ICSC+LAW SYMPOSIUM OH/KY/IN/MI/PA

Hilton Columbus/Polaris
Columbus, OH
Friday, March 1, 2024
2:50 – 3:50 pm

Session 4A: Time to Check In (on Hotels in Retail Complexes)

Panelists

Renee Naylor
Partner
Honigman LLP

Karen Pifer
Partner
Honigman LLP

Adam Valente
President
Continental Hospitality Group

OUTLINE

Time to Check In (on Hotels in Retail Complexes)
Hotels are fast becoming a desirable component of many retail complexes. However, historical prohibitions against hotels in shopping centers, the unique challenges of hotel operations, and the current restraints on capital, complicate adding this asset class to many retail complexes. In this session, the speakers will discuss the current state of the hotel business as it relates to retail complexes and provide insight into how these partnerships may continue to develop.

I. Introduction

A. Speaker introductions

B. Brief overview of the evolution of hotels in shopping center developments

C. Importance of diversification in retail spaces

II. Challenges to Adding Hotels to Shopping Centers

A. Legal, Regulatory and Historical Hurtles

i. Zoning approvals

ii. Tax Parcels and Lot Lines

iii. Drafting declarations and amending existing declarations

iv. Use restrictions

v. Parking requirements

vi. Vehicular, pedestrian and utility easements

vii. Signage

viii. Contribution for common area expenses

B. Operational Challenges

i. Hotel management experience

ii. Finding the right flag / branding

iii. Quality controls and condition covenants

iv. Competing interests of the users in a mixed development project

(a) Parking

(b) HVAC use

(c) Noises, vibrations, odors

(d) Signage

(e) Cross-access

(f) Location of public transportation access points

III. Benefits to Adding Hotel to Mixed Use Developments

A. Enhanced Customer Experience

i. Convenience for shoppers and travelers

ii. Diversity and desirability of amenities

iii. Trends and evolution in services and demand for facilities

B. Economic Advantages

i. Diversified revenue streams for developers

ii. RevPAR and retail data show synergy between hotel and retail uses

C. Case Studies / Examples

IV. Current Trends and Market Factors

A. Capital Constraints

i. High interest rate environment

ii. Lack of available capital

iii. Lower LTV and additional lender requirements makes financing more difficult for borrowers

B. Shifting consumer behavior and expectations

i. The rise in demand for experiences supports positive outlook for hotels in desirable mixed-use environments

ii. Hybrid work arrangements and growth in extended stay

iii. Return to brick-and-mortar stores

iv. Focus on ESG in hotels and retail

C. 2024 market forecast

i. Stabilizing capital markets

ii. Pipeline for new construction and rise in conversion projects

iii. Underperforming properties

V. Conclusion

A. Recap

B. Questions

SESSION MATERIALS

Combining a hotel with one or more additional asset classes is not a new concept. History is replete with examples of mixed-use developments that combine hotels with a number of complementary uses, such as retail, office, residential, and even theater. In fact, one of the first mixed-use complexes to incorporate a hotel is the Auditorium Building in Chicago, which was completed in 1889. Originally intended to house Chicago's opera, symphony and other performing arts, the developers of the Auditorium Building added a 400-room hotel to offset potential losses from the operation of the theater. The result was an architecturally innovative building with a spectacular center auditorium surrounded by office and hotel. Since that time, we have integrated hotels with large success into multi-story vertical high-rise developments and into horizontal mixed-used complexes.

Yet, the evolution of hotel mixed-use developments is not solely a tale of bricks and mortar; it is a narrative of the changing desires and expectations of consumers. Without doubt, mixed-used developments have grown more popular in recent years, as the synergy between hotel, retail and other asset classes has become increasingly evident.

As we emerge from the pandemic and reflect on the trends that have emerged over the last couple years, it's time to take refreshed look at hotel and retail mixed-use developments.

I. Challenges to Adding Hotels to Retail Complexes

Incorporating a hotel into a retail center comes with numerous challenges. Zoning is likely one of the first hurdles. Owners and developers must evaluate existing zoning regulations (including requirements and restrictions on use, hours of operation, building height, parking, building setbacks and density) to determine whether the proposed development would meet current guidelines, or whether a zoning reclassification, variance or conditional use permit is required. The process of obtaining zoning variances or other zoning changes may be time consuming and costly, so it's imperative to evaluate these zoning restrictions early in the design process. As the project progresses, it will take careful planning, collaboration, and, in some cases, innovative architectural solutions, to create a functional space that caters to both retail and hospitality aspects and complies with local zoning regulations.

