Extracting Value from Hotels in Hawaii through Conversion

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In recent years, the Hawaiian Islands and, specifically, the Waikiki district of Oahu has experienced a trend of properties being converted from use as transient hotels to that of resort condominiums and timeshares. This trend is now being replicated in other markets in the United States. Such conversions involve fracturing the existing ownership structure of the asset and, as such, are generally irreversible. The economic justifications behind hotel conversions tend to be unique to each deal; however, it can be assumed that the existing property ownership is extracting value from such assets that might otherwise be unrealizable. In this article, the authors discuss why the current trend of converting the use of transient lodging facilities in Hawaii to alternative uses is so appealing to developers.

Our market research indicates that the Hawaii market evidences strong demand for a full range of transient lodging products. Prime locations, such as beachfront Waikiki, will likely not see any new hotel development under current zoning laws that restrain density. Obtaining approvals for new hotel development in Hawaii will continue to be a challenge, thus providing barriers to entry that benefit exiting supply. Hotel values in Hawaii have performed very well overall, recently, and most transactions have improvements in an asset's operating performance factored into the sale price.

Hotel values, however, are typically predicated upon the net cash flow that the asset can bring to the bottom line and must take into account the cost of operating the hotel business that generates the cash flow. Therefore, while demand for transient lodging facilities, currently, remains very strong in Hawaii, there are many reasons hotel use may no longer be the highest and best use for certain existing properties in Hawaii, including:

- Stagnant or deteriorating average rate attainment due to increased competition from newer resorts or alternative destinations; and rising operating costs due to increasing labor costs have contributed to put pressure on operating profit margins.
- Standards for transient accommodation have changed dramatically in recent years and older, existing hotels require massive outlays of capital in order to refurbish their bathrooms, wire the guestrooms for Internet access, replace the bedding and softgoods to meet the latest styles, construct elaborate fitness centers and spas, and provide the on-demand services to which travelers have become accustomed.
- Restrictive zoning codes, particularly in Waikiki, have limited the options of hotel owners seeking to redevelop their existing improvements or build to an optimal density.

These factors have resulted in the decreased expectation of investors for returns from hotel operations and an increased reliance upon asset value appreciation realized upon sale. Many investors and hotel owners are therefore considering conversions to resort condominium or timeshare. These alternatives allow the equity investor to extract as much equity as possible from the asset and substantially exit the investment in the shortest amount of time (thus foregoing the risk and reward of generating future net income from operations). Unit sales raise capital quickly; they also reduce risk and promise faster returns to investors, which allows

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lenders to recoup a large amount of money up front. Developers benefit from the markup on condo sales and earn profits from management of the condo pool.

The values of resort condominium and timeshare developments in the Hawaii Islands are currently soaring for a variety of reasons, including:

- Historically low interest rates have now been sustained over a three-year period and lending institutions have exhibited a willingness to allow homeowners to accumulate a tremendous amount of leverage.
- Disappointing returns experienced by individual investors in equity stock investments in recent years have driven capital toward real estate investments perceived as less risky.
- The demographic shift of an increasingly large proportion of the Baby-Boom generation retiring in the continental United States has resulted in many couples selling larger family homes in cold climates and purchasing smaller condominiums located in warmer climates, such as Hawaii.
- Demand is also driven by first-time buyer local professionals, many of whom have been priced out of the housing market.
- Timeshare, as a form of property ownership, has gained acceptance and grown at a rapid rate, as it has been branded by the dominant hotel companies.

Given these factors, converting existing hotels to resort condominium or timeshare use may provide appropriate alternative use and ownership structures that make owning and investing in hotel assets more desirable.

Conversion to Resort Condominium Use

Resort condominiums (residential condominiums with a transient rental pool) have been a common form of development in Hawaii over the last 30 years. These condominium apartments (generally two-bedroom and two-bath units with full kitchens) are typically purchased by investors who frequently visit the Hawaiian Islands and seek to earn rental income to offset their annual ownership costs. Conversion costs from hotel to resort condominium use are generally contained to such tasks as simply knocking down a wall and/or installing a kitchenette in addition to a soft goods refurbishment. The strength of the residential condominium market, as well as the transient visitor and investor markets make such conversion projects a financially viable development alternative. When resort condominiums are converted from hotel use, some of the services and amenities generally carry over, thus making the units more marketable.

We have identified several properties that have either recently been converted to resort condominium use or have previously been converted and are currently in the process of selling off the converted units.

