Navigating the Many Upfront Issues of Branded Residential Development

All Parties Must Understand the Steps of the Process

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The hotel branded residential segment continues to grow, not just for many renowned hotel brands but extending to luxury fashion and automotive brands that link designs or accessories to the sale of residential real estate.

What started as a "upfront" financing tool enabling the construction of an adjoining luxury hotel is today expanding to "stand-alone" residence-only product linked to a brand and common area "club house" — spa, club room specialty food and beverage, etc. — but with no contiguous hotel.

At face value, it sounds like a win-win for all parties.

For the developer, it's a significant 20% to 40% sales premium than if project residences are sold unbranded. There's the assurance of a high level of design quality and brand prestige associated with the project. And don't forget the ability to leverage the adjoining hotel's facilities — spa, housekeeping and food and beverage — for use by the relatively captive and affluent residence-owner audience.

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The brand operator wins by leveraging the brand to an expanded real estate customer base beyond the transient hotel guest. The brand operator can also obtain a brand license fee — typically between 3% and 6% of residence gross sales price — for the relatively nominal effort of associating the brand with the sales effort. Lastly, the operator collects additional fees for managing the residences as well providing this captive audience to the ancillary hotel offerings.

How does the residence buyer win? First and foremost, he or she earns the status and prestige of buying into and living in a luxury brand and lifestyle. This brings greater assurance that the design and fit out will be carried out to the high standard promised in the sales brochure and that the common areas and the common rules and regulations will be maintained and enforced. Finally, there's the enhanced resale value of a branded unit, as well as the potential "investment return" element where the residence can be placed into a rental pool and let out as hotel inventory.

The above all sounds good. But it is surprising how little thought is given to the overall concept and structure of such projects — particularly by the developer and residence buyers — before launching ahead. It is often the brand operator who tries to steer the overall project concept in a way that better aligns the participants — and ultimately benefits their brand — based on their previous learning experiences from successful branded residential projects and those less so.

An often neglected first step is to clarify the mixed use and/or strata ownership rules in the project jurisdiction, such as:

- Whether there are mandatory owners associations who oversee maintenance of the residences' common areas;
- If there are no such rules and the developer maintains these areas and charges these costs to residence owners through annual levies — potentially with significant captive premium; or
- In cases when alternative legislation applies. For example, in Dubai, the developer must engage a licensed third party building manager to oversee common areas maintenance, establish the budget and assess common service charges on residence owners.

The common-areas governance rules directly affect the structure of the project and how all legal documentation required to allocate management and maintenance responsibilities between the developer, brand operator and the owners association or building manager.
Once the legal structure is confirmed, one should determine the intended residence buyer demographic. Buyers seeking an investment product or a holiday home which they occupy for several weeks per year and rent out the remainder will naturally prefer a rental pool arrangement, whereas those who view their residence as a "home" will prefer a more stable community environment where they know their neighbors. They will be less keen on the transient community that a rental pool structure brings.

Where there is the “middle ground” of an “optional” rental pool, it is important to structure and allocate the common area facilities — such as the pool, gym, club room, etc. — so that the transient hotel/rental pool guests do not infringe on constancy of those residents treating it as their home.

This demographic difference may be highlighted by the growing popularity of “stand-alone” residences, which most brands promote as luxury residential living facilities and, save for certain tourist settings an circumstances, generally do not offer rental programs.

Assuming there is a residence rental pool, how is it structured? Do you compensate the residence owner via a fixed lease payment for their unit, a percentage of gross rooms revenue related to the unit’s letting, or is there a “pooling” of total rental pool gross rooms revenue that is then distributed to residence owners based on various weighting factors? And what overheads are deducted from this owner distribution, such as furniture, fixtures and equipment contributions, utilities and maintenance costs, property/other taxes and property insurance in addition to common area assessments.

Will the rental program rooms revenues — non-rooms revenues remain hotel services — be provided for in a separate profit-and-loss statement or included in the hotel’s? A successful rental program is likely to shift a progressive gross-operating-profit-based hotel incentive fee upward to the operator’s advantage, since the GOP margins on residence units tend to be higher than standard hotel rooms.

The tendency is for operators to avoid the pooling of rental program distributions or including the program in the hotel P&L. This is to avoid the residence owners challenging the allocations of expenses/other charges between the hotel and rental program demanding access to the hotel’s financials. Also. It makes the rental program with residence owners more like an ordinary real estate lease investment, whereas associating it with the hotel’s performance potentially characterizes it more as an investment in the hotel’s operation, which can also bring added disclosure and collective investment regulations into play as well as create additional legal challenges risk for such schemes.

A good deal of upfront thought — preferably with advisers experienced in branded residential projects — is required before embarking on a branded residential development for all players. While the more experienced brand operators have faced these issues and have trial-and-error-devised solutions, developers and residence buyers also need to do their homework and get experienced advice. This is even more important in emerging markets where the mixed-use legislation is less developed.

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