

November 8, 2005

Santa Monica, CA

INFORMATION ITEM

TO: Mayor and Councilmembers
FROM: City Staff
SUBJECT: Third Street Promenade Vending Cart Program

Introduction

Current Independent Cart Operators (ICO) addressed City Council on September 13th and October 11th 2005 to complain about the terms imposed on ICOs by the new master cart operator, Provenzano Resources Inc. (PRI) and their access to the new program. This report addresses the reasonableness of those terms and the status of current ICOs.

Discussion

Staff sought information regarding license fees paid by ICOs at other Southern California outdoor retail locations and the percentage of rent charged at those centers from an industry source unrelated to PRI. The comparison locations are not identified and the information is provided in ranges to protect the proprietary information shared.

Staff also sought advice from The Lamy Group, LTD, an international financial management consulting firm specializing in retail sales, compliance and specialty examinations, restaurant operations and lease services. In the past, City staff has retained The Lamy Group to audit restaurant and hotel leases on City-owned property.

For this assignment, Kenneth S. Lamy, founder and president of The Lamy Group, conferred with highly experienced professionals who have and currently hold positions as controller and director of cart programs, with a combined experience in excess of 20 years.

Several factors affect the profitability of a vending cart operation. They are:

- Expected gross receipts
- The amount of the license fee
- The cost of goods
- The cost of labor
- The cost for visual merchandising
- Other costs
- License Term
- Turn-over

Gross Receipts: The September 22, 2005 Information Item noted that PRI's average license fee was based on anticipated average gross receipts of \$16,000 per month. It is PRI's expectation that with better visual display, attentive management and new products, ICOs in the new program should do better than past performance. Current ICOs do not concur.

Of the ten Southern California outdoor retail centers for which information was provided, eight charge ICOs license fees based upon a percentage of gross receipts. Dividing the percentage rate by the average monthly license fee showed that anticipated gross revenues are on average between \$14,000 and \$28,000 per month. The Sample Monthly Pro Forma attached to this memorandum uses an estimate of \$14,000.

License Fee: As reported in the Information Memo to Council dated September 22, 2005, Promenade Services had charged ICOs a flat rate license fee ranging from about \$1,700 to \$2,000 per month. The ICOs made individual arrangements to roll-out their carts. Roll-out services generally were about \$10 per day, or \$300 per month. Adding this expense to the monthly license fee, the effective license fee ranged from \$2,000 to \$2,300 per month for most current ICOs.

PRI is charging, on average, a license fee of \$2,400 per month. This includes the cost of roll-out by a PRI employee being paid Living Wage.

The rate that PRI is charging ICOs is at the median of the rates charged to ICOs at the ten outdoor retail centers for which information was provided. These retail centers reported license fees that ranged on average from \$1,708 to \$4,073 per month.

Percentage License Fee Rate: PRI sets its license fee at a rate equivalent to 15% of expected gross receipts, plus 15% of the amount in excess of expected gross receipts. Charging 15% of gross receipts for license fees is fairly standard in Southern California retail centers. Of ten outdoor retail shopping centers in Southern California for which information is available, seven set their license fees at 15% of gross receipts; one set its fee at 10% of gross receipts, and two do not base license fees on a percentage rate. According to The Lamy Group, Ltd, 15% is an accepted rate for percentage licenses in the specialty leasing industry by master cart operators who provide carts to ICOs. The attached pro forma uses a license fee based at 15% of gross receipts.

Cost of Goods: Although the cost of goods sold varies according to the type of product sold, when preparing a pro forma for an ICO The Lamy Group advises that a conservative rule of thumb is 30% of gross receipts for cost of goods. For those ICOs who obtain their product from close-outs or discount houses, their cost of goods may be lower. The attached pro forma assumes cost of goods at 30% of gross receipts.

Cost of Labor: In accordance with the terms of the agreement between the City and PRI, the carts must be on the Promenade a minimum of 73 hours per week. Some ICOs work their own cart for a portion of the work week, while others rely entirely on employees to work their carts. The attached pro forma assumes that the ICO will hire an employee to work a cart during the minimum 73 hours that the cart is on the Promenade, and that the ICO will use his or her own time for any additional hours and other duties.

ICOs may compensate employees based on an hourly rate, salary and/or commission. The attached pro forma assumes that whatever compensation package is used will be equivalent to approximately \$11.50 per hour, for a total of \$3,600 per month.

Visual Merchandising: The Agreement between the City and PRI requires PRI to retain a Visual Merchandiser to be responsible for the overall image of the Program and the visual display of each merchant. PRI contracts with Hopper Studios, a small, woman-owned business, to provide this service.

Visual merchandising entails the design, fabrication and installation of shelving and display cases appropriate to the individual ICO's merchandise. Special attention is paid to lighting, awnings, cash wrap, transparency of product and overall appearance. The shelving and display cases protect the merchandise from breakage and theft while displaying the product to its advantage. The quality, functionality and durability of shelving and displays is very important in an environment such as the Third Street Promenade where carts are moved twice daily and are outdoors in a marine climate. The shelving and display cases are designed to facilitate opening for business as soon as the cart arrives at its location so that business can commence without spending time arranging merchandise while on the Promenade. The display determinations for cart merchandise should be as important as those for store owners – an essential fixture that attracts and appeals to customers. Visual Displays may last for many years, depending upon the level of wear and tear.