It is similarly important for developers to address, at the outset of a project, how the retail parcel and hotel parcel will be split. How lot lines are drawn will have implications on zoning requirements (i.e., setbacks and parking ratios), property taxes, traffic flow and others. For instance, if parcel boundaries are crafted too narrowly, or face a main street that has deeper setback requirements than the side street, the resulting lot could have drastic limitations on the size of building, may not be able to accommodate sufficient parking for a hotel of the desired size, or have inconvenient access to the retail center and/or public right of way. Whether the intent is for the developer to construct the hotel itself or sell the lot to a third-party developer, these fundamental decisions could have tremendous impact on the profitability of the land.

The mechanism for splitting parcels is yet another decision point for developers. Both lot splits and condominiums are frequently used to separate the retail and hotel components. A condominium regime is more commonly used for high-rise developments that have common infrastructure, whereas a lot split is more commonly used for an outparcel to a shopping center. State-specific laws and regulations also play a factor in this decision. For example, in Michigan, a developer may need to use condominium structure to separate the lots if the overall development has no remaining (or limited available) lot splits. And in Illinois, a developer may find it less challenging to legally separate the lots because of the number of restrictions and requirements in the Illinois Condominium Property Act.

In all events, the overall development will need a declaration of easements and restrictive covenants, master deed, or similar agreement to govern the relationship between the hotel and retail parcels. These declarations will cover, among other things, easements, use restrictions and common area maintenance. Although every center's needs will differ, it is common to see a hotel parcel that is self-parked, has reciprocal vehicular and pedestrian ingress and egress rights over the drive aisles throughout the center, and limited common area maintenance obligations. In vertical mixed-used developments, you may further see exclusive parking spaces granted to the hotel user, and reciprocal easements for elevators, emergency staircases, dumpsters, and building systems. There are additional complications when adding a hotel to an existing center that was not developed with hotel use in mind. The existing declarations may not provide some of the features, discussed above, that a hotel user would demand, and moreover, may expressly prohibit hotel use. In that case, owner will need to have their declarations amended to accommodate the new use.

A commonly debated topic is that of common area maintenance and common area charges. Since a hotel is largely self-contained, a hotel owner may not want to contribute a traditional prorata share of maintenance costs for the entire shopping center (i.e., share in the overall parking lot maintenance, snow removal and lighting), but instead, contribute a fixed amount towards maintenance and replacement of the ring road or its main access drive. In high-rise developments, the design and use of the central HVAC system requires special attention. The engineering constraints of a vertical high-rise development typically requires the construction of one heating and cooling plant to serve the entire project. Equitably allocating the costs of this plant, including costs of periodic capital improvements, maintenance personnel and utility consumption, can be a real challenge. The hotel is a 24-hour operation, whereas the retail and office components have more limited hours, but may have more intensive needs during those limited hours. There are ways of measuring consumption of utilities by the different components, but it is not always as easy a one would hope, and the accounting of what costs of the central plant can be passed-through to occupants and what should be excluded is as complicated as inclusions and exclusions for common areas in a more traditional shopping center.

Signage creates another area of potential conflict. In some circumstances, the hotel and retail occupants will share a common sign, and the parties will need to agree on the order and size of their respective panels. In other instances, the hotel parcel will have its own signage, which in turn requires careful consideration to avoid affecting the visibility of retail tenants or their respective signs.

Hotel/retail mixed use developments face ongoing operational challenges as well. As the center grows, parking may become an issue if there are insufficient spaces to accommodate both a busy hotel and a busy retail center. Centers that have more seasonal variation may struggle more with the balance between too many and too few parking spaces. And, particularly in high-rise complexes where the different components of the development are stacked on top of each other, noise, vibrations and odors may cause conflict between the retail and hotel components of the center.

Management is also key to ensuring operational efficiency and long-term profitability. Although developers may want to own and operate the hotel(s) in their center(s), they may not have the expertise to do so. In that scenario, developers may choose to engage an experienced third-party manager, sell the hotel parcel (either prior to or after development), or bring in a partner with knowledge on hotel operations. Whatever the solution, it is critical to the success of the overall development that the components be individually strong and the respective owners have the expertise necessary for that particular asset class.

