



Research Articles

CONDO-HOTELS

GREAT PROSPECTS, BUT BEWARE OF THE RISKS

Condo-hotels have become increasingly popular over the last few years and are seen as the hot topic within the industry. Many hotel consultancy firms remain very positive and optimistic about the sector. In our opinion, investors should take advantage of the opportunity that condo-hotels have to offer.

However, care should be taken. We believe that, as it tends to happen, the market is ahead of the law. Regulation around this product remains deficient, to say the least. This has recently led to several lawsuits between condo-hotel unit owners and developers/operators being filed in the US. Additional concerns to confront in this segment are oversupply in certain markets and lack of liquidity.

We see all these issues as a risk for the industry that will have to be addressed in the near future in order to avoid raising the alarm amongst investors. The power of branding and having the expertise of a top international hotel operator are factors that we view as key mitigants to the existing risks of condo-hotels. As an investor, who you are or who you marry becomes critical.

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Executive summary

The market for condo-hotels is booming

Condo-hotels are nothing new (in fact, condo-hotels have been in the market for the last 50 years). What is relatively new is the proliferation of this lodging formula around the globe. Investors are increasingly interested in this market, which is growing significantly. The residential component of condo-hotels makes many luxury projects financially feasible where limited financing and escalating construction costs would otherwise be prohibitive (meaning that it would be non-viable if such developments were stand-alone hotel projects). The conversion of hotel property into residential product was a facet of many deals in the US in 2005. The market for condo-hotels has been buoyant over the last few months. In 2005, more than US\$25billion (34%) of real estate in the US was sold with the intention of converting the property partially or entirely into residential condos or condo-hotels. According to Lodging Econometrics, this trend is likely to continue in the foreseeable future.

Prospects remain very positive; the sector has the support of industry experts

The prospects for the industry seem quite attractive. If we take a step back and think of what condo-hotels are and the reasons why they were initially developed, then we will see that the product has many ingredients to be successful. According to Jones Lang LaSalle Hotels, the great interest shown by developers, operators and investors supports the investment case for this sector. Jeffer, Mangels, Butler & Marmaro LLP (JMBM), a US based full-service business law firm, says that it is optimistic about the future of this unique real estate product. According to them, factors such as a growing demand for hotel rooms, a low interest rate environment, hungry capital looking to invest in real estate or baby boomers with disposable income for resort vacations and capital to buy property have established condo-hotels as a major real estate trend for the foreseeable future. JLLH also said earlier this year that it remains optimistic about the future of the alternative hotel investment market in Europe.

We believe that a way investors have to mitigate the risks is by either being or partnering with a strong branded hospitality group who understands this industry

And our view? We see condo-hotels as a great industry with excellent prospects but with peripheral issues that cannot be ignored. As described below, the risks are there. That, though, is not the key issue. It is how investors handle those risks that becomes critical. Clearly, the condo-hotel industry offers great potential with attractive returns. We believe that a way investors in condo-hotels have to maximise those returns and mitigate the risks is by either being or partnering with a strong hospitality group who understands this industry and that can offer, amongst many other things, a leading brand name. Embarking in a condo-hotel development project hand-in-hand with a top international hotel company is a way we see to reduce investors' exposure. Not only because of the company's expertise, but also because of the power of its brand. Company names such as Ritz-Carlton or Four Seasons cannot totally guarantee a project's success but can certainly reduce or eliminate many of the risks mentioned below.

The risks? A few variables to take into consideration

And what are those risks? As the number of condo-hotel projects increases world-wide, so do the different ways to develop them. There are several variables and many different players to take into



consideration (mainly the hotel owner/developer, the condo-hotel unit owner and the hotel owner/operator). All have their responsibilities and rights. However, there is a fine line separating those. Who does what and who pays for what are not questions with straight-forward answers in most cases. We have looked into the subject and we still have some unanswered questions and significant doubts. The object of this article is to provide an overview of condo-hotels and its prospects. We have tried to talk as generally as possible about what they are and how they operate, which has proven difficult. We have inevitably come across many particular issues and questions, which answers vary from country to country or from project to project. And that is precisely the problem. This lack of clarity around condo-hotels is, in our view, not doing the industry any favour.

