act in order to meet its responsibilities under the agreement. The purpose of the new Association would be to manage the State-owned parcels via a Master Lease agreement with the State DLNR. Under this scenario, DLNR may gain management efficiency by shifting the responsibilities of property management from the department to the new entity.

As discussed in Section III of this report, the appeal and value to the Master Lessee and tenants created by the Master Lease suggest advantages of the Master Lease model over the traditional general lease model. An advantage to tenants is that costs for services (e.g., security) are spread amongst members, as the Association assumes the responsibility for contracting for such services for the benefit of all the State tenants. Consolidating operational functions for services such as trash collection, may provide the Association an opportunity to negotiate contract for services, that result in a more economical cost than if each tenant negotiated on their own for services. Additionally, the Master Lease Model positions the Association to manage risk from tenant default of payments and continue service to its tenants.

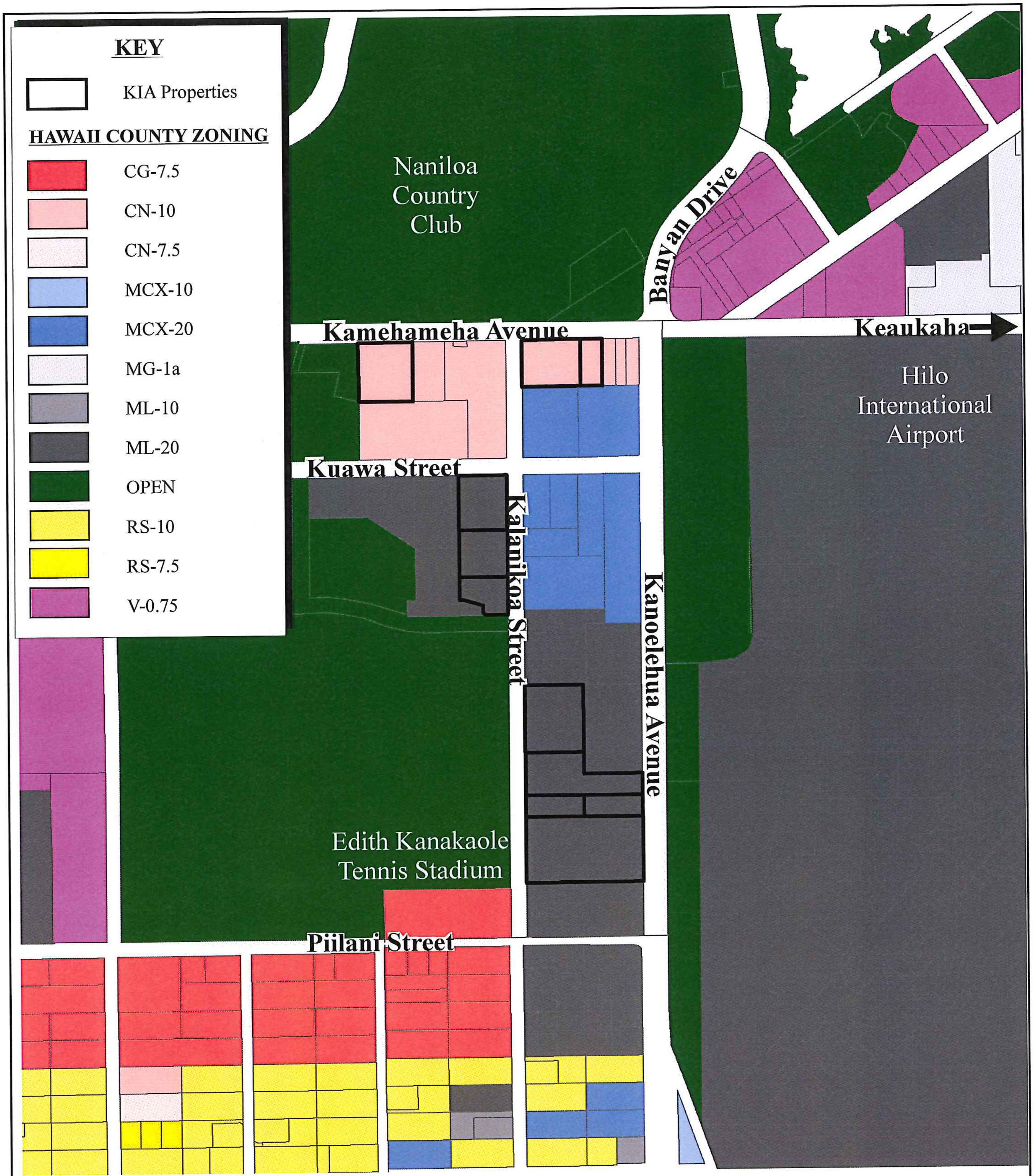
Implementation of the Master Lease under the Association Model involves factors such as the progressive expiration of leases as presented in **Table 2** of this report. As leases terminate, there is the opportunity for State tenants to become members in the new Association as new leases can be negotiated based on a Master Lease framework. As previously noted, the largest number of leases expire in 2016. Cumulatively, 39 percent (27 leases) of the leases will expire in that year. As State tenants are included as members in the new Association, membership grows towards a critical mass that is perceived to be sufficient for the governance of the new Association via its board of directors. As a corollary, the growth in membership sets a financial foundation in the form of an increasing revenue stream that is derived from assessments levied on new members. A revenue stream that supports the operations of an Association is an important factor in order for the entity to perform and meet its responsibilities under a Master Lease agreement. The new Association's ability to sustain its operations financially depends on the generation of revenues that supports the entity's budget. Additionally, having critical mass based on membership is a factor in considering the options for implementing the Master Lease framework to determine when a new Association can be incorporated in order for the State to begin negotiations with the new entity. For purposes of defining reasonable milestones based on a progressive growth of membership due to expiring leases, **Table 10** illustrates an implementation timeline.

