The 10 biggest mistakes shopping centers make when adding a hotel

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Great opportunity . . . and danger . . . await shopping center owners who seek to add hotels to their shopping centers, malls and retail centers.

An interesting confluence of factors has ignited a wave of hotel development — adding hotels to shopping centers, malls and retail centers. This trend is already underway and will be headline news for the next couple of years.

There are compelling synergies for both the shopping center and the hotel. These have been thoroughly documented by major players. One major shopping center owner performed a multi-year study on its 200+ properties and found that the right hotel can boost gross sales at shopping centers 20% to 40%. And the associated hotels also get a boost in Revenue Per Available Room (RevPAR) of 30% to 40% over hotels in their competitive set.

If you need more information on the basics — why people are adding hotels to shopping centers and malls — look at the articles posted on www.HotelLawyer.com. From the home page, scroll down and look on the right-hand side for under “Hotel Development” or go to www.hotellaw.jmbm.com/hotel_development.

Look before you leap.

The title of this article says it all. If you are thinking about adding a new hotel to your shopping center or mall, consider our list of the “10 biggest mistakes.” See if you are making any of the dangerous assumptions that could be costly to your project.

The 10 biggest mistakes shopping centers make when adding a hotel
by
Jim Butler and Guy Maisnik
JMBM’s Global Hospitality Group®

A strong word of caution before you “try this at home”

Combining hotel and retail elements into a mixed-use project presents the potential for great benefit as well as serious hazard. Most shopping center owners and developers “don’t know what they don’t know” about hotels.

There is a vast cultural difference between the hotel world and the shopping center world. Unless properly advised by experienced veterans, many shopping center owners will find the learning curve painful and expensive.
The 10 biggest mistakes . . . from almost a decade of lessons learned.

We started working with a few of the major shopping center owners on adding hotels to their projects in the mid 2000s. Now that the wave of hotel-retail is in its Renaissance, we find that shopping center owners have a tendency to get stuck in certain problem areas, and are particularly prone to some missteps that can be avoided.

Here is our list of the 10 biggest mistakes shopping center owners make when adding a hotel to their projects. A more detailed discussion follows below.

1. The first thing I need to do is tie up a great brand!
2. The brand will provide all the technical assistance and design I need to lay out the hotel component of my project.
3. The brand loves my project. They will even invest some equity to “align our interests.”
4. I want to turn over the hotel development to someone else. We just don’t have the expertise to do hotels.
5. The stock analysts and investors will hate our being in the hotel business.
6. Hotels are different from retail, but my present (shopping center) advisors can handle it.
7. I should have a hotel at every one of my retail centers.
8. I can finance this just like the rest of my center … or let the hotel developer get the financing.
9. The hotel is just like a typical retail anchor in my centers.
10. A hotel ground lease (or air rights lease) is similar to an anchor lease.

Mistake #1: The first thing I need to do is tie up a great brand!

- You will always be able to get a great brand. The key is to get the right brand and the right deal. Don’t rush into this or get tied up too early.
- The brand representatives are professionals whose full-time job is getting owners locked up early and put on a path that limits an owner’s options.
- Brand representatives are charged with taking care of the brand’s interests — not yours. They have a serious conflict of interest. Their advice is tainted by their overriding loyalty their employer, the brand. Best advice: Run an RFP using the HMA PRO™ approach (see http://alturl.com/97m28), and only engage the brands when you have everything in order.

Mistake #2: The brand will provide all the technical assistance and design I need to lay out the hotel component of my project.

- Most brands no longer have in-house development expertise.
- Take a hard look at the value of a brand’s “technical assistance.” Why pay for the brand’s outside experts to fight you on what you want to accomplish?
- Of course, you will have to give the brand reasonable approval rights, but in a properly conducted RFP/HMA PRO™, you will find a great brand that will accept reasonable approaches guided by knowledgeable experts. Best advice: Hire your own hotel-retail expert — someone loyal only to you. Without conflicting interests, your expert should help you develop the “programming” that will be optimal for your project. Then, sell that program to the brands.

Mistake #3: The brand loves my project. They will even invest some equity to “align our
interests.”

- Brand investment in your hotel project may be the most expensive capital you will ever take.
- Whenever the brands invest capital, provide credit enhancements or give other financial support, there will be a tremendous impact on the terms of a very long-term hotel management agreement.
- The change in management agreement terms in these cases can cost tens of millions of dollars and deprive the hotel owner/developer of all-important controls, approval rights, termination rights and flexibility.
- The brands get such a large percentage of the gross income — off the top — that the investment typically pales in comparison. The typical brand receives 12% to 14% of the gross revenues of your hotel for management fees, marketing fees, brand loyalty program fees, reservation services, IT services, purchasing and a host of other charges.
- In other words, brand investment does NOT align interests very well. It is a way that brands “buy” terms that they would otherwise never be able to negotiate.

**Best advice:** Before taking capital from a hotel brand, you need to fully understand the alternatives and the “true cost” of this capital. There are better ways!