Several risks around the sector should be addressed

In the US, the scrutiny from the securities agencies are the main legal concern for developers. Then comes the risk of buyer lawsuits due to unfulfilled expectations from those who had an over-optimistic opinion of the condo-hotel unit's rental programme. Also, how individual unit owners face the reality of the hotel industry still remains to be seen (operational risk, seasonality, capital expenditure needs and the like). Other risks, as mentioned above, are determining which party has control over the project infrastructure and shared facilities and making all the complex agreements work together. The main challenge seems to be establishing a comprehensive legal framework around condo-hotels.

Starwood has taken a more conservative approach towards the condo-hotels sector

JMBM says that *"it is likely that we will see a good number of condo-hotels become the subject of litigation because they were developed without appropriate guidance for sound business, economic and legal viability"*. Press and research articles have been published about Starwood considering stepping back from managing condo-hotel projects, concerned by numerous lawsuits around the US. This is an overstatement and is perhaps not totally accurate. The company has told us that it will simply take a more critical approach towards the condo-hotels sector and that it will always look at market opportunities on a case by case basis. They consider that the regulatory environment has changed and that it is prudent to act more conservatively, analysing projects on an individual basis (considering each market, regulatory environment, product and brand individually). With so many issues surrounding the condo-hotels segment, seeking sound legal advice and having adequate preparation and documentation is imperative. This is where we believe that being a top hospitality group with a powerful brand or partnering with one becomes a great advantage.

Oversupply and liquidity are additional reasons for concern

Other concerns that exist around condo-hotels are oversupply in certain markets, the absence of a secondary market and, consequently, liquidity problems. Oversupply could negatively affect investors' returns in the form of rent and capital appreciation. Also, given the cyclical nature of the business, the value of condo-hotels could be negatively impacted if there is an economic downturn. And it is too early in the cycle to know whether there is a secondary resale market or even how much condo-hotels are likely to appreciate over time.



Great prospects,
but know your
risks

To conclude, we can say that condo-hotels offer considerable advantages for all market participants. Developers can find a quick exit to their investment and get better financing conditions. Condo-hotel owners can purchase a generally upscale property that includes a high level of services without having to think about maintaining it. And hotel operators can grow their portfolios in a way that would not be financially feasible without the condo-hotel formula. That said, overusing such formula (like turning 100% of hotel rooms into condos), regulatory restrictions or lack of appropriate financial and legal advice can overshadow those advantages. In a nutshell: condo-hotels offer great prospects, but know your risks.

Individually
owned units,
centrally
managed by an
operator

What is a condo-hotel?

A condo-hotel is a property with different units that are centrally managed by an operator (a single brand). In contrast with a hotel, these units are individually owned. Hotels are generally owned by single hoteliers owning the entire property. However, in a condo-hotel, the rooms are sold to investors who can use their units but who are also allowed to rent those units whenever they are not using them in exchange for rental income. The rental programme allows for single night rental periods, as opposed to weekly or monthly minimum periods (which tend to be the case in other alternative hotel investment vehicles).

A condo-hotel has the look of a hotel. The rooms are generally the same as in a traditional hotel. Sometimes, however, condo-hotel units can be larger (they can be apartment-style units). This is done to increase the appeal of these units for potential buyers. In terms of the services offered, these are the same than in a hotel: housekeeping, food and beverage, retail facilities, meeting space or room service, to mention a few.

The condo-hotel term is used to reference a variety of hotel products. At one end there is a property that functions as a hotel, but where all rooms are condominiumised and owned by individual owners who may put their units in a rental program and then be used as hotel inventory. At the other end there is a hotel or resort property that has one building for hotel guests and another building with condos (where owners may share facilities with hotel guests). And then there are variations that fall within these two products.

A contract
between unit
owners and a
management
company

In order for the condo-hotel to be run smoothly, it is necessary that a contract exists between the individual owners and a management company and that the latter has a consistent maintenance requirement. The management company tends to be a third party renowned hotel operator.

