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If You Build It, They Will Come: How to Finance Hotel Construction

By Kenneth E. MacKenzie

While the hotel industry is enjoying an extended period of robust economic performance, there is virtually no way to make the numbers work for traditional ground-up construction of any new full-service hotel building. The costs of construction are simply too high. In its "Hospitality Industry Top 10 Thoughts for 2007," professional services firm Ernst & Young identified construction costs as a key trend influencing decision-making in the industry. With increasing competition for labor and materials from the world's emerging economies, there would appear to be no end in sight. Yet hotels are being built nonetheless. What, then, are some of the approaches being used to get new hotel projects off of the drawing board and into the ground?

If the hotel alone does not work, developers may decide to make the hotel a focal point of a larger project involving a mix of uses. Depending upon the market in which the project is located, these uses could include any combination of retail, office, residential or recreational space. Greater density leads to more sensible numbers and, hopefully, accretive synergies with the hotel use and better overall land-use planning. The increased complexity and duration of such a mixed-use project, however, has necessarily restricted the playing field to those relatively few companies capable of moving a mega-project from conception through marketing and execution. Call to mind the likes of Forest City Enterprises, Streuver Brothers or Boston Properties, builders of whole communities. To the extent the aforementioned narrowing results in better-conceived and capitalized projects, the industry as a whole and the cities and towns in which such projects are located will benefit. In addition, the self-governing influence of construction costs on hotel supply has in large part been responsible for sustaining the current good times in the industry.

Reuse With Incentives

Take an old building with good bones that no longer serves any useful purpose as originally envisioned, put it in a vibrant urban area, throw in some state and federal incentives for development, and pretty soon you have a recipe for a viable hotel project. A short walk around Boston's financial district and its periphery would take you past the Langham Hotel (formerly the Federal Reserve Building and a historic landmark), the Marriott at the Custom House (formerly a custom house and renowned Boston landmark), the Hilton on Broad Street (formerly an office building), the Marriott Long Wharf (formerly a warehouse) and the Liberty (formerly the Charles Street Jail). Such adaptive reuse projects are truly a win/win proposition. The community gets a new, revenue-generating building that puts an otherwise abandoned structure back on the property tax rolls, and the developer gets tax breaks that render the project economically feasible. Plus, the "cool" factor of these types of projects is undeniable. "Cool" usually helps to fill hotel rooms and is more enduring than "trendy."

Occasionally, a creative hotel financing idea can save a treasured building from the wrecking ball. Don Holm of the National Trust Community Investment Corp. provided a case study involving the redevelopment of the Civil War-era Masonic Temple in Baltimore into 90,000 square feet of banquet and conference space serving two adjacent hotels, the Tremont Park Hotel and the Tremont Plaza Hotel. The old Grand Lodge had originally been slated for demolition in favor of construction of a municipal parking garage. The hotels' owner and developer, William C. Smith & Co., working with NTCIC, put together a package of federal and state historic tax credits and new markets tax credit-enhanced financing allowing it to purchase the lodge and turn it into something unique. A hotel, while clearly a piece of real estate, also is an operating business that creates lots of jobs and it is therefore potentially eligible for development incentives not generally available to all real estate projects. The Tremont Grand project team successfully leveraged historic preservation and economic development incentives to create well-paying service jobs targeted at local residents and contribute significantly to the renaissance of Baltimore's historic Charles Street area.

Sell the Rooms, Keep the Hotel

What if you could get the hotel guests to pay for the cost of building the hotel and then charge them a fee for managing it? Sounds too good to be true, doesn't it? It's not only true, but the practice has become pervasive. The so-called "condo hotel" is no longer merely the latest creative hotel financing idea, but rather is a fairly well-established model with compelling economics for the developer. In a condo hotel, all or a significant portion of the rooms are condominium units that are sold to third-party buyers. The developer does not even break ground until he has significant and binding

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presale commitments. Once the building is up, the units sell out and the developer has drastically reduced, or perhaps even eliminated, its equity commitment to the project. In effect, the developer has gotten a nearly free hotel. The unitbuyers get to put the units into a rental program typically managed by a major hotel brand. While an owner is not using a unit, a hotel guest will be in it, the hotel operator will be collecting the income and maintaining the unit, for which it will charge a fee. For lawyers, the condo hotel structure involves a cornucopia of complex legal issues, ranging from avoidance of characterization of unit sales as sales of unregistered securities to drafting proper controls in the governing documents to assure the hotel will conform to the brand standard. While there are many well-done condo hotels out there (mostly in the ultra-luxury segment), there are a number of poorly conceived projects. The draw of "free" money is a powerful thing. One cannot help but wonder when the good times in the hotel industry finally end if the condo hotel will join the timeshare as something for a consumer to avoid. Timeshares are now called fractionals. Perhaps the industry will be as creative with the condo hotel should the need arise. In the meanwhile, litigation partners are filing their teeth.

Select Service

You say a full-service hotel costs too much to build and you cannot take advantage of any of the traditional strategies? Never fear, the major hotel flags are rolling out "select service" brands, such as Aloft, Indigo and Hyatt Place. The select service brands emphasize the quality of the guest's in-room experience, as opposed to requiring the full panoply of more expensive full-service hotel meeting areas, restaurants and the like. The construction cost numbers for the brands are made to work in today's environment and the design elements of each are calculated to fit the lifestyle of today's traveler. Lifestyles, however, can always change. The buildings designed for a particular lifestyle can change, but not for free. Thus, some thought should be given to whether a particular brand under consideration for a specific application represents a long-term solution for creation of an asset or a short-term fix that will be due for overhaul before overhaul makes financial sense.

Tools do exist to make feasible what at first blush would appear dead on arrival. Because most analysts believe there are at least a few more years of good times ahead for the hotel industry, because the hotel asset class is generally outperforming other real estate asset classes, and because the fundamentals governing hotel performance have never been stronger, the pressure to build continues. ■