



Condo Hotel Finance: Great Opportunity or Trap for the Unwary?

By *Jim Butler and Guy Maisnik*

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As real estate markets have recovered and then sizzled, financing has become extremely competitive for most categories of real estate, leaving lenders with razor thin margins. One exception to this game of low-ball is the financing of condo hotels*. Because of the many complexities that are built into the condo hotel regime, the newness of the product itself, and the heady profits experienced by some condo hotel developers, the market for condo hotel financing is relatively price-insensitive.

Lenders interested in taking advantage of this financing opportunity face one big hurdle from the outset. Very few lenders have any experience in condo hotel lending. Normally, this would not be a serious problem. The lender would simply hire outside advisors to work with its internal staff for the first deal or two until they were comfortable handling it on their own. This concept certainly works well, but the difficulty is a temporary shortage of talent.

Condo hotels are not new. But the recent explosion of interest and projects is. It has taxed the limited resources at many levels -- brands, operators, consultants and knowledgeable condo hotel lawyers. Unfortunately, there is no shortage of advisors who want to get on this bandwagon, but the developers and lenders using them will pay a mighty price for the education -- either in

* Condo hotels are a hybrid real estate product where a hotel is condominiumized, and all or a part of the hotel rooms are turned into condo units. The units are purchased by individual consumers who can then make the individual condo units available to the hotel operator as part of the hotel's room inventory. (See, Condo Hotels: Managing the Investment, Commercial Mortgage Insight, August 2005.)

wasted costs as the experts "go to school" on their client's dime, or in missed practical advice and guidance that is only learned one deal at a time.

Lenders will be well advised to thoroughly check the condo hotel-specific experience of their advisors -- not what they have done in condo development. Not what they have done in hotel development. But what specific condo hotel deals they have done? Who have they worked for? What were the results?

This vetting process is critical because "fixing" condo hotel deals that are poorly conceived or badly structured is nearly impossible and lenders that fund problem projects can be left with a complicated bundle of business and legal issues that far outweigh the usual headaches of a hotel or condo project workout. But these projects can be very rewarding for lenders that develop or access the right expertise to study the environment, understand the issues, find the right project and, most importantly, carefully underwrite the condo hotel regime.

Reaping the Benefits of Condo Hotel Lending

In addition to the relative price insensitivity of developers shopping for condo hotel loans, lenders have found additional benefits to funding these projects.

Short-term payoff. Typical condo hotel financing will involve a construction loan on the entire condo hotel project that converts into a smaller permanent loan on the "residual hotel" — the parts of the hotel that are left after the condominiumized rooms have been sold off to consumers. This scenario offers a definable

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source of repayment for the loan within a relatively short timeframe.

Reduced risk through pre-sales. Compared to traditional hotel finance, much of the lender's risk can be reduced during the pre-construction phase with proceeds generated by pre-selling condos. Although pre-selling the project's condos is not always required, some lenders demand sufficient pre-sales of condo units before a shovel ever hits the dirt. These lenders view the pre-sale market, or lack of it, as an indicator of a project's viability. A lender that is not entirely comfortable with a developer's track record or is unfamiliar with the nitty-gritty economics of a condo hotel project can establish a pre-sale requirement in addition to other restrictions in the loan documents.

Good hotel brands increase revenue. Compared to similar condo units in the same market, units in condo hotels nearly always sell at a premium. Consumers are willing to pay substantially more for units in properties with hotel amenities, particularly properties that carry an upscale hotel brand. The additional revenue provided by this value-added component allows developers to pay down loans more aggressively than in traditional hotel or condo scenarios.

Growth market. The convergence of a number of trends -- a growing and unmet demand for more hotel rooms, hungry foreign capital looking to invest in U.S. real estate, baby boomers with disposable income for resort vacations and capital for buying real estate, equity driven by the 1031 exchange market, a lack of viable real estate tax shelters and the low interest rate environment -- have established condo hotels as a major real estate trend for the foreseeable future.

Assessing the Risks and Rewards of Condo Hotel Lending

Lenders understand risk/reward ratios better than most professionals and will want to be thoroughly familiar with the risks attendant to condo hotels, before making loans.

Consumer financing. In the context of a condo hotel, individual condo unit financing can still be rather limited. Until more consumer-oriented lenders learn how to benefit from the condo hotel opportunity, construction lenders will want to be fully informed as to how condo purchasers will obtain mortgage financing for the units in their project or their willingness to pay more of the purchase price in cash. This is often provided by local lenders.

Market feasibility. Condo hotels will not flourish in every local market. Consultants sufficiently familiar with hotels, condos and the unique particulars of condo hotels can provide savvy lenders with data on market conditions that will help them evaluate the viability of a specific project.