Considerations
must be
addressed in the
initial structure,
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rules of the

Condo-hotels as a product are significantly more complex than traditional hotels and involve many additional aspects. The legal structure, design, financing, construction, marketing and hotel operation all affect one another. Simple changes in one aspect of the project may have a ripple effect on all the others. All of these considerations must be addressed in the condo-hotel's initial structure,



game is not an easy task

as changing the rules of the game is not an easy task. It may prove impossible to amend a certain aspect of the deal, as consent may be required from all and each of the divergent stakeholders.

How does a condo-hotel differ from other forms of accommodation?

Other lodging formulas exist, which offer similar characteristics but that are not the same

Condo-hotels are becoming increasingly popular. Investors and the general public are becoming more familiarised with the term, although it is still sometimes misused. Other lodging formulas exist, which offer similar characteristics to condo-hotels but that are not the same as these. There is some differentiation between concepts like condo-hotels and fractional units or timeshare. In the table below we highlight the main differences.

Table 1: Comparison of the principal alternative hotel investment vehicles

Product	Product Quality	Destination Focus	Real Estate Interest	Economic Benefit	Liquidity	Prospects
Timeshare	Low to Upscale	Resort	Defined right of occupation	Opportunity cost / benefit of use, plus swap and exchange	Low, high depreciation and re-sale restrictions	Mature market, substitution impact of VOC / Fractional units
Vacation Ownership	Upscale to Luxury	Resort	Defined right of occupation	As above with additional hotel / brand benefits	Low	Growing as hotel brands extend reach
Fractional ownership / Private Residence Club	Upscale to Luxury	Resort / City Centre	Ownership of a share of a single letting unit	As above, plus potential capital appreciation	Underpinned by real estate values, highly dependant upon individual project	Growth in city centre and high value destinations
Serviced apartments	Limited Service to Luxury	Resort / City Centre	Ownership of entire real estate or single letting unit	Income from operations, opportunity for capital appreciation	No restrictions, existing pool of operators and buyers set to grow	Growth within branded supply and new investor base
Condo-hotels	Midscale to Luxury	Resort / City Centre	Ownership of a single letting unit	Income returns + limited opportunity cost / benefit of use	Good prospects, underpinned by real estate values and income returns	Growth potential amongst investor base and in city centres

Source: Jones Lang LaSalle Hotels

The market for condo-hotels globally

The condo-hotel trend began mostly in mature US

Condo-hotels have become very popular over the last few years. The industry in the US has grown from US\$160 million in 1999 to US\$1.5 billion currently. This trend began mostly in well-established resort markets such as Florida, Hawaii or Las Vegas in the US and Mexico.



resort markets, though the concept is now spreading world-wide

The concept, however, is now spreading to many other parts of the world (like Canada, Caribbean, Europe, South-East Asia, etc.). Today, condo-hotels are moving further into urban areas as well and have also developed in city-centre locations around key markets like New York, London or Paris.

Mixed-used projects becoming popular

Its potential is generating global interest. The residential component is becoming a must-have in many hotel projects. It makes the numbers work for projects that would not readily be financed as straight hotel deals.

There is a problem of oversupply in certain markets

The market for condo-hotels is currently very hot, although it seems to have overheated in some places. More than the big bubble bursting, what we may see are smaller localised bubbles bursting. Almost 20% of all hotel room supply coming into the US market are condo-hotel projects. Is there a risk of oversupply? JLLH believes that the bubble is already going bust in markets like Miami. According to Hotels Magazine, southern Florida and southern California are reaching saturation. Smith Travel Research believes that condo-hotels may be in oversupply, especially in Florida, Nevada and California. The housing boom has generally attracted large numbers of investors and developers, resulting in an apparent oversupply of condo-hotels.

We are in an advanced stage of the cycle in the US, which is not the case overseas

JLLH considers that, in general, we are in an advanced stage of the cycle in the US and that things are "normalising", but definitely not dying. The level of activity seen in certain parts of the US over the last few years has simply been unsustainable. Developers are now becoming more interested in other areas, especially overseas. Many foreign markets are at early stages of condo-hotel development (Mexico is an obvious destination, together with less mature markets like Costa Rica, the Caribbean, Europe or Asia).