As discussed in Section C.1., there are options for State involvement in the new Association as a method for implementation and may involve the State's creation of the new non-profit, as well as participation in the entity's governance via the board of directors until the critical mass for membership is achieved for governance and financial stability. During this implementation period, membership will grow, the revenue stream will increase, and assessments can be stabilized, and adjusted to be in line with the Association's objectives.

DLNR's decision to implement a Master Lease option involves analyzing and weighing the economic effects on KIA tenants (e.g., assessments) relative to DLNR's cost-savings and management efficiency opportunities for the agency by allocating property management responsibilities of State owned lands to an Association.

APPENDIX A.

Maps of Kanoelehua Industrial Area Existing Uses and Land Use Designations

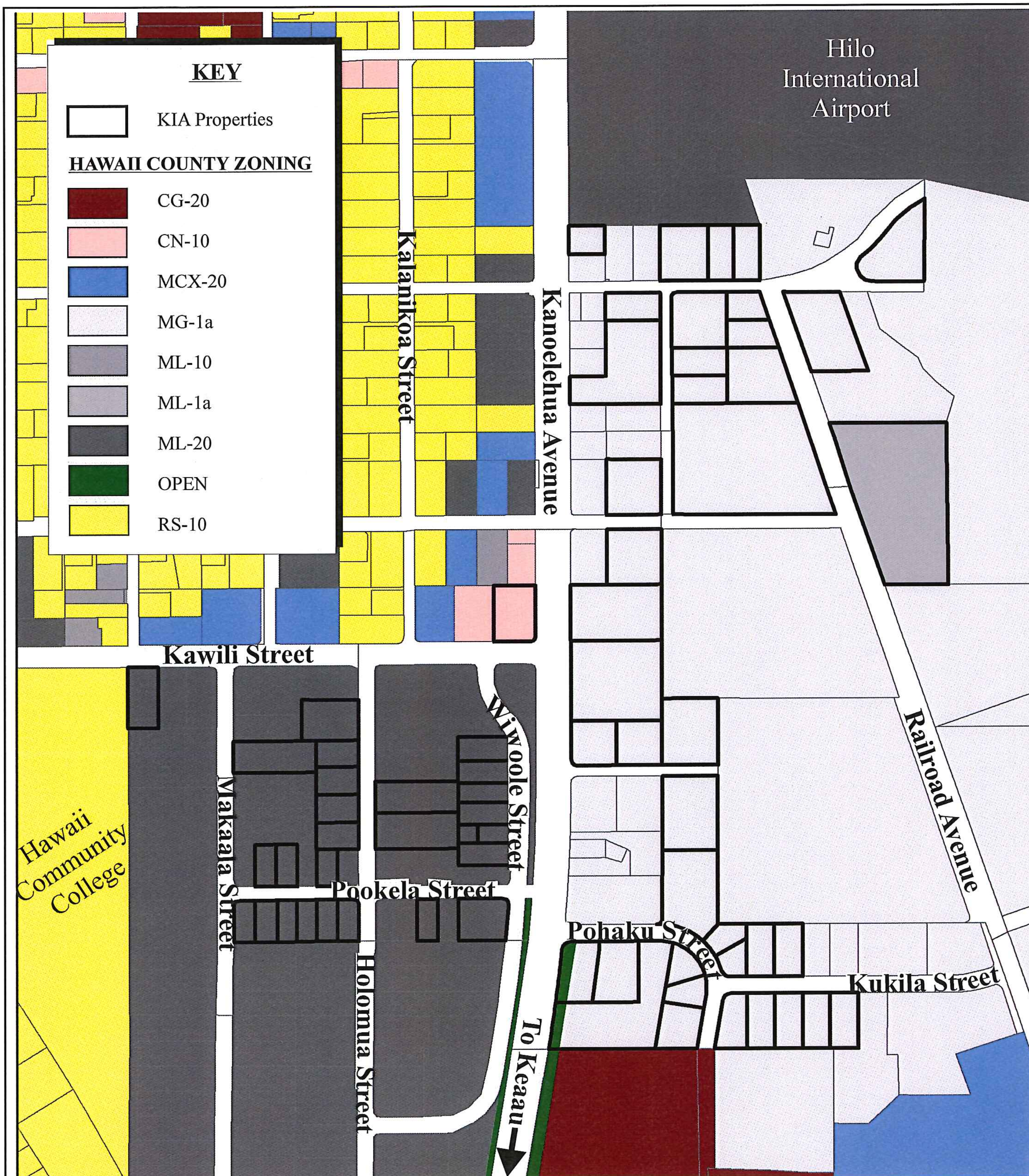


Source: County of Hawaii and Department of Land and Natural Resources

Figure A-1 Kanoelehua Industrial Area
North Study Area Hawaii County Zoning Designations

