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CONDO HOTELS - EVOLUTION TOWARD A COMMERCIAL HOTEL STRUCTURE

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Condominium hotels, or condo hotels, have become an increasingly popular format for development, particularly in resort-oriented locations. Obviously, the nightly rental of condominium units, which are placed in a rental pool by condo-owners, is nothing new, as this practice has occurred for years in resorts and a few urban locations. What has changed, however, are the scope and nature of these properties and the relative relationships between the condo-owners, property managers, traveling customers, and project developers. This article will explore the scope and nature of these changes. In this new generation of condo hotels, the size and complexity of the physical development of these properties has tended to increase. The individual condominium units are designed to have ample lock-off capabilities, which can dramatically multiply the overall key count of a condominium property (to provide individual bedroom/bathroom configurations). Additionally, these properties offer a wide array of amenities and services, similar to those found at typical full-service hotels. Condo hotels now often feature expanded food and beverage facilities, recreation, front desk/concierge services, retail, and generous amounts of meeting space. Previously, these areas were managed and maintained by either the project developer and/or a Homeowners' Association ("HOA"). Under such a structure, rooms were rented on a best efforts basis (at times, by a hired local operator) without the benefit of aggressive marketing or a widespread reach to attract vacationers. Today, the industry has shifted its strategy toward the outright sale of the hotel management opportunity to nationally-affiliated hotel companies, operating these properties similar to that of a conventional hotel operation. This has been achieved by separately deeding all of the hotel-like features mentioned above as individual condominium units (even including the maids closets on each floor). These commercial condos are then sold to a hotel operating company. Along with rental agreements from the individual condo buyers, this allows the hotel operator to effectively manage the property as a hotel. From the traveler's perspective, these properties (other than having larger guest room facilities) seem to offer an experience identical to that of a luxury resort hotel, in terms of services and amenities. From the condominium buyers' points of view, these types of developments can offer enhanced financial returns when owners choose to place their units in a rental pool. During periods in which owners are not utilizing their units, the hotel operator manages the condos. By capitalizing on a hotel's national affiliations, reservation systems, brand recognition, and management expertise, unit owners are more likely to receive a higher level of rental income through a rental pool agreement with a recognized professional operator, despite having to surrender a portion of their units' revenues. This type of development also provides an interesting approach for hotel operators. In some respects, it is similar to owning a hotel outright, because the operator does own some real estate (i.e., the commercial condominium units appurtenant to running a hotel), however, individual condo buyers own the actual guest rooms. As such, the overall cash investment by the manager is not as great as that found in typical hotel deals. To a certain extent, the manager is essentially granted a long-term management contract, because a long-term management relationship is expected to exist with the condo owners. The difference lies within the fact that condo hotel operators are able manage these properties without a specified termination date, since they actually own real property in the project (in perpetuity). In order to place a unit in the rental pool, a management and rental agreement is signed between the unit owner and the hotel management company. This agreement provides for a number of things, as follows. A portion of the revenues received from the nightly sales of rental pool units flows through to the condo owners. The hotel management company retains the remaining portion of the rental revenue stream. Additionally, a usage agreement (stipulating frequency and notice requirements for owner usage of condos) is implemented between condo owners and the operator. Furthermore, the agreement

Summary

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will provide for the impound of an FF&E reserve (maintained by the hotel operator). The FF&E furnishing packages (including replacements) within rental pool condos need to conform to certain standards. Failure to comply with such standards may either necessitate immediate refurbishment (at the unit owners' expense) or the expulsion of non-conforming condos from the rental pool. Given that owners of such units are attempting to maximize their rental revenues, they are so induced to keep their furnishings in optimal condition. Although, several such incentives exist for prospective condo buyers to purchase units in a condo hotel and place them in the rental pool, typically, owners are not legally obligated do so. Directly renting one's unit to others or hiring a third-party property manager to oversee the renting of a unit, is possible. However, this renting option is usually not a very viable approach, since guests may not have full privileges and/or usage of areas otherwise controlled by the hotel manager. Financial responsibility for maintenance and repairs of common space is allocated among condominium unit owners, based on their pro rata shares. An HOA is usually instituted to retain ownership of such areas and oversee the collection of dues from unit owners. Such dues typically cover reserves, common area maintenance, property insurance, and utilities expenses. Real estate taxes are usually paid for directly by the condo owners and the hotel manager pays for its costs of operations (i.e., salaries and other direct hotel expenses). Developers of condo hotel projects are attracted to this development approach due to their ability to quickly monetize the management function of the property. In essence, the sale of the hotel management opportunity becomes akin to another condo unit that can be sold for immediate profit. If the hotel management opportunity is sold upfront (during the sell-out phase of the residential condominiums), the developer may be able to receive rental revenues from the completed, but unsold units, being rented nightly to hotel guests. In undertaking this type of approach, it is also important to note the potential for securities law issues to arise out of the sale of condo hotel units. Sales of condominiums may be deemed to be the sales of securities if certain conditions exist at the time of sale. Such terms may include the expression of projected rental revenues to potential buyers, execution of long-term management contracts (10 to 25 years) with a hotel operator for the management of units, absence of a sales force control program, requirements of rental pool participation, and required rental company stipulations. In order to avoid coming under the scrutiny of any federal or state securities agencies, however, developers may take several simple preventative measures while planning condo hotel projects. These may include refraining from setting rental revenue expectations for prospective buyers (the responsibility of generating financial projections should lie with the interested purchasing parties); instituting a third-party agent to oversee the sales of condo units and distribute rental program information, thereby, relieving developers from directly promoting rental programs; permitting condo owners to either rent their units to third parties or not rent their units at all; and allowing owners to appoint a rental management company of choice to manage the rental of their units (although selecting a manager other than the condo hotel's management company would be impractical in attempting to effectively maximize rental income, as previously described). This is a new and interesting approach to the development of lodging properties. As its use becomes more commonplace in the market, levels of understanding and acceptance by both the lodging industry and the condo buying universe is expected to increase.

About Michael T Sullivan

Michael T. Sullivan is Managing Director of HVS Capital Corp., joining HVS in June 2001. Previously, he served as Managing Director of Sonnenblick-Goldman, which he joined in 1974. During his career, he has been responsible for the financing and sale of more than 650 hospitality properties (hotels, resorts, golf courses, and shared ownership) and for completing, on average, roughly $1.0 billion per year in debt and equity transactions in hotels/resorts nationwide. In his current position, he oversees a staff of hospitality banking professionals, all of whom are involved in the origination and placement of debt and equity realty assignments, with a primary focus on the Lodging and Leisure Industry. Mr. Sullivan attended the University of Arizona, where he received a degree in accounting and marketing. He is a Certified Instructor for the National Apartment Association and a frequent speaker for the Colorado Apartment Association, BOMA, and other trade real estate groups.