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Avoiding the Pitfalls of Hotel Residences

The market for hotel residences has rebounded relatively well over the past couple of years. Demand has increased, and sale prices have gradually climbed up in most global destinations. North America and Europe have seen the market revitalized and future pipelines remain particularly strong in Asia, India and the Middle East where demand continues to be robust.

The model of branded residences seems ideal and sometimes is almost too good to be true: developers are able to generate cash flow more quickly and profitably, branded operators are able to expand and have new sources of management revenues as well as royalties associated with the use of their name, and private owners have a long-term investment opportunity with a possibility of rental revenue when not using the residence themselves.

In addition to many successes, however, the industry has witnessed a number of technical hitches, complicated court cases and full-scale fiascos that have arisen from development of hotel residences. These problems have related to both stand-alone hotel residences as well as residences that exist together with a hotel, sometimes with a rental pool program.

To better understand the successes and challenges of hotel residences, Strategic Hotel Consulting conducted research with global players including operators, developers and unit owners. Our research revealed the challenges that commonly occur are surprisingly similar regardless of the developer and operator, geographic location, type of development or the resident owner profile.

Below are key issues that should be taken into consideration when developing and operating hotel residences.

Transparency

Individual unit owners are a unique characteristic of hotel residences. The number of owners can be in the dozens, as is the case with most resort developments such as Four Seasons Punta Mita, Whistler and Mauritius and Six Senses Con Dao in Vietnam. The number can also be in hundreds, as is the case with some of the larger developments such as the Kempinski Palm Jumeirah in Dubai, Jumeirah Living in London or the Fairmont Vancouver. As many operators have experienced, managing the separate owners can be extremely challenging.

Most operators report that a key success factor is to engage in absolute transparency over the operations of the residences. This means communicating openly and providing detailed reports to the owners in terms of the revenue income (in the case of a rental pool) as well as residence expenses. Some owners might be satisfied with less information, but many like to know in detail the operations, cash flow and property handling of the residences.

To ensure there is full transparency, most operators provide monthly or quarterly reports to the owners, outlining revenues and expenses that have occurred and informing the residence owners of any issues of relevance such as maintenance of the residences or common areas.

Clarity of purchase agreement

Many hotel residence agreements give owners an option to join a hotel rental pool, although this can also be mandatory. Many owners — most operators report approximately 70% to 90% — take up this option. However, some may not wish to participate. In cases where the owner keeps the residence for their own use, this does not normally raise issues between the hotel operator and the owner, although operators prefer to keep the residences occupied to generate incremental revenues from food and beverage outlets, spa and other resort facilities.

However, sometimes residence owners wish to rent out the residence and do so independently without the operator. This usually happens if the owner feels the rental terms are not fair (operator or hotel owner getting too large a slice) and/or the market is favourable and there is sufficient demand to rent out the residence without the marketing and sales engine of the operator. This may not necessarily cause an issue if the residence is rented out on a long-term basis since most operators are lenient towards long-term rentals. However, issues tend to arise in cases when the owner directly tries to compete with the operator by selling nightly rentals of the residence.

Situations have occurred, for example, in Dubai, where the operator has had to take legal action against residence owners due to renting of the residence outside the hotel pool. In these instances the owners have appointed local real estate and travel agents to sell their unit on a nightly basis. Some have gone as far as listing their residence via online travel agents and accepting reservations as if the residence was a hotel. In these cases operators have taken prompt legal action and in most cases successfully sued the owners.

Litigations such as the above hardly reinforce the relationship between owners and operators and therefore would be best avoided from the start. A clear purchase agreement, signed between the developer and the owner and outlining in detail how the residences can be used and rented out, can avoid such situations from occurring.

Conservative investment return projections

Hotel residences that participate in rental pools are often sold with the promise of a luxurious lifestyle and ample investment returns. While the luxurious lifestyle is usually achieved, the investment returns through rental schemes tend to be modest, with most parties reporting returns in the range of a few percent. As a result, many developers and operators have over-committed at the sale phase and under-delivered at the operational phase, which has created unhappy investors and residence owners.

There are many cases in which the investment returns have not reached the highly optimistic “best-case scenarios” often provided by the developers. This has caused countless complaints, and in some cases residence owners have sued developers for fraudulent misrepresentation of anticipated income. This was the case with a branded hotel residence in Miami where a group of residence owners successfully sued the operator and the developer on the grounds of paying inflated residence prices based on false and fabricated promises of investment returns.

Similarly, there have been cases where developers have exaggerated volumes of residence sales in order to attract demand. A group of residence owners in New York filed a lawsuit in 2012 claiming that they were tricked into buying the branded residences by deceptive apartment sales figures. The court case was eventually settled with plaintiffs recovering nearly all of their deposits.

As a result of the owner complaints and court cases most operators and developers have learned that with residences it is better to under-promise and over-deliver. Many developers now provide conservative estimates of future projections and investment returns. Similarly, many present potential owners with alternative market scenarios (not only "best case") to ensure they have realistic expectations of investment returns. Most developers are now reluctant to provide investment guarantees and operators almost categorically refuse to do so.

Consideration of local laws

Due to their complex nature and business model, hotel residences require detailed knowledge of local laws. This is especially the case in relation to the owning or renting of the units, insurances and real-estate taxes.

Some regions such as North America have fairly regulated real-estate laws in relation to owning or operating income-generating real-estate assets. This has led to numerous problems in selling and operating hotel residences (or "condo-hotels," as they are more commonly referred to in North America). One of the biggest issues in the United States has been in relation to the Securities Exchange Commission (SEC) law and how this is applied. After much discussion and debate, a recent change in the law allows hotel residences to be sold as investment securities, which is likely to further boost the U.S. market.

Similarly, other countries have their own specific laws that need to be considered. For example, in Switzerland there are restrictions on foreign ownership of real estate (a key concern for the upcoming Bürgenstock Resort) while in Saint Kitts and Nevis foreign ownership grants citizenship (a key selling point of the upcoming Park Hyatt).

Hotel residences and rental pool concepts are also still relatively new to many regions, and some countries — for example, in Asia and the Middle East — are still refining relevant local laws to adapt to the sudden influx of hotel residences.

Go ahead, but be careful

Hotel residences can be exceptionally successful for all parties involved. However, the concept can be complex, and while various schemes have had their successes, they have also encountered setbacks and challenges. The typical owner/operator issues tend to relate to transparency, managing owner expectations and clarity of the agreement. From the developer's strategic perspective, hotel residences also require specific consideration, key aspects including a project entry and exit strategy, creation of cash flow and brand appropriateness and exposure.

About Tea Ros - Strategic Hotel Consulting

Tea Ros is the Managing Director of Strategic Hotel Consulting, an international management consulting firm specialising in hotel and tourism investments. Strategic Hotel Consulting provides advice to owners, investors, developers and operators on how to optimise project investment, enhance asset value and maximise profitability. For more information, please see www.strategichotelconsulting.com or contact tea@strategichotelconsulting.com.