Pricing

Condo-hotels are usually a product targeted to the upper end of the market

Clearly, there are many different types of condo-hotels. However, we can say that it is usually a product targeted to the upper end of the market. Branded condo-hotel projects are usually managed by the world's top-tier lodging brands, which should give an indication of this proclivity towards the higher end of the market. Some of today's strongest operators in this segment are Ritz-Carlton and Four Seasons. However, the list also includes other brands like JW Marriott, Mandarin Oriental, St. Regis and Westin.

Prices depend on several factors

Prices range widely from project to project. Pricing depend on various aspects like location, estate of the market, size, amenities, quality of the product and on who the hotel operator is.

Branded products achieve a 25%-50% premium

The branded product tends to be more expensive than non-branded. We can say that, on average, investors are ready to pay a premium of around 25-50% for a branded top-tier operator like Mandarin Oriental, to mention and example.

Prices/sq.mt. for condo-hotels in

According to Condo-Hotel Center, prices of condo-hotel units in the US market typically range from US\$300,000 to US\$1,000,000. However,



Spain can range from €3,000 to €8,000 approx.

across the entire spectrum, prices can range from US\$200,000 to US\$2,000,000 per unit. Around 60% of buyers in the US shop in the US\$295,000 to US\$425,000 price range for condos.

In order to provide some figures, we have taken the Spanish market as an example. Prices per square meter for condo-hotels in Spain can range from €3,000 to €8,000 approximately (in general terms, that is). Similarly, the size of a unit may vary substantially from one project to another. The size of a condo-hotel unit can go from around 60 sq. mt. (a simple hotel room) to c.250 sq. mt. (a suite or apartment). That would give us a unit price of between €180,000 and €2,000,000 per condo-hotel unit (a very wide range). However, looking at the average price of 5 projects recently announced by a developer in Spain, we get to a more realistic range of €180,000 to €300,000 per unit.

Prices per unit in landmark projects (Plaza Hotel in New York or Trump's latest project in Hawaii) can range from US\$400,000 to US\$9million.

As mentioned above, though, pricing obviously depends on which market we are talking about and the estate of that market. And, clearly, on the product itself. Take the condo-hotel units in the Plaza Hotel in New York. Prices go from US\$1.6million to US\$9million (there is even a US\$29.5million triplex apartment). On a per square meter basis, this would translate into approximately US\$45,000 /sq mt. Another example of this would be Trump's latest residential mixed-use project in Hawaii. It sold 464 luxury units worth more than US\$700million in just one day, which set a new world record for residential development sales. Buyers paid an average price of US\$1.5million, with units priced from the mid US\$400,000 for studios to more than US\$9million for a three-bedroom penthouse. This is just an example of how wide the pricing range can be.

Different parties involved – who does what?

The developer

There are several advantages for the condo-hotel developer

Condo-hotel developers can benefit from several advantages. Developers can find an almost immediate exit to their investment and get faster returns. They can quickly get cash inflows from the sale and pre-sale of the condo-hotel units. Also, developers can achieve a higher price for the units (compared with other forms of accommodation), given that these benefit from having the hotel facilities and services near by (such as restaurants or a concierge, to give an example). Developers can sell upfront the commercial space and hotel operations to a hotel management company for immediate profit. Thus, potential unit buyers would know who the operator would be and which hotel brand would be used to market the condo-hotel units. This would also allow the developer to receive rental income from hotel guests for those units that have been completed but that have not yet been sold.

What the developer can sell to the owners may vary

It is important to highlight that what the developer can sell to the individual owners may vary. In some cases, the developer sells the units, together with common space areas. In other cases, the developer sells the units but retains an interest in the common areas. And in other, the developer sells some units and none of the common areas (in many cases the developer becomes the hotel owner). In



terms of the shared facilities and common areas, it is generally the developer or hotel owner or operator who controls the non-revenue producing critical areas, but must ask homeowners and other who use them to pay for their fair share of usage.