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources



Source: County of Hawaii and Department of Land and Natural Resources

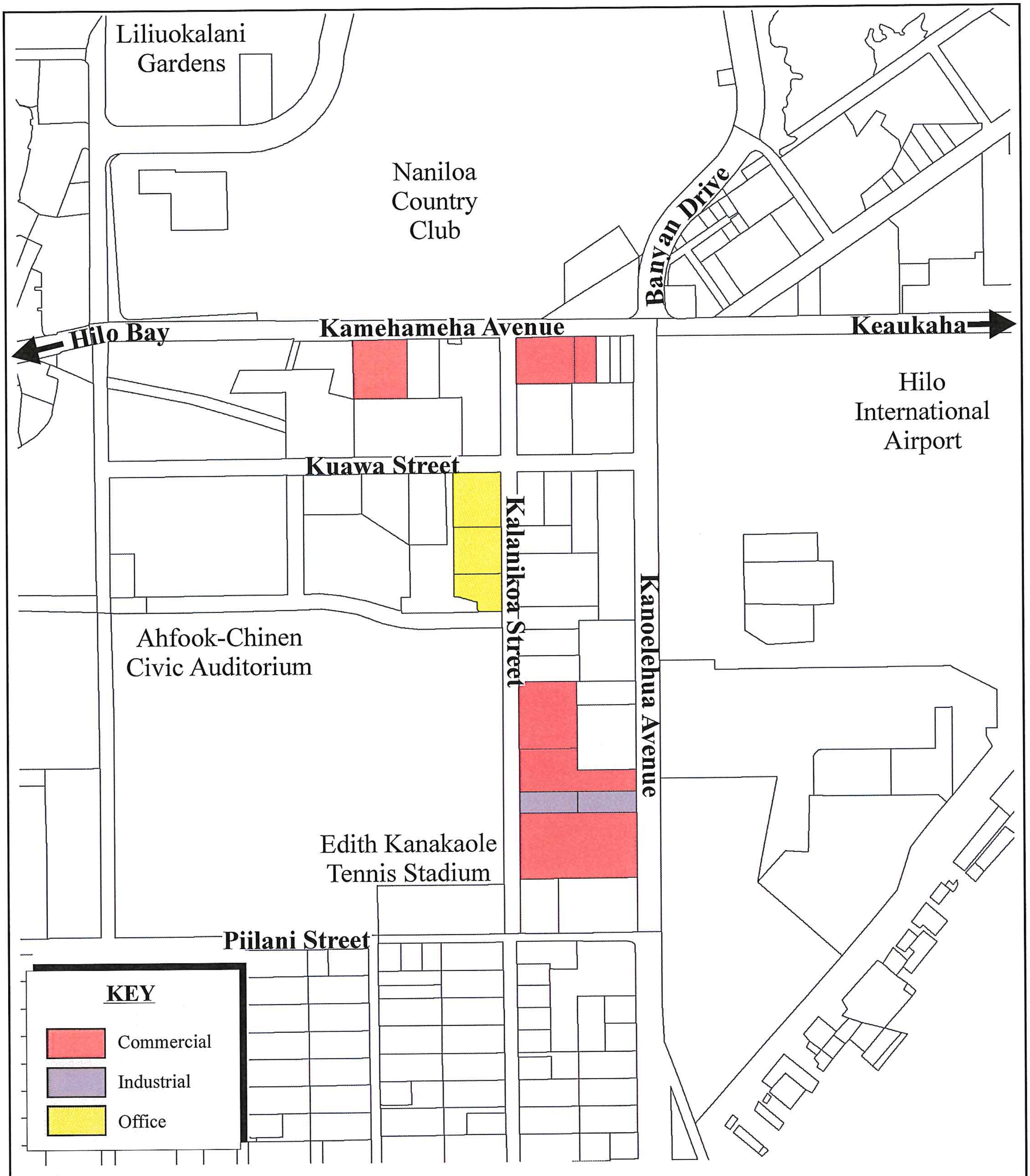
Figure A-2 Kanoelehua Industrial Area South Study Area Hawaii County Zoning Designations

