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Hotel Conversions Hot, But Tricky To Seal Up

By **Natalie Rodriguez**

Law360, New York (December 19, 2013, 2:31 PM ET) -- With the lodging market heating up, hungry developers are turning to unconventional sites such as abandoned posts offices and half-filled apartment towers to shoehorn in new hotels. But while these offer a way forward in tight markets, financial and zoning hurdles abound, attorneys say.

Across the country, hotel conversion projects have been popping up, mostly in urban markets with little leeway, economically or physically, for teardowns and brand-new developments, according to experts. And while these projects offer, on paper, a quicker and easier path to market, they can be plagued by issues with securing capital and proper land use entitlements.

“What clients must be aware of is you’ve got significant legal and business concerns to contend with, and if you’re not well-capitalized and have the ability to be flexible ... you’re toast,” said Marc Shuster of Berger Singerman LLP.

One of the biggest issues in switching a building from residential or office use to hotel use is the entitlements process, according to Teresa Goebel, a partner at Goodwin Procter LLP. Particularly if community members or city officials are wary as to whether an unconventional hotel can be a hit in their area, the land use approvals process can become time-consuming and expensive, according to experts.

On top of rezoning, clients also could run into problems working around landmark restrictions or easements for other properties, according to Dennis Russo, co-chairman ofHerrick Feinstein LLP’s real estate group.

“Before you get your construction and redevelopment financing, you’ll want to get your entitlements first,” Goebel said.

The improving economy has ushered in a sudden need for more rooms, which has triggered many of the recent hotel conversions, according to Jon Grosser, chair ofStradley Ronon Stevens & Young LLP's real estate practice.

Often these projects end up flourishing in large cities that are fully developed and offer little infill space to start fresh with new buildings, according to Grosser. This is the case in New York’s emerging spots, like Chinatown and the Bowery, as well as in certain neighborhoods in San Francisco, Miami and Dallas, he said.

“The buyers and the sellers, they cannot stay away from the hotel markets in certain cities,” Shuster said.

Helping the trend is an oversupply of Class B and C office buildings that are being underutilized and provide good prospects for conversions, according to experts.

But even with all of these economic tailwinds, scoring financing can still be an issue.

“You have to be careful about underwriting the cost of construction,” Grosser said, noting that lenders are traditionally leery of hotel debt, and even more so when it comes to creative conversions. “I do think that it becomes a challenge to finance, especially the smaller hotels where pro formas might not show as much of a net return.”

Lenders want to see a track record, so if a client doesn’t have a couple of successful projects under its belt, negotiating a favorable financing deal will be a tough task, according to experts.

Often, a loan negotiated for such a project will need to be 100 percent recourse with a guaranty from an equity partner for a pretty sizable chunk of the debt, according to experts.

On the plus side, however, private equity funds for hotel deals are flowing pretty freely. And if a deal can’t be done entirely with equity, the rest can usually be financed through a syndication deal, in which five or six banks get involved to underwrite the financing package, according to Grosser.

Another good option is to do the financing in two stages, scoring a loan to buy the land first and following up with a more substantial lending package after securing new zoning entitlements and a hotel management deal, according to Goebel.

Often, the stage before sealing up that larger financing piece is the best time for the developer to start negotiating with a hotel management company, so it complies with brand standards from the start, she said. Plus, developers also need to consider the troubles that might arise in choosing an operator or manager if the nearby area has franchised hotels holding geographic exclusivity rights, according to Shuster.

“It’s a tricky balance among the owner, the lender and the hotel management company and how you get those pieces together,” Goebel said.

Once construction starts, it’s important to stick to the timeline lenders are expecting. “I would want to set deadlines and penalties in the [construction] contract,” Russo said.

Due to these issues, it's usually experienced operators with cash behind them or a long lead time to score financing that can successfully navigate through the land use and financing issues, according to Shuster. But enough are scoring big to keep developers trying.

“Hotel operators and investors are active, and they are active in a way they haven’t been in the past three to five years,” Grosser said.

--Editing by Kat Laskowski and Richard McVay.