The scrutiny from the securities agencies is one of the risks for the developer

In terms of the risks, there are a few worth mentioning. Developers in certain markets like the US are closely watched by the securities agencies. And by that we mean not only projects developed within US boundaries, but also condo-hotels sold to US citizens outside the US. A condo-hotel is generally marketed as a real estate asset. However, units encumbered by a rental requirement imposed by the developer should be sold as stocks or shares. In that case, the sale would be registered as a security with the SEC (Securities and Exchange Commission), which implies a costly, highly administrative and time-consuming process. In order to sell a condo-hotel as a piece of real estate (seeking to avoid security status), developers have to make sure that they comply with certain rules. Some of these would include the following:

- Avoid giving potential buyers any future rental income or expected occupancy rates (as the responsibility of calculating the expected returns should lie with the buyers themselves). However, it is not uncommon in some countries to offer the condo-hotel unit owner a fixed return for the first few years (of around 4%-5% annually), which would be guaranteed by the developer or hotel owner.
- Avoid very substantial restrictions on the unit owner's use or occupancy of the unit. If a developer uses an ordinance process to create material restrictions on a unit owner's use, the SEC (or a court) could decide that those restrictions imposed by ordinance were in fact caused by the developer's own actions, and thus renders the condo offering a security. Therefore, developers should limit their participation in the ordinance drafting process.
- Developers should select a different party to oversee the sale of the condo-hotel units and distribute information on the rental programme. Sales representatives should not discuss the potential economic or fiscal benefits that entering the rental programme could bring.
- Allow the condo-hotel owners to refrain from putting their units in the rental pool if they wish to do so.
- Allow owners to appoint a rental management company of their choice to manage the rental of their units. Also, developers may not prevent or discourage owners from renting the units themselves.
- Each condo-hotel unit will have its own individual income statement (owners will not share in the pooling of the rents).
- Sales and promotional material related to the rental programme is limited to the following statement: "Ownership may include the opportunity to place your home in a rental agreement".
- A buyer cannot put its condo-hotel unit into the rental programme before having signed the purchase and sale agreement for the unit.



With these securities limitations, getting the owners to put their units in the rental programme requires incentives

The hotel operator, on the other hand, will want to have a predictable inventory of rooms to rent out to hotel guests in order to ensure the efficiency of its yield management system. It is then when we see that the rules mentioned above could present challenges. With these securities limitations, getting the unit owners to put their units in the rental programme requires incentives to encourage them to sign long term rental management agreements (rental agreements must have a term limit, say 3 to 5 years). To be considered successful in this respect, a condo-hotel project should have around 80% or 90% of its units in the rental programme.

The developer has to support the costs of a late sale

Another risk for the developer is that, if the condo-hotel units do not get sold rapidly or at least as quickly as initially planned, the developer has to bear the costs associated with those units until they get sold.

In addition to this, any potential expansion plans present a challenge

In addition to this, any potential expansion plans present a challenge. Developers might find resistance from existing condo-hotel owners to further extend a project. Individual owners might be reluctant to give their approval for various reasons (perhaps the most obvious one being the fear of receiving lower rental income due to dilution caused by adding more units to the project).

The unit owner

The advantages for condo-hotel owners would include the following:

Various advantages exist for condo-hotel owners

- The possibility to use their properties whenever they wish. This is not the case in those units that are included in the rental pool, as the hotel operator needs to know in advance its room inventory (it needs to guarantee that guests booking in advance will have rooms available). In these cases, condo-hotel owners are generally restricted in their personal use of the unit (this is particularly true during peak seasons). How much they can use their unit varies from case to case. Personal use can be extended to a maximum of say four to eight weeks per year, in order to ensure the operator the use of the unit as a hotel operation. Prices of the various condo-hotel units diverge, depending on the different restriction levels attached to the property. Unit owners have to notify the operator about their intention to occupy their unit as soon as possible (at least 60 days in advance generally), in order to guarantee availability of their units.
- Having all the hotel amenities and services at their disposal (restaurants, room service, housekeeping, concierge, spa and fitness room, to mention a few). The condo-hotel owner has the right to use these, although at an extra cost in some cases (for example, the unit owner can use the hotel's swimming pool whenever he wants at no extra cost but will have to pay for housekeeping services if he decides to have them).
- If the unit owner decides to put its property in the rental pool, having the option to receive rental income for their unit whenever they are not using it. Rent rates are always fixed by the operator based on occupancy, market demand and



competitive properties. It is worth highlighting that the operator is entitled to rent any regular hotel room before it rents the condo-hotel units. Owners should acknowledge that their unit may not be rented as often as other units. In any case, however, the allocation of rooms within the rental pool programme is done on a rotational basis in order to ensure a fair and reasonable distribution of the unit bookings. This rotational system tends to be segmented by category, according to the different types of rooms (e.g. suites, ocean view rooms, etc.).

