FEATURE A realistic option today as private investors replace banks reluctant to lend on new hotel property

Strata sales finance hotels

FRANK O'BRIEN
WESTERN INVESTOR

Hotel developers have had a hard time raising financing in the past two years due to 9/11, SARS and a general downturn in tourism and travel.

Average hotel occupancies in Greater Vancouver, for instance, slid to 59.5 per cent this year — from 61.8 per cent in 2002 — and the average room income dipped by $5 a night to $115, according to a report by **Pannell Kerr Forester**. Hardly a crash, but enough to make lenders nervous.

The tighter lending has convinced hotel developers to consider alternative financing and, for some, strata sales to individual investors is a strong option. Under this strategy, suites in the hotel are pre-sold to investors and this leverage is used to acquire a construction loan to actually complete the hotel.

"Strata financing has become a realistic alternative for hotel developers," noted **Craig Donnelly**, a partner in chartered accounting firm **HLB Cinnamon, Jang, Willoughby**, who has advised on a number of strata hotels, including the **Westin Resort** in Whistler and **Delta** properties in Vancouver.

The viability of any particular project depends on many factors, such as location, type of hotel and attractiveness to investors, Donnelly said. "A preliminary feasibility study is a must before committing to the development."

Presales needed

The hotel developer must first realize that a number of suites will need to be sold before the development can proceed, which will require up-front marketing and sales expenses. Typically, a lender will require a significant number of presales before agreeing to fund construction of the project. It is not uncommon for this to range as high as 65 per cent.

The strata titles are registered like a residential condominium suite. It is up to the developer to decide whether to have a mandatory rental pool, which will restrict the amount of time an owner can use the suite. If so, a covenant will have to be included in the purchase agreement that each strata lot be available to the pool under a rental management agreement.

Be flexible

While rare, there are cases where such arrangements have been altered to meet different market conditions. The **Coast Inn at Apex** near Penticton, for instance, is changing from a mandatory rental pool to non-restrictive use, effective next June. According to local realtors, the move has made the Inn's strata suites more attractive to investors who want greater flexibility of use. The **Royal Private Residence Club** on Okanagan Lake is now being sold as a limited partnership, with the option of exchanging for fractional real estate once a prospectus is filed. And the **Opus Hotel** in Vancouver also changed its ownership arrangement after it was completed.

"The moral of the story is to be flexible and have contingency plans in case plan A is not successful," Donnelly said.

Management fees

Determining the rental management commission is key to the deal.

The management fee must be enough to attract a reputable manager, but too lucrative a deal for the manager means reduced returns for the investors. If the return is not attractive enough for the investors, the developer may not be able to sell the suites. Management agreements typically call for a base management fee with incentives based on achieving certain financial targets.

In simple terms, the typical rental pool agreements call for the manager, on behalf of the owners, to collect the rents, pay the expenses and distribute the residual income to the owners.

The decision whether to flag the hotel requires a cost benefit analysis.

The primary benefits of a franchise are brand recognition, access to an international reservation systems and management expertise. A recognizable affiliation, say the Delta chain or the **Four Seasons**, can increase the confidence of investors and lenders in the project. On the downside, major franchise flags demand higher fees. Developers need to understand that the franchise fees will be on top of any strata fees, which may make the project a hard sell to investors.

Whether the strata buyer shares in the income generated by other hotel facilities is a decision of the developer. It is common that the investors share food, beverage and other revenue streams, as these other revenue sources are typical of hotel operations.

Hotel strata offerings take longer than a simple real estate offering because they are more complex.

It is important to pull a team together quickly to get all the pieces in place.


Photo: Coast Hotels

The Coast Inn at Apex changed from a mandatory rental pool to a non-restrictive strata hotel, which allows investors to use or rent the suite as often as they wish

Team needed

Experienced advisers can help reduce the length of time as they are familiar with the key components.

All members of the team should be involved as early as possible to maximize the chance of a successful development.

The team should consist of a realtor experienced with project marketing, whose job it is to sell the suites; a lawyer; a hotel consultant/appraiser; an accountant, who should be independent of the hotel; a consultant and a hotel operator, who will advise on providing hands-on management. The franchisor should also be part of the team if the hotel is to be flagged.

And, of course, the developer who puts the whole package together. ◆

Western Investor thanks hotel strata expert Craig Donnelly CA, president of CW Donnelly Inc. and a corporate partner of HLB Cinnamon, Jang, Willoughby & Co., Chartered Accountants, Burnaby, B.C., for assistance with this article. Donnelly can be reached at 604-435-4317. E-mail: cdonnelly@cjw.com.