Condo hotels and the Securities and Exchange Commission. From a legal standpoint, state and federal securities laws play a significant role in the structure of the condo hotel and in the sales aspect of the individual condos. While the sale of a traditional condo generally does not involve the sale of a "security," a security will be involved once a condo sale includes almost any discussion of rental management services. Yet, the rental management agreement between condo owners and the hotel operator is paramount, as the agreement will provide an adequate supply of hotel rooms. Unless lenders want to deal with a project mired in SEC injunctions and consumer securities litigation, they will want to be satisfied that they are in compliance. They want their borrowers to be fully conversant in these regulatory issues and guided by experienced counsel who can provide the procedures, training, documentation and other safeguards necessary to ensure that both SEC compliance and economic viability are achieved.

Know Your Strengths and Weaknesses. Funding a condo hotel project requires a detailed understanding of the issues inherent in both hotel finance and condominium finance. Hotel lenders will understand, for example, that the availability of condo units for all or a part of the hotel room inventory is crucial to the success of a condo hotel project. They will understand how the "right"

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operator, a hotel operating agreement designed to cope with the challenges of the condo hotel regime, and even the brand, will affect the success of the project. On the other hand, condominium lenders will understand the critical role of the HOA and CC&R documents in maintaining the property and the risks relative to potential construction defect litigation. Yet obtaining expertise from both sides of the condo hotel aisle is not enough. You will want to work with experts who have detailed knowledge of the condo hotel product.

Follow your own best advice. In the rush to participate in this profitable new wave of finance, lenders should be reminded to perform the requisite due diligence. Who is the developer and who are the contractors and subcontractors performing the work? Are they following best practices for construction and documentation? Do they have the appropriate indemnities and releases in place? Do they have the right insurance for protecting the lender from the cost of potential litigation?

Understanding the Product and the Players

The interaction of the condo and hotel components creates a “third dimension” of unique issues and competing interests that are challenging to even the most seasoned of real estate professionals. Because we have handled a significant number of condo hotel deals, we have been called upon to review documentation of many projects prepared by experienced real estate advisors who simply lack substantial condo hotel experience. Unfortunately, we usually see numerous areas of serious weakness in the structure of the condo hotel regime. In many cases we are unable to provide a “fix” to the problems because once one condo unit is sold, or other third parties have become involved, it is usually impossible to get the necessary agreement of all parties to unscramble the omelet in order to make it again correctly. And fixing one “feature” of a condo hotel regime has a ripple affect on many other areas. While we are optimistic about the future of this unique real estate product, 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.

To avoid this grim scenario, you will want your project structured by professionals that have actually put together more than one hotel condo deal and can explain in detail the opportunities and pitfalls that are inherent to these projects. Make sure a firm with actual condo hotel experience performs your market studies and financial modeling. Work with condo hotel lawyers and condo-marketing organizations that understand the challenges presented by SEC compliance and take them seriously.

Your hotel operator should have experience in operating condo hotels -- understanding how to encourage condo unit buyers to put their units into the hotel rental management program, the unique challenges of accounting to each individual owner for the results of his unit, how to balance and rotate occupancies for fair and equitable results, and the complications of working with a homeowners association.

Retain an experienced condo hotel lawyer who can weave together the priorities of all parties -- the lenders’, the developers’, the hotel operators’ and the condo owners’— so that all have some “skin in the game” and are committed to making it work. This is done through a careful handling of hotel operating issues, condo investor concerns, and appropriate allocation of “shared facility” and “dedicated facility” costs and revenues. It also involves knitting solutions tightly throughout the hotel management agreement, the HOA management agreement, the facilities maintenance agreement, the hotel rental program agreement, and the HOA and CC&R documents. Underwriting the condo hotel requires an underwriting of all these factors and their mutual interaction with the specific real estate involved.

Catching the Wave

The rising tide of condo hotel development in the United States and abroad is lifting the hospitality industry to new levels and lenders are catching the wave, anticipating significant profits.

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Unfortunately, some condo hotel lenders will be carried out to sea by currents they never saw coming, while others will navigate safely to shore with enviable balance sheets.

Our vantage point as seasoned hotel lawyers (our Global Hospitality Group has participated in hotel transactions totaling more than \$35 billion and involving more than 1,000 properties worldwide)

has allowed us to participate in the condo hotel boom since its early days.

While our clients have benefited from the lessons we have learned as the condo hotel market has developed, we understand that the “basics” are still more important than ever: there is no substitute for proper underwriting, and assembling the right team to execute a project can increase the odds for success exponentially.



Jim Butler is recognized as one of the top hotel lawyers in the world. He devotes 100% of his practice to hospitality, representing hotel owners, developers and lenders. Jim leads the Global Hospitality Group—a team of 50 seasoned professionals with more than \$35 billion of hotel transactional experience, involving more than 1,000 properties located around the globe. They are more than “just” great hotel lawyers. They are also hospitality consultants and business advisors. Through the practical experience of more than 36 condo hotel projects in the United States and Latin America, the Global Hospitality Group has distilled the best aspects of earlier projects and advanced the “cutting edge technology” to find better solutions to many condo hotel issues. Jim Butler is a Founding Partner of

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