- Not having to think about maintaining the property (no hassle for the unit owner).
- Owners also benefit from tax breaks associated with mortgages and depreciation of their units.
- Unit owners should receive detailed information about all unit activity and their account activity on a quarterly basis.

In contrast, owners have to bear the costs of owning a condo-hotel. Here we have to differentiate between the costs that are common to all owners and those that are only attributable to those owners who decide to put their unit in the rental pool.

Costs for all owners

However, owners have plenty of costs to support

- Owners have to pay the price for the unit itself and all transaction costs associated with the purchase.
- FF&E costs (Furniture, Fixtures & Equipment). Condo-hotel units are generally sold including FF&E (which is reflected in the unit price). In those cases where FF&E is not included and the unit is part of the rental pool (which would happen in very rare occasions), the unit owner has the obligation to provide FF&E himself and to make sure that these meet the required standards.
- Property tax, which is a cost paid directly by the unit owners.
- A Homeowners' Association (HOA) is usually created to retain ownership of common space areas which have not been allocated to the hotel owner. Ownership is allocated on a pro-rata basis (based on the unit owners' shares). It is important to highlight here that all expenses should be accounted for before fair allocations can be determined (otherwise, the allocation exercise becomes useless). The HOA oversees the collection of dues from the owners, which generally cover expenses like the following:
 - Maintenance and repair costs for common areas (transient areas for the owners such as corridors or the lobby, to mention a few examples), which have to be kept to a certain standard.
 - Property insurance, which includes the unit's damage insurance costs plus the share of insurance associated with common areas and the premises (the building itself).
 - Utilities (electricity, water and the like).
 - Reserves.



In those cases where some units do not participate in the hotel's rental programme, then the non-participating owners may not have access to all facilities and services (and, consequently, will not be charged for those).

There is some confusion about what the HOA can and cannot do

When the developer exits the project completely (it sells the units and the common areas associated with them to the condo-hotel owners), the HOA can decide which hotel operator will be retained. A proposed ordinance in the US required that a condo-hotel HOA enter into an agreement with a hotel manager that would last at least 5 years. However, the condo regulations in some states limit the duration of contracts that a HOA may enter into (which, effectively, generates a conflict between the proposed ordinance and state law).

Another recently proposed ordinance in the US required that the developer or an entity other than the condo-hotel owners owns the common areas (so that the HOA would not own them). However, regulation of some states requires that common areas are owned by the HOA. Also, some state laws do not allow cities to determine who owns property, requiring that ordinances be limited to restrictions on the use of property. These are just other examples of how confusing the regulatory system around condo-hotels can be.

Additional costs for owners whose unit is part of the rental pool

There are additional costs that owners participating in the rental programme have to bear

Condo-hotel units are sold to individual investors by the real estate developer. The hotel operation is then sold to a well-known hotel management company. Those owners who want to include their unit in the rental pool programme sign a management contract and a rental agreement with the hotel management company. In the US, around 85% of all rooms go into the rental pool, with this figure increasing to c.90% in branded or high-end units.

This contract is generally renewable on an annual basis and mainly includes the following aspects:

- The hotel operator receives a management fee upfront (generally in the order of 10%). This fee is paid to help support mainly the hotel operator's marketing, advertising and branding costs, group sales, reservation systems, travel agent commissions and credit card fees.
- The condo-hotel unit owners and the hotel owner split the revenues received from the room rental pool (it is usually a 50-50 split). The revenues considered are *after* the 10% management fee given to the hotel operator. Additionally, the hotel owner receives all the food and beverage, recreational and meeting space revenues. The hotel owner uses its part of the rental pool income to (i) help support operating costs (such as salaries or other direct hotel expenses and overhead costs) and (ii) to contribute to profit. Costs like housekeeping will therefore be assumed by the hotel owner when the unit is rented to a third party. However, when used by the unit owner, housekeeping will be in most cases compulsory and at his expense in order to maintain cleanliness of the unit.



