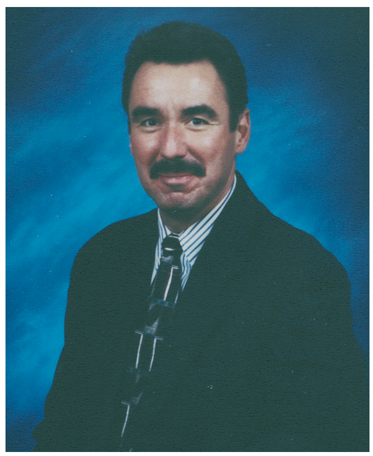
Condo Hotels: Lodging's New Segment—Again

It has become virtually impossible to attend an industry conference, read an industry trade journal or peruse one of the online industry sources without coming across commentary relating to the condo hotel development boom we're witnessing in certain parts of the country. With all the hype, one would think that the concept was new and novel. In fact, it has been around for many years—not only in Europe and Latin America, but right here in the U.S.

In a slightly different form—cooperative ownership—the concept of individual hotel units being privately owned and marketed for sale by a hotel operator goes back at least 50 years. In New York City, three stellar examples—The Carlyle, Sherry Netherland and Stanhope—have been operating in this fashion since as far back as the mid-1950s. The concept gained nationwide notice in the 1980s, as hotel units were developed and sold primarily as tax shelters until the tax laws changed in 1986 and the tax benefits of ownership went away. Most recently and more prominently, the concept resurfaced about eight years ago in Florida. While Florida remains a hotbed of condominium hotel development, condo hotel projects are also being developed in a number of other major cities, such as Las Vegas, Dallas and San Francisco.



Typical buyers of condo hotel units are consumers looking for second homes but opting not to buy a conventional residential condominium because they don't anticipate making sufficient use of them for it to make economic sense and/or to make it worth the trouble and effort of owning and maintaining the units.

In some cases, most notably in South Florida where the condo hotel market is extremely hot, buyers are often investors—many of them from Latin America and Europe. Europeans think the U.S. prices are a bargain, given the current exchange rate of the Euro versus the U.S. dollar. Latin Americans see investing in the U.S. real estate market as a safe harbor for their investment funds. Virtually all condo hotel investors at present see the product as a chance for significant appreciation in value. South Florida housing prices have more than doubled in the last five years, and the pace of appreciation seems unabated as land becomes scarcer and becomes more attractive to more consumers and developers.

The benefits for developers. For the developer, there are several benefits of a condo hotel versus a conventional lodging property:

- The most obvious attraction has been investment returns that in some cases can reach 25 to 30 percent compared to returns on conventional hotels of about half that amount.
- For new-construction condo hotel projects, sales of units prior to construction can raise the core equity the developer needs to secure financing. The sale of the condo units makes it possible to have the 40-percent (typically) equity that many hotel lenders now require. Sometimes the pot can be sweetened for the developer and exceptions to the 40-percent equity requirement abound. In one instance—the development of the Q Club (Hilton) along the beachfront in Fort Lauderdale, FL—the developer reportedly was able to secure a construction loan for 85 percent of the project value, bringing a relatively small equity contribution (15 percent) to the table. When the development involves conversion of an existing hotel, this boundary can be pushed even further. Some developers report equity contributions as low as 10 percent.

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- Construction costs are typically higher for condo hotels than for conventional properties. Units are generally larger and the amenities and finishes typically must be top-notch to support sales prices that are significantly higher on a per-square-foot basis than for conventional residential condominiums. Buyers can justify the higher prices because ownership allows them to take advantage of all the facilities, amenities and services of a top-notch brand-name hotel.

The three Starwood-related condo hotel projects in Fort

Lauderdale— the Atlantic (already open) and the St. Regis and W, both under construction—are good examples of this business model. Sales at all three properties are reportedly in the $1,000 per-square-foot range compared to $400 to $500 per square foot for high-end residential condominium units in the surrounding South Florida market.

The attraction for buyers. Unit owners can benefit financially by letting the hotel management sell their units through a rental program, offsetting some of the costs of owning the units. With some very limited exceptions, these rental programs cannot be mandatory, nor can the developers' sales forces even so much as hint at the level of economic benefit which might result from the developer-sponsored rental program during the sales process. Either event could result in the transaction coming under the scrutiny of state or federal securities laws. SEC registration can be a difficult and costly process that developers wish to avoid.

The unknowns. From both an investor and hotelier perspective, the long-term evolution of the condo hotel product will be interesting to watch. Consider the following:

- The hotel operator in a condo hotel is beholden not to one or several owners, but potentially to hundreds of owners of the condominium units, each of whom might scrutinize and argue about operating budgets as they relate to maintenance fees and assessments.
- As in any condominium, the unit owners ultimately have the voting power to control the building budget. What would happen should the unit owners provide insufficient capital to maintain the building at operator or brand standards and the flag is removed? Such an event could have a serious impact on the operating levels of the hotel as well as on returns to owners.
- In the typical condo hotel, the developer sells all the units but maintains ownership of the common areas, restaurants, etc. Arguments related to allocation of expenses between the owners of the units and the owners of the common areas have already made headlines at several condo hotels, with the promise of more to come.
- Because the current wave of condo hotel conversions and new construction is so recent, there is no established track record regarding the long-term appreciation in real estate value of the units at resale. Should the anticipated appreciation not materialize, the concept could very well start falling out of favor.

The framework and operating scenario by which a condo hotel functions is a very complex and rapidly evolving one which taxes the skills of even the brightest and most experienced legal minds. From the developer's perspective, the condo hotel structure provides a creative way of getting a hotel development done which might not be economically justified or feasible otherwise. And from this perspective, and barring an unforeseen industry meltdown caused by external factors, the concept appears here to stay—again.

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