**Mistake #4: I want to turn over the hotel development to someone else. We just don’t have the expertise to do hotels.**

- There are benefits to having an experienced hotel developer take over the development of your shopping center’s hotel. However, there are significant benefits for the shopping center owner to develop the hotel itself.
- Most hotel developers only know about hotels. Their goal is to develop a successful hotel. They are not principally concerned about how the hotel can help the shopping center, and they probably don’t have any experience with those issues. Only the shopping center owner cares about both the hotel and the shopping center.
- The hotel will generally receive its benefit from the shopping center without much effort. But for the shopping center to benefit from the hotel, you need to put in place the right “structure” of complex business and legal arrangements (along with their implementing documentation).
- For example: getting the “right brand” for your retail mix, negotiating a hotel management agreement that will benefit the shopping center, arranging financing for hotel construction, developing the mixed-use legal and operating procedures, negotiating SNDAs with the hotel brands, hotel lenders, shopping center lenders, and developing workable CC&Rs and REAs to realize the benefits of hotel-retail mixed-use. Hotel developers will handle all of these things for the benefit of the hotel, but they are not likely to optimize benefits to the shopping center without active guidance and participation by the shopping center owner.
- More importantly, it is difficult to get a good result in a complicated business and legal structure when you don’t have a seat at the table where the deals are being cut. It is exponentially more difficult when all you can do is whisper in the ear of someone who does have a seat at the table. Even with the best of intentions, these parties will have different interests and goals. **Best advice:** Under any circumstances, the shopping center owner should actively participate in all aspects of structuring how the hotel interfaces or interacts with the retail project, including issues such as the hotel using the shopping center publicity resources to a clear understanding of cooperation on cross-promotions. If you don’t have hotel-retail expertise in your organization, hire your own expert team to guide you through the whole process — a team that is on your payroll, owes its sole loyalty to you, and will be looking out for your best interests. If the shopping center owner can put the entire project “structure” in place first before bringing in partners, developers or other players with conflicting interests, the financial and operational results can be far superior.

**Mistake #5: The stock analysts and investors will hate our being in the hotel business.**
To thrive against competition from online retail sales and other bricks-and-mortar retail, shopping centers need to be more creative and aggressive in providing a unique “customer experience” at their centers. Analysts and investors need to understand this and to see the hard data that shows the strong synergies and significant financial benefits of hotel-retail mixed-use.

- If you don’t find a way to deal with this issue, your competitors will.
- You may want the hotel to be on a separate legal parcel, adjacent to but outside the perimeter of the shopping center. You may also conduct the hotel development in an entity that is outside the REIT that owns your shopping centers.
- Cities love the bed taxes generated by hotels (generally called transient occupancy taxes or TOT). Cities are often willing to allow an increase in the buildable area for a hotel that would not be permitted for additional retail spaces. Also, in exchange for building a hotel, cities may be willing to provide significant financial incentives such as complete or partial TOT holiday for a specified term of years, expedited permits or zoning changes, parking concessions and the like.
- You can always sell your investment in the hotel once you have the right structure. You may even be able to arrange a forward sale commitment to institutional hotel investors, though this type of arrangement will give up a lot of the upside potential in the hotel. **Best advice:** Do your homework, be prepared and then go explain the advantages of hotel-retail to the investment community.

**Mistake #6: Hotels are different from retail, but my present (shopping center) advisors can handle it.**

- Hotels are too different from retail to use advisors who do not understand the business and legal relationships among the hotel owner, the shopping center owner, the brands and the capital providers involved in the transaction.
- Hotels can have complex franchise and brand management agreements, and different issues for tax, financing, operations, management, liquor licenses, employment, environmental, insurance, capital requirements and structures.
- There are competing interests among all stakeholders. The hotel management agreement, ground lease, REA and SNDAG differ significantly for a hotel anchor than a retail anchor. In fact, these arrangements are probably driven more than 90% by hotel-specific issues, norms, customs and practices, and less than 10% driven by issues that would be encountered with a typical retail anchor.
- Complex mixed-use elements must dovetail so that each use enhances the value of the other uses.
- You need both hotel and shopping center expertise to guide the structuring of everything from the CC&Rs to the hotel management agreement, and from REAs and SNDAs to side agreements. **Best advice:** Get an advisor with hotel-specific experience who has also worked through the complex issues of integrating hotel-retail uses to create value for the shopping center.

**Mistake #7: I should have a hotel at every one of my retail centers.**

- Not every shopping center will be enhanced by a hotel. And not every hotel will benefit from proximity to a shopping center. In some cases, the hotel can be a great amenity for destination retail. In others, the retail can be an amenity for a hotel with a local demand base. Sometimes there is just no need or synergy for a new hotel. Each situation must be analyzed by an experienced consultant to test the market conditions and potential demand.
- A well done market study will test the viability of the hotel project. If it can work, the deal has to be structured to realize all of the potential “synergies” of hotel-retail.
It takes a lot of focused effort by experienced hotel-retail experts to realize the optimal synergies that are possible in hotel-retail mixed-use. These synergies do not "just happen" automatically. **Best advice:** Get a thorough market analysis done before you start on the adventure. This analysis will help you identify key elements for a successful deal structure of a hotel-retail mixed-use project.

