



Condominium hotels – lessons learned

Improvement in the global second-home and overall lodging markets, particularly in gateway and primary resort destinations, combined with an updated regulatory framework is causing a resurgence of interest in condominium hotels.

Condominium hotels vary in structure and operation throughout the globe. While in most locations they physically resemble a condominium development, offering large units with kitchen facilities and little public space beyond a reception area, in other locations the asset resembles a typical transient lodging operation. This latter model became popular during the last real estate upcycle in the 2000s, particularly in the US. In this model, the ownership structure is divided between a hotel lot owner, who owns the building's public spaces and ancillary revenue-generating facilities, and individual unit owners, who, if participating in an available rental program, share in the revenues and expenses associated with the rental of their units as transient lodging accommodations. This kind of condominium hotel features the public space, amenities and level of finishes consistent with a hotel operated by the affiliated brand.

Regardless of the physical appearance or operating structure, condominium hotels are often considered attractive to developers, lodging operators and unit owners alike. In markets where traditional construction lending was limited, the presale of units had allowed developers to obtain construction financing, aligning themselves with a hotel operator to gain pricing premiums on unit sales. Lodging operators benefited

from new inventory under management and potentially earning a licensing fee on the sale of the units. Unit owners often purchased units assuming that values would continue to appreciate and that the income generated from their revenue split would cover their costs of ownership.

With the global economic decline, however, many condominium hotels, particularly those located in the US, have faced litigation, restructuring or bankruptcy, mostly due to issues surrounding control, income allocation and securities issues. At the core of the complexity has been the applicability of securities laws to the offering of condominium hotel units.

The US Securities and Exchange Commission (SEC), in a 1973 release (SEC Release 33-5347) and in subsequent no-action letters, has addressed the issue of when the sale of condominium units constitutes the sale of a "security." In brief, the SEC's guidance prohibits (a) the pooling of income, (b) emphasis of the investment aspects of the condominium and (c) restrictions on use of the condominium (such as a mandatory rental program). This issue affected projects targeting both US buyers, a major source of global investment in second-home real estate, and international buyers, who, familiar with the concept back home, faced additional complexity and risk.



Most developers sought to avoid the costly and impractical registration process and set up procedures to avoid having to register, or targeted non-US buyers, who were except from such regulations. They offered optional rental programs, avoided sharing or discussing any information related to the economics and separated the rental program and purchasing decisions. Income and expenses were individually allocated to unit owners whose unit participated in the rental program. This complexity was further exacerbated by the deal being put together prior to unit owners being involved. For example, revenue and expense allocations may have made sense to the operator and developer but often did not sit well with unit owners, who ended up sometimes facing higher than anticipated maintenance fees and capital expenditure requirements with lower than expected revenue.

The impact of avoiding SEC registration produced relatively uninformed purchase decisions by the primary contributor of capital to the project, the unit purchaser. Buyers, not having been provided forward-looking income estimates, often overestimated occupancy and rate assumptions. Further, by splitting revenue, the hotel operation often struggled. Given the high prices paid for highly amenitized units during this era, the revenue that a given unit could produce often calculated negative returns. Unit owners blamed the hotel brands and the developer for lack of financial returns despite often being in markets in which hotel performance may not have been feasible given the prices paid per unit.

Given that the rental program participation could not be mandated, owners frequently rented their units outside the hotel operator's voluntary program, with the unit guest unable to access the hotel operator's services and amenities. Operators, struggling with managing inventory around owner usage and varying rental program participation, also were required to address frequent unit

owner calls for explanations, accounting for each unit's income and expenses separately, and carefully balancing rotation of units among developer and unit owner inventory.

These issues, combined with a complex set of agreements that often were unclear or inconsistent with the structure, led some projects to fail. And the global economic downturn exacerbated the situation.

Recently, in the US, the Jumpstart Our Business Startups (JOBS) Act contained provisions that are being applied to condominium hotels and serve to bring the structure more closely aligned with other global markets. This, and a resurgent global economy and real estate market, may give new hope to branded condominium hotels. In the JOBS Act, the new Rule 506(c) allows for greater general solicitation and advertising as long as buyers are accredited investors.

If a condominium hotel is under the new rule, a developer could then pool revenues and expenses, mandate participation in a rental pool and provide greater information that may emphasize economic benefits. These new provisions serve to provide more information to the buyer.

While many questions remain regarding compliance with rules concerning securities sales, many globally recognized lodging operators are weighing the pros and cons of managing condominium hotels and/or have developed procedures to control risk (requiring a certain percentage of units to be dedicated hotel inventory, for example).

In the right markets, condominium hotels can be mutually beneficial for all parties when interests are aligned and the details are carefully thought through, disclosed and documented.