The demand to purchase these converted units has been exhibited by extraordinary rapid sales

Table 1 – Selected Recently Converted Hawaii Condominium-Hotels

Name	Location	New Name	Year Converted	Number of Converted Units	Unit Types	Range of Unit Sales Price
Radisson Kauai Beach Resort	Lihue, Kauai	---	Initial stage	---	---	---
Islander on the Beach Resort	Kapaa, Kauai	---	Initial stage	197	Studio & 1BR	$210,000 to $570,000
Bamboo Hotel	Waikiki, Oahu	---	2004	97	Studio, 1BR, & 2BR	$107,000 to $650,000
Waikiki Terrace Hotel	Waikiki, Oahu	Luana Waikiki	2004	217	Studio, 1BR, & 2BR	$155,000 to $310,000
Waikiki Parkside Hotel	Waikiki, Oahu	Palms at Waikiki	2004	248	Studio & 1BR	$116,000 to $225,000
Kuhio Village Resort	Waikiki, Oahu	---	2003	166	Studio	$40,000 for leasehold $50,000 for fee simple
Aston Coral Reef	Waikiki, Oahu	Coral Reef Hotel	2003	247	Studio, 1BR, & 2BR	$59,500 to $150,000
Ohana Waikiki Hobron Hotel	Waikiki, Oahu	The Windsor	2003	179	1BR & 2BR	$260,000 to $309,000

pace as the units have come on the market. For example, all 166 units of the Kuhio Village Resort were reportedly sold-out just days after being brought to market and, in August 2004, the 248 units at the Palms at Waikiki were reportedly sold in nine hours resulting in an estimated $28.8 million in gross proceeds. Similarly, all unit sales at the 217-suite condominium-hotel Luana Waikiki were reportedly in escrow after being on the market for a month.

Conversion to Timeshare Use

Over the past five years, the timeshare industry has grown dramatically on all of the major islands of Hawaii. The demand for timeshare units in Hawaii is extremely strong at the current time, with significant sales occurring on Oahu, Kauai, Hawaii, and Maui. Timeshare in Hawaii has always achieved premium pricing relative that of timeshare product in other U.S. locales due to a shortage of supply; and Hawaii timeshares are typically designated as peak season year round, as compared with timeshare in most other locations that have seasonal pricing differentials.

Some of the timeshare developments that have been converted from hotels in recent years are listed in Table 2, below.

Table 2–Selected Recently Converted Hawaii Timeshares

Name	Location	New Name	Year Converted	Number of Converted Units	Unit Types	Range of Unit Sales Price (Per Week)
Hilton Hawaiian Village and Beach Resort	Waikiki, Oahu	---	Ongoing	453	1BR, 2BR, & 3BR	$26,900 to $63,000
Marriott	Kaanapali, Maui	Marriott Maui Ocean Club	Ongoing	312	1BR & 2BR	$19,900 to $54,750
Royal Sea Cliffs	Kailua-Kona, Hawaii	---	Ongoing	76	1BR & 2BR	$29,500 to $43,500
Ohana Reef Towers	Waikiki, Oahu	Fairfield Hawaii at Waikiki Beach Walk	Ongoing	480	2BR	$17,000 to $18,000

The Hilton Hawaiian Village and Beach Resort's 453-room, 24-story Kalia Tower was newly built in 1999, only to be taken out of inventory in 2002 due to the presence of mold and other construction defects. The tower was subsequently gutted and reconstructed and, while some of the inventory has already been converted to timeshare units, due to strong demand for timeshare, preliminary plans are in place to convert the entire remaining Kalia Tower inventory to timeshare. Similarly, the 312-unit Marriott Maui Ocean Club on Oahu has announced plans to fully convert the property's existing guestrooms to timeshare and has submitted plans to build two 10-story towers containing an additional 143 timeshare units. Fairfield is selling timeshare inventory at the 76-unit Royal Sea Cliffs located on the Big Island, Hawaii, in the resort town of Kailua-Kona, which is a conversion of condominiums that were originally constructed in 1982.

Conclusion

A number of factors have aligned to stimulate the conversion of transient hotel rooms into resort condominiums and timeshares on the Hawaiian Islands. Due to demographics and the trends in the investments markets, we do not foresee this phenomenon slowing within the near term. However, at some point in the future, the real estate markets will likely again shift and the pendulum will swing in the other direction. As existing hotel rooms are taken out of inventory and supply growth is restrained, the remaining hotels should become more valuable thus lessening the benefits of conversion. Similarly, the supply for resort condominium and timeshare units will eventually catch up with demand and unit price appreciation will slow. However, until that time arrives, we expect to see many more hotels in Hawaii converted to resort condominium or timeshare use. ③

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Stephen O'Connor is a Senior Associate with HVS in San Francisco. Much of his feasibility and appraisal work over the last 12 months has been conducted in Hawaii in connection with various development and conversion projects. Stephen holds a Masters degree in Hotel Administration from Cornell University and a Bachelors degree from Dartmouth College.

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