The visual merchandising process entails the following:

- ICOs meet with Danielle Hopper of Hopper Studios. Merchants bring samples of merchandise, lists of products they are approved to sell, and information regarding inventory levels.
- Depending on the overall concept and products, Hopper develops a design that maximizes product displayed. Additionally, the design for each cart creates a unique identity appropriate for the merchandise and theme.
- Hopper designs and builds additional custom fixtures as needed. For some concepts, such as jewelry, the case work is fabricated by a third party under design direction. Hopper may customize the case work through additional woodworking, painting, metal work or other visual display elements.
- Hopper installs the displays when the carts arrive. They assist the merchants in the placement of their product on the cart and insure that work is complete and the desired appeal is achieved prior to the first day of business. Additionally, they instruct the merchant about proper ongoing merchandising.

The visual merchandising fees collected by PRI and passed through to Hopper Studios are \$1,800, \$2,700, \$3,750, or \$6,000.

Level 1: 1,800 Products such as handbags; single concept product that can withstand most movement; display is highly theatrical; no cases

Level 2: 2,700 Products that are 'soft goods' such as shawls and scarves; no breakage possible; custom displays made by Hopper Studios

Level 3: 3,750 Demonstration products that require add-ons to the cart (tables); some casework; all custom display; (one ICO who was offered Level 3 requested higher visuals, and agreed to pay \$4,500)

Level 4: 6,000 Primarily jewelry, or fragile product such as perfume; this may include complete custom casework, including locks, lighting, shelving, etc.

Food Units: 2,200 includes menu board; displays of product or samples; some cases.

Artist Unit: 150- \$500 varies

As of November 1, 2005, under the terms of their contract, PRI has presented 19 deal sheets to staff for approval of which five are from existing ICOs. The deal sheets reflect the following visual merchandising fees:

Visual Merchandising Fees as of November 1, 2005

Fee	Number of ICOs paying
\$1,800	0
\$2,200	3
\$2,700	5
\$3,750	7
\$4,500	1
\$6,000	3
Total	19

The Lamy Group considered these visual merchandising fees a reasonable and customary expense of doing business in the specialty leasing industry. The attached pro forma assumes the highest visual merchandising fee of \$6,000.

Other Costs: An ICO should anticipate other miscellaneous costs for such things as insurance, permits, accounting, bank fees, and supplies. The attached pro forma assumes average monthly miscellaneous expenses at \$1,000 per month.

License Term: The Lamy Group considers a six-month License Agreement a reasonable period in which to amortize the one-time costs associated with start-up of a specialty leasing cart. In fact, The Lamy Group reported that many master cart operators prefer to enter into three-month license agreements because it provides them the ability to make merchandise mix adjustments in a timely manner, based upon actual sales performance.

The attached pro-forma amortizes the highest visual merchandising fee over the initial six-month term.

Turn Over: Vending cart programs experience turn-over in product and turn-over in operators. The Lamy Group reported that turn-over of operators can be expected to be about 10% per year. He explained that the product sold is usually a secondary cause of turnover, as the popularity of certain products changes and ICOs make adjustments. Primary reasons for operator turnover deal with employee performance, ICO fatigue and profitability. The Lamy Group reports that cart operations can have a life cycle as short

as a few months to as long as eight to twelve years. Some cart operators eventually expand into in-line stores.

Staff will track the turnover in PRI's program on the Promenade to determine how it compares to industry experience.

Pro Forma: This attached pro forma, as noted above, uses conservative assumptions confirmed by credible industry sources. It shows that for an average month an ICO would earn 15% profit on gross receipts of \$14,000 per month over the initial six-month term. After the visual merchandising fee is fully amortized, the net profit would increase to 22% of gross revenue per month.

Status of current ICOs: In accordance with Council direction of October 11, 2005, staff and Promenade Services notified current ICOs that they could continue to operate on the Promenade through November 13, 2005. Most carts have been stored in Parking Structure No. 3 so that the storage area and commissary can be made available to PRI. Special arrangements were made for two oversized carts.

Bayside staff is hosting a job fair on November 11, 2005, to link current cart employees with new ICOs and staff is working with Chrysalis to assist cart pushers to take next career steps, capitalizing on the references and experience they have gained on the Promenade.

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Attachment: Independent Cart Operator Pro Forma of Average Monthly Revenue and Expenses

**Independent Cart Operator
Pro Forma of Average Monthly Revenue and Expenses**

Gross Receipts	\$14,000	PRI expects its ICO to generate, on average, \$16,000 per month; the pro forma uses the lowest amount reported by the eight Southern California outdoor retail centers for which information on gross receipts could be derived.
Monthly Expenses		
Rent	\$2,100	15% of gross
Cost of Goods	\$4,200	30% of gross
Labor	\$3,600	\$11.50/hr @ 73 hours per week
Visual Merchandising	\$1,000	\$6,000/6 mo.
Miscellaneous	\$1,000	Insurance, supplies, permits, bank fees, etc.
Total expenses	\$11,900	
Net Profit	\$2,100	
Profit/Gross Receipts	15.0%	