- A "usage agreement" is signed between the hotel owner / operator and the unit owners, which includes an annual FF&E reserve that is maintained by the operator (this reserve account is usually around 4% of gross revenues). The hotel operator sets the standards that the FF&E furnishing packages in the rental pool units have to meet (in fact, it is not only FF&E but also the proper infrastructure of the unit). If a condo owner fails to comply with such standards, the operator can make use of the reserve account, require refurbishment of the unit at the owner's expense or require expulsion of the unit from the rental pool. That being said, if there is an extraordinary event that damages the unit under a specific guest usage, it will be the hotel guest who will be charged for the expenses (the unit owner is only responsible for the normal wear of the unit).
- The condo-hotel owner shall contract insurance for material damage (it would be like insurance for what is actually inside the unit, for an amount equal to full replacement of FF&E) and premises liability (insurance against any loss or claim arisen from guests renting the unit). The unit owner is obliged by the hotel operator or sometimes the hotel owner/developer to prove payment of such insurance costs.

The hotel operator

Several pros and cons that exist for the operator have already been mentioned above.

The operator has to support a lower cash investment compared with fully owning a hotel

Some international branded hotel chains stress the need for developers to understand that they are building a hotel, not just condos. The operator expects to have group demand, which means having adequate meeting space and sufficient back-of-the-house space. Accessible food and beverage outlets, spa or gym are part of the brand package consumers count on when they see the flag over the door. Hoteliers who want to protect their brand and provide continuity in the guest experience have to bring discipline to the process.

Hoteliers who want to protect their brand have to bring discipline to the process

Challenges for the hotel operator would be maintaining the brand standards whilst having to deal with many different unit owners. Another problem that operators may face is having to deal with lack of product. That can be the case in those projects where 100% of hotel rooms are turned into condos. That is, if all available rooms are sold to condo-hotel unit owners and most decide not to participate in the rental pool, then the hotel operator would have no room inventory to offer to its guests. Also, in those cases where the hotel operator is also the owner, it will have to be confident about the margins that the hotel can produce (given that it is giving those owners whose units are part of the rental pool around half of the income received).

The financing company

The main advantage for financiers is that

The company financing the deal also has several advantages worth mentioning:



they get their money back earlier than in other longer-term financings

- Given that developers usually pre-sell the condo-hotel units, financiers get their money back earlier than in other long-term financings.
- There tends to be a pre-sale deposit of around 15%-20%. This provides funding for the higher risk construction phase.
- It is generally the norm that financing institutions do not provide financing to the developer if the latter has not reached a 50% threshold in presales of the planned condo-hotel units. Sometimes, financiers can be more flexible and provide financing even if the developer has not reached this 50% threshold. This would only be in those cases where a solid and long-standing relationship exists between the developer and the financier, when the developer has a good reputation and proven track record or when it has previously proved its strong financial position.

On average, projects are 60% debt and 40% equity financed

It is clear that financing conditions vary from project to project. However, we can say that, on average, construction costs are 60% debt-financed and 40% equity-financed. In relation to the term of the loan, financing is generally granted for a 5 year period, with a one-year extension.

The developer is sometimes obliged to use the down-payment as bank collateral

Generally, when purchasing a condo-hotel unit, buyers have to make a down-payment to the developer. In some countries, like in Spain, the developer is obliged to use this payment as bank collateral (which gives the buyer a guarantee against the development company). This, however, is not an extended practice world-wide. It may even differ within one same country (in the US, for instance, legislation varies from state to state: in California, funding from pre-sales cannot be used to finance construction, while it can in Nevada).

Final thoughts

Investors should take advantage of this hot market, but with caution.

To sum up: condo-hotels offer great potential. The industry has grown fast over the last few months and is expected to continue to do so. What remains to be seen is whether all the existing risks that surround the product will bring a halt to the rapid expansion that this market segment is experiencing. In our view, investors should take advantage of this promising industry, always watching very carefully aspects like "How?", "Where?" and, of course, "With Whom?".

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