0 125 250 500 Feet

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\South ZoningREV



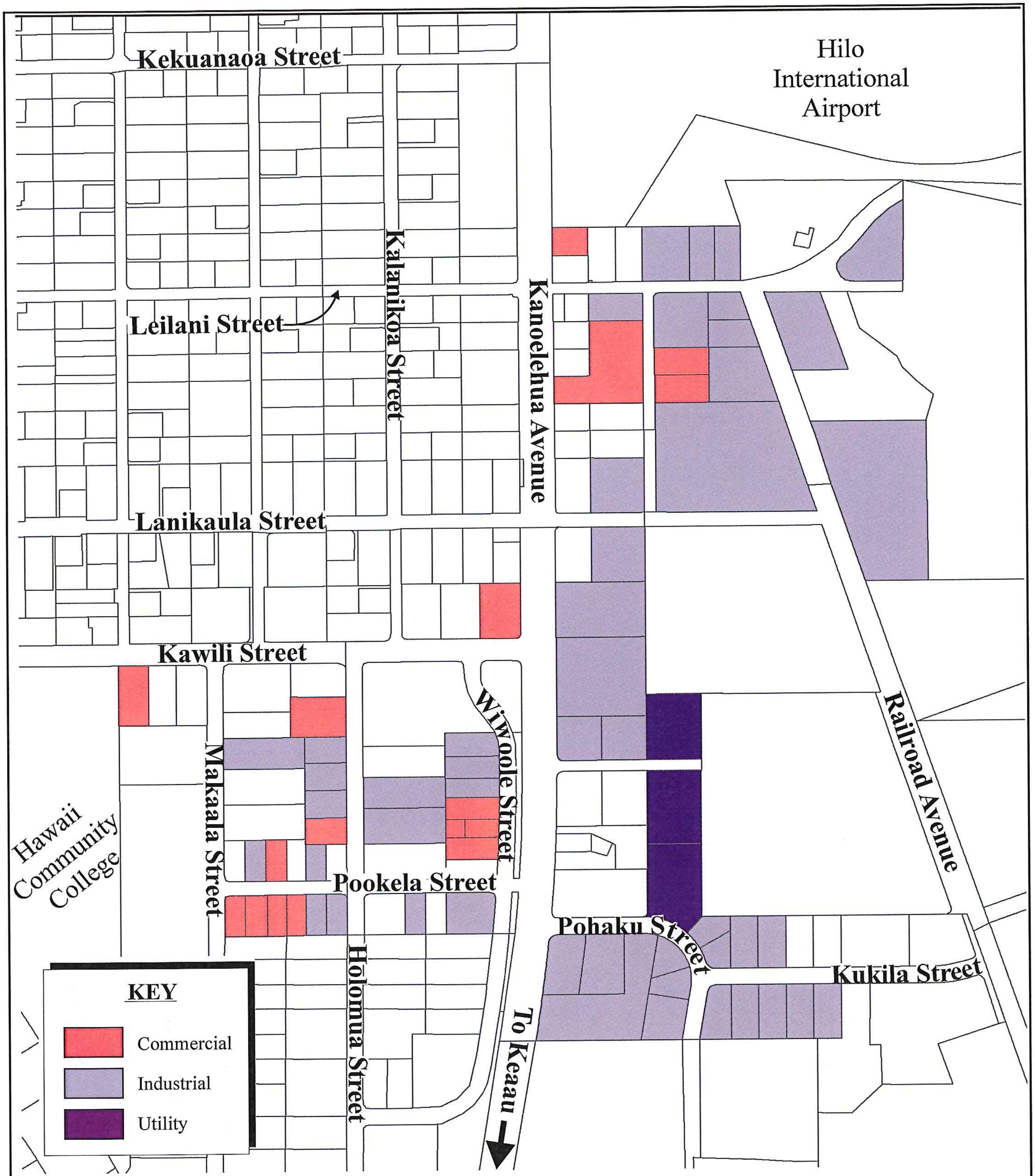
Source: County of Hawaii and Department of Land and Natural Resources

