

BRANDED MIXED-USE DEVELOPMENT

Part 1

Introduction

Over the course of my career, as both a hotel company development executive and an advisor to owners/developers of hotels, I have been exposed on many occasions to the urban mixed-use project with a hotel and branded residences and the destination resort project with the same components; the biggest difference – perhaps, the only one that is material to this article – is that buyers might be more inclined to live in the former than the latter.

The development of a mixed-use project with these components, in either instance, is complex, challenging, enervating and, typically, exciting, but it requires flexibility, discipline and, though this may appear self-serving, expert assistance. We have seen even the most sophisticated investors fail miserably in the Caribbean (*see* <https://www.wsj.com/articles/SB126014120205579167>).

For the uninitiated in the hotel industry, even those whose degree of sophistication in real estate far exceeds my own (common characteristics of most of Four Corners Advisors' development clients), I advise them that there are two ways to understand the branded mixed-use hotel with a branded residential overlay (for this article, the "Branded Mixed-Use Project" or "Project," used interchangeably). The first is to consider a luxury vacation rental home whose owner desires professional management to handle all aspects of rental, operations and maintenance, monitor the property condition and recommend to the Owner, for the Owner's approval, expenditures for capital needs for the property. In this instance, the Manager stands as an agent of the Owner to rent the home, vet the tenants, collect, account for and remit the funds and, in all respects, act in the Owner's stead in dealing with the vacation home. The Owner pays the Manager a fee.

The second, perhaps more cynical approach, is for the real estate investor to consider a retail lease to a luxury store. The store is operated by the tenant, according to its own standards and with tenant-approved design in every aspect, with reporting obligations, no interference from the landlord and, usually, a long-term tenure, if – and for so long as – the store pays its rent, including a percentage of profits in some cases, timely and maintains its premises. In the retail arena, rent may well include a percentage of profits. In the hotel environment, however, there is no rent payable, the Manager gets a fee, shares in the profits, and maintains control over the asset.

The Branded Mixed-Use Project under a hotel management agreement (and other incidental documents), where there is an Owner and a Manager is like both constructs, except:

- ✚ All capital obligations and responsibilities and risk of economic loss in the operations remain with the Owner; unless negotiated in an arduous negotiating environment, there are no guaranties or minimum payments
- ✚ The development and operating standards are established by the Manager
- ✚ The term is even longer than a retail lease term is likely to be, potentially approaching 75 years

- ✚ The Owner's ability to contest certain elements of the annual budget that are characterized as "brand standards" is limited
- ✚ The Owner's ability to involve itself in operations is minimized
- ✚ The Owner's ability to terminate the Manager is limited
- ✚ The Manager might dictate the involvement of one or more favored designers
- ✚ There will be restrictions on the sale of the Project
- ✚ There is no rent payable; the operation's profit and loss are mostly controlled by the Manager and are dependent on market conditions, performance issues, continuing capital calls for upkeep and refurbishment, and appeal of the Project
- ✚ Financial terms for compensation of the Manager will likely fall within market-driven norms

Although – it is hoped – that the recent pandemic is a once-in-a-lifetime event that no agreement might address, the Owner may have limited control over decisions such as curtailing or ceasing operations. Furthermore, market-driven norms limit the Manager's liability to gross negligence, willful misconduct or fraud, and the Manager will have broad discretion over all employees, including, for example, the ability to temporarily use employees, including senior executive staff, for other projects.

With this understanding, the negotiation of Hotel Management Agreement documents can begin.

Any consideration of the development and ownership of an urban project or a luxury resort in the Caribbean under one of the popular luxury brands should be started with the foregoing in mind. In dealing with management companies, one should be mindful that their in-house and outside experts will be intimately familiar with the documentation in a manner that even experienced developers cannot match (further underscoring the need to engage experts familiar with these companies and their documents); this results in a degree of aggressiveness in their negotiating style. Though the management companies will be grateful for the opportunity to discuss a transaction and will afford a degree of flexibility (within bounds) in negotiations (surprisingly, perhaps, mostly in the basic financial terms). However, the discussions will be challenging and time-consuming, perhaps almost agonizingly slow; the negotiations will take longer than one might imagine, with start-to-conclusion of documentation ranging from 8 months on the short side to as many as 18 months. All (or most) of this takes place before design can advance too far, so the negotiation time needs to be added to a flexible development schedule.

The luxury hotel's operations are complicated but likely enhanced by the presence of residences developed and sold by the owner under the brand's name (for which a significant license fee would be payable), and residential operations (maintenance, homeowner association governance and day-to-day operations) would fall under the brand's dominion. Any plan for including the rental and operation of the residences within the hotel inventory will be reviewed, vetted entirely and approved – if not mandated – by the brand, and the developer will be required to provide indemnities (and, probably, guaranties) against claims that might arise under a variety of laws and situations, most notably, securities regulations and consumer protection laws under United States law, the laws of the various states (which may differ from state to state), or, if the hotel is located outside of the United States, the laws of that jurisdiction. Indeed, the design of the residential units themselves, the

marketing plan and use of the brand's name, logo and images, and, in some cases, the identification of the developer's sales force and the sales methods will all be subject to the brand's approval.

Lastly, even for a sophisticated real estate owner/developer, dealing with the brand manager during operations should be organized and orderly, and communication should be led by an experienced luxury asset manager, who has a knowledge of hotel operations, an ability to benchmark the subject hotel's operations in virtually every manifestation of operations against competitors in and out of market, understanding of the branded residential rental protocols and, to the extent permitted by the governing documentation, the capability of pushing back against the operating team. Be mindful, too, that a successful negotiation will yield a (very) long-term relationship between Owner and Manager, so the negotiation of the definitive agreements, however challenging, should be direct and assertive while avoiding hostility that might poison the Owner-Manager relationship before it begins.

Part 2 will address the phases of the Branded Mixed-Use Project's development processes and of a Hotel Transactions Consultant's services, and **Part 3** will address a variety of issues critical to the Project that requires consideration, including a detailed discussion of the integration of the residences with the Hotel.