**Mistake #8: I can finance this just like the rest of my center … or let the hotel developer get the financing.**

- It is difficult to finance any hotel development now.
- The shopping center owner may have to provide the cash or facilitate the financing.
- The shopping center owner probably can get construction financing itself.
- It may be tough to finance hotel development on a ground lease.
- Hotel investors and developers are wary of leases — prefer development on fee simple land. **Best advice:** Check your options, but understand that it is likely the shopping center owner will have to provide the cash or facilitate the financing.

**Mistake #9: The hotel is just like a typical retail anchor in my centers.**

In some ways the hotel is similar to a retail anchor:

- If successful, the hotel anchor will draw quality tenants and customers.
- It can enhance the critical "consumer experience" that shopping center owners strive to achieve.

In other important respects a hotel is not like a typical retail anchor:

- It provides several hundred new credit cards per day for the retailers at the shopping center — shoppers from outside the local market area, and people who tend to spend more when away from home.
- Hotels have brands and operators (with very long-term contracts) whose interests must be aligned with the shopping center owner’s goals.
- The lease terms, management agreement terms, SNDAs, REAs and side agreements are totally different for a hotel than for a retail anchor. The terms are driven by hotel specific considerations. (see items #6 and #10 in this list). **Best advice:** Throw out your assumptions and learn how hotels differ from the typical anchor before you get started.

**Mistake #10: A hotel ground lease (or air rights lease) is similar to an anchor lease.**

- Because hotel revenues are cyclical as well as seasonal, the economics of a hotel lease differ from those with a typical anchor.
- The hotel rental structure (both base and percentage) has to be viable for both the shopping center owner and the hotel developer/investor.
- The shopping center owner has to ensure that the developer/investor can raise debt and equity capital with a ground lease. This can be challenging in the current environment where there is a dearth of debt financing for hotel development.
- CAM charges for a hotel, if any, can differ significantly.
- Careful attention must be paid to use and exclusivity considerations for both the hotel and existing retail.
- Insurance and liability considerations and provisions for hotel operations differ from retail.
- What if the hotel wants to go dark? What provisions are feasible to mitigate that calamity? How do brand and operator SNDAs affect this?
- REIT shopping center owners must be mindful that the hotel anchor is an operating business. **Best advice:** If your advisors do not have practical experience in dealing with these issues before, get new advisors!

**A new wave — hotels are being added to shopping centers, malls and retail centers in a Renaissance of hotel-retail mixed-use**

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There are compelling synergies for both the shopping center and the hotel. These have been thoroughly documented by major players. One major shopping center owner performed a multi-year study on its 200+ properties and found that the right hotel can boost gross sales at shopping centers 20% to 40%. And the associated hotels also get a boost in Revenue Per Available Room (RevPAR) of 30% to 40% over hotels in their competitive set.

This list of “10 biggest mistakes” is based on the experience our hotel lawyers have gained working on hotel-retail mixed-use projects. You can find more information on this subject at www.HotelLawyer.com. Scroll down and look under “Hotel development” and “Hotel Mixed-Use” on the right-hand side.

Drop us a quick email if you would like to discuss issues with your project or get copies of some other articles we have written for Hotel Business, columns in our Hotel Law Blog, interviews in GlobeSt.com, and presentations for the Urban Land Institute.

We wish you well on your journey. It certainly helps to have a guide — someone who has been there before and knows the way.

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Jim Butler is one of the top hotel lawyers in the world. Just GOOGLE “hotel lawyer” and you will see why. As Chairman of JMBM’s Global Hospitality Group®, Jim devotes 100% of his practice to hotel owners, developers and lenders. He leads a team of seasoned professionals with more than 20 years and $87 billion of hotel transactional experience, involving more than 3,900 properties around the globe. Jim’s team has negotiated, re-negotiated, litigated, arbitrated or advised on more than 1,000 hotel management agreements, and have some unique proprietary approaches to unlocking value in hotels that can benefit lenders, borrowers and investors. For more information, visit www.HotelLawyer.com or contact Jim directly at 310.201-3526 or at jbutler@jmbm.com.
Guy Maisnik is a hotel lawyer with nearly three decades in commercial real estate transactions, including extensive work with shopping center development. He is a partner and Vice Chair of JMBM’s Global Hospitality Group®, a member of the JMBM Chinese Investment Group™ and a partner in the JMBM’s real estate department. Guy advises clients on hotel transactions, representing owners, developers and lenders in hotel transactions, including buying, selling and ground leasing of hotels, complex mixed used resort development, fractional and timeshare financing, joint ventures, management agreements. For more information, please contact Guy Maisnik at 310.201.3588 or mgm@jmbm.com.