Figure A-3 Kanoelehua Industrial Area
North Study Area Existing Uses

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\FeasibilityAssessment\North\North UsesREV



Source: County of Hawaii and Department of Land and Natural Resources

Figure A-4 Kanoelehua Industrial Area
South Study Area Existing Uses

0 125 250 500 Feet

MUNEKIYO HIRAGA

Prepared for: State of Hawaii, Department of Land and Natural Resources

SOH DLNR\Kanoelehua Industrial\Feasibility Assessment\South\South UsesREV

APPENDIX B.

Kanoelehua Industrial Area Zoning Districts

KANOELEHUA INDUSTRIAL AREA

County of Hawaii Zoning Information

Zoning District	Zoning Code	Permitted Uses	Minimum Land Area for Each Building Site (in feet)	Height Limit (in feet)	Minimum Building Site Area (in sq. ft.)	Minimum Building Site Average Width (in feet)	Minimum Yards Front	Minimum Yards Rear	Minimum Yards Side
CURRENT ZONING DESIGNATIONS									
Neighborhood Commercial	CN-10	Commercial/Retail	10000	40	7,500	60	15	15	0*
General Industrial	MG-1a	Industrial	1 acre	50***	20000	100	20	0**	0**
Limited Industrial	ML-10	Light Industrial	10000	45	10000	75	15	0**	0**
Limited Industrial	ML-20	Light Industrial	20000	45	10000	75	15	0**	0**
Open	O	Open Space/Recreation	None	None	None	None	None	None	None
NEARBY ZONING DESIGNATIONS									
General Commercial	CG-7.5	Commercial/Retail	7500	120	7500	60	15	15	0**
General Commercial	CG-20	Commercial/Retail	20000	120	7500	60	15	15	0**
Industrial/ Commercial Mixed	MCX-20	Industrial/Commercial	20000	45	20000	90	20	0**	0**
Limited Industrial	ML-1a	Light Industrial	1 acre	45	10000	75	15	0**	0**
Single-Family Residential	RS-10	Residential	None	35	10,000	70	20	20	15

* Except where adjoining building is in RS, RD, RM, RCX, or V district

** Except where adjoining building is in RS, RD, RM, or RCX district

*** Or 100 feet, provided it is approved by Director