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The Comforts of Home

Condominium-hotels are on the rise again.

Condominium-hotels were popular in the United States during the 1970s and 1980s, a time when units were often used as tax shelters, but that market largely dried up with the adoption of the Tax Reform Act of 1986. They recently have resurfaced, however, for various reasons, including the scarcity of debt capital for hotel development, the stock market's volatility, baby boomers' search for investment opportunities in vacation-oriented real estate, and the desire of operators to achieve brand growth.

In a typical condominium-hotel, the developer either converts an existing hotel into condominiums or develops a "purpose-built" condominium-hotel. In either case, the condominium units or "guest rooms" are offered for sale, and buyers are given an opportunity to place their units into a rental program to defray the cost of owning and using them. In nearly all cases, participation in the rental program is strictly at the election of the unit owner.

Generally, condominium-hotels are being developed in high-traffic tourism destinations in which residential real estate prices and interest in seasonal usage are high. They are operated by a wide range of branded and unbranded operators that have joined early market entrants such as In-trawest, Crescent, Sonesta, and Starwood. South Florida is one of the largest condominium-hotel markets due to the strong domestic and international demand there for second or vacation homes and Latin Americans' interest in investing in the relatively secure U.S. real estate market. Developers are also building condominium-hotels in other resort destinations such as Las Vegas, Arizona, California, and Hawaii, and some operators are converting existing hotels into condominium-hotels in urban markets such as Boston, Chicago, New York, and San Francisco.

While some condominium-hotel development is being undertaken by traditional hotel developers, many residential condominium developers also have entered the market to search for new development opportunities or to make a natural progression from the highly amenitized luxury condominium model to a "branded" residential condominium offering a rental program. Developers are selling condominium units to a variety of buyers. "Buyers include Latin Americans and Europeans, local buyers, corporations buying units as executive suites, sports figures, and other types of buyers," says Carolyn Block-Ellert, co-owner/broker of Premier Sales Group of Fort Lauderdale, Florida.

Condominium-hotel units offer owners vacation homes with the services and amenities of high-end hotels. When not using their units, owners may place them in a rental program that can mitigate the expense of leisure usage and may produce a profit. Owners experience the benefits of a nationally branded hotel management company, such as brand recognition, sophisticated marketing programs, centralized reservation systems, management expertise, and a wide variety of services and amenities. In addition, condominium units may command higher room rates than those charged for traditional hotel rooms because the units usually are larger and include more features. "Owners want amenities that will make their units seem more personalized," points out Michael Carsch, general manager of the Ritz-Carlton, Key Biscayne. "This will create demand [among] guests looking for an upscale vacation experience with the comforts of a private home."

Condominium-hotels offer developers two distinct business opportunities: the sale of condominium units and the ownership of an operating hotel. Some condominium-hotel developers prefer to exit after selling the units, while others view hotel operations as an important opportunity. (At present, there is no established market for selling the operating hotel business, although such a market could emerge over the next two years.)

For developers, the condominium-hotel structure provides an alternative to long-term hotel financing, which typically requires upfront equity of 30 to 40 percent or more of project costs. Local or international banks that finance condominium-hotels treat them like any other residential condominium development, with lenders requiring binding contracts for the purchase of units. Construction loans are paid off through condominium sales, ideally leaving the developer's residual interest in the project debt free. If necessary, the developer's interest can be mortgaged to cover any operating shortfalls arising from the hotel operation that are not passed on to unit purchasers. By affiliating with a branded operator, developers may benefit from a quicker sales pace, higher unit prices, and better hotel performance; in return, developers usually pay a royalty fee to the operator.



WQ COMMUNITIES (ONE BAL HARBOUR)

MARK LUNT is a senior manager and practice leader with Ernst & Young's hospitality advisory practice in Miami, Florida, for the Southeast and the Caribbean.

ANDREW ROBINS is chair of the real estate department and director of the leisure and resorts group at Gunster Yoakley & Stewart, PA, based in Fort Lauderdale, Florida.

Operators increasingly feel that the condominium-hotel regime allows for an acceptable level of control of the facility and the guest experience provided by a traditional hotel. However, operators are concerned about control over room inventory. U.S. securities laws (as well as applicable “blue-sky laws”) prevent a developer from requiring owners to participate in rental programs. Consequently, the number of unit owners participating in a rental program in a given year and the amount of owner occupancy permitted by the program determine hotel room inventory, and that number can change from time to time. Vast improvements in program structure, however, have worked to make this a generally manageable risk. All in all, operators seem to generally agree that condominium-hotels work in most circumstances in which a traditional hotel would work. In addition, there is an opportunity to book royalty fees, sometimes adding up to millions of dollars even before the hotel opens, which is a powerful inducement to many operators.

The applicability of securities laws to the offering of condominium-hotel units is the biggest issue affecting the structure and success of condominium-hotels. The U.S. Securities and Exchange Commission (SEC) in a 1973 release (SEC Release 33-5347) and in subsequent no-action letters has addressed the issue of when the sale of condominium units constitutes the sale of a “security.” In brief, the SEC’s guidance prohibits the pooling of income (a unit owner may not benefit from the rental of another unit owner’s condominium or from nonrooms revenue), forbids emphasis of the investment aspects of the condominium during the sale of the unit, and puts restrictions on use of the condominium (such as a requirement that the condominium be placed in a rental program).

The process of selling units within a condominium-hotel is a potential land mine for securities law compliance. By emphasizing the investment aspects of the condominium unit or providing performance projections, a sales agent could cross the carefully laid line that protects a developer from securities liability.

While it might be desirable to merely register a condominium-hotel offering with the SEC and applicable state regulators, most who have carefully considered this option have determined that doing so is impractical for a host of reasons. In reality, securities laws were not drafted and adopted with the reasonable needs of real estate developers and purchasers in mind.

While condominium-hotel offerings can readily be structured to avoid the issues that

would necessitate registration, doing so without unduly prejudicing the various stakeholders in the project can prove to be a challenge. Clearly the impact of the SEC’s pronouncements has been to produce relatively uninformed purchase decisions by the primary contributor of capital to the project, the unit purchaser.

Given the lack of information available to most buyers, the developer should take steps to address that the unit purchase makes sense based on the potential benefits to the buyer. If a deal benefits the developer and operator but results in an inappropriate expense to unit owners, the consequence could be expensive litigation. For this reason, extensive financial modeling of condominium-hotels, including the separate interests of unit owners and the developer, is critically important. Proper modeling enables complex allocations of costs that produce reasonable results for all stakeholders and allows for greater flexibility in structuring economic returns.

A rental agreement between a participating unit owner and the developer spells out the terms and conditions under which the owner’s condominium unit is rented to hotel guests and allocates both revenues and expenses between the unit owner and the developer. It also prescribes conditions of owner usage: the times of year owners may use their units, for how long, and so forth. Many projects limit usage during the high season to ensure that an adequate supply of rooms is available for guests. In some instances, the operator may provide a higher percentage of room revenues to the owner in return for greater restrictions on owner usage. These restrictions do not present a securities issue as long as the unit owner has voluntarily entered the program. The agreement also spells out when unit owners may have to invest additional funds to cover operating shortfalls or to bring units up to operating standards. Generally, standard furnishings, fixtures, and equipment (FF&E) are required of each unit, although arrangements regarding FF&E vary considerably. The operator’s fees and all of the other matters addressed in a typical hotel management agreement are left to that separate document, typically a contract between the developer and the operator.

Whether handling sales and marketing in house or through a third party, a developer should create mechanisms that discourage violations of the securities laws and assist in establishing a defense should a claim be made. These mechanisms include training and scripting the sales team, use of unidentified shoppers to test actual compliance, and separating

rental program representatives from the sales process. “Sales forces should be well trained, and presentations should be carefully scripted,” notes Block-Ellert. Experienced developers and operators are learning how best to present information within the limitations of the securities laws and how to appropriately manage buyer expectations.

Condominium-hotels are complex projects to develop, market, and manage. Nevertheless, developers, operators, and condominium owners can take steps to help ensure success. For developers, this means selecting the right location, financing projects at the lowest costs, finding strong, experienced condominium-hotel operators, and properly structuring management contracts with operators. Operators need to properly structure rental agreements with condominium unit owners, develop programs for efficiently managing inventory, establish control over common-area maintenance and furniture packages, develop realistic budgets for condominium-hotel operations, and carefully determine responsibility for operating shortfalls and cost overruns. Buyers should see their condominium units not as investments but rather as vacation or second homes that may generate rental income and may appreciate in value. Equally important, developers, operators, and buyers should agree on common goals, understand risks, and be prepared to address challenges as they arise.

“Condominium-hotels can be a significant development opportunity or a long-term financial black hole fraught with tremendous legal liability,” says Steve Sorensen, vice president/senior project manager of developer WCI Communities. “It’s important to approach this business model with great care. You don’t just build these properties, sell out, and walk away. If you don’t put thorough thought into the way the various stakeholders’ building governance documents, operational budgets, and property management pieces fit together, you could have a prescription for disaster.” ■