Moreover, finding the right brand of hotel for your retail development, one that compliments the atmosphere of the retail center, is integral to success. By way of (exaggerated) illustration, a Ritz Carlton would not do well on an outparcel of an outlet mall in the suburbs, and a Holiday Inn Express would not be the best choice for a luxury shopping experience in a bustling city center. Finding the correct brand and the correct character can be exceptionally nuanced. Consumers of branded hotels generally identify with a certain lifestyle and taste, so developers should be mindful of harmonizing the rest of the retail center with those preferences. The same is true of consumers of certain retail brands, so developers and owners should likewise make sure any hotel they add to their mixed-use complex harmonizes with the rest of the center.

Once the brand is selected, there's the question of how the retail center is able to ensure continuity in quality. Some developers opt to impose quality covenants on the hotel component of the development (for instance, a restrictive covenant against any hotel that is not a nationally-operated chain). The benefit to that approach is that, even after a sale of the hotel parcel, developers can retain some control over the quality and feel of the hotel within their development. The drawback is that owners of the hotel parcel may not want to commit to maintaining a certain brand or quality level in perpetuity, and may want to preserve flexibility should the center fail or come across other challenges. The hotel owner may likewise want quality controls on the retail portion of the development. For centers that are anchored with a hotel, the hotel owner may even request approval rights over retail and/or food and beverage tenants.

II. Benefits to Adding Hotel to Mixed-Use Developments

Over the last decade, the retail landscape has undergone significant transformations, with a notable shift towards prioritizing customer experience, enhanced services, and diverse amenities. The advent of the digital age has transformed the way consumers explore and buy products, and as of the end of 2023, over 15% of sales in the United States were made online. However, the ecommerce trend has also sparked a renewed desire for genuine, hands-on experiences. Brick-and-mortar stores fulfill this need by providing a distinctive environment where customers can interact with products, seek guidance from informed staff, and fully embrace the brand's essence. The tangible presence establishes trust, cultivates loyalty, and enhances brand awareness. For retailers, it presents a chance to establish enduring connections that online platforms cannot duplicate. As the retail industry increases its focus on providing a unique customer experience, it increasingly shares common ground with the hospitality sector.

In hospitality, consumers are likewise demanding a more experiential approach. Guests increasingly value a holistic hospitality experience, including greater customization and diversity in available amenities. The trend in remote working and so-called "bleisure" travel has amplified the demand for properties that seamlessly blend live, work, and play elements.

Moreover, rising room rates (from a surge in demand, increased operational expenses and inflationary pressures over the last few years) are bringing a rise in guest expectations. Hotels that can offer guests unique amenities and experiences will be able draw (and keep) customers at their properties.

This trend presents an exciting opportunity for collaboration among hotels, food and beverage venues, and retail operators. A well-curated retail center can offer a range of products and services that cater to the evolving preferences of the modern consumer. Take, for instance, the surging demand for wellness and fitness services among hotel guests. In standalone hotels, providing such amenities, which are often non-revenue generating components of the hotel, can be both challenging and costly. However, through strategic partnerships with retail centers, hotels can seamlessly grant their guests access to high quality fitness centers, workout classes, and even pickleball courts, without materially adversely affecting their bottom line. There is also a growing consumer desire for local immersion, with an emphasis on authentic food, beverage, and entertainment experiences. In a mixed-use development, hotels can offer guests convenient access to a diverse range of local culinary and entertainment options. The presence of the hotel, in turn, will increase foot traffic to the businesses within the retail component of the development, as guests naturally gravitate towards those offerings during their stay. This symbiotic relationship not only enhances the overall guest experience but also stimulates economic activity, creating a win-win scenario for both the hospitality and retail sectors.

Aside from an enhanced customer experience, mixed-use properties offer commercial real estate owners and investors an economic advantage. With multiple asset classes under one roof or in one development, mixed-use properties benefit from a broad renter base. Having a variety of tenants creates a diversified income stream and reduces dependency on a single asset class. Owners can navigate potential slowdowns in one component of the development by relying on revenue generated from others. Furthermore, the widespread appeal of mixed-use properties ensures a steady and consistent cash flow, adding a layer of financial stability. In the hotel sector too, studies show that hotels may be able to achieve a 30% to 40%

premium in revenue per available room (RevPAR) over comparable hotels in the competitive set when located in a mixed-use development.

VI. Current Trends and Market Factors

Capital constraints seemed to be the trending theme of 2023. Interest rates hit an all-time high since the eighties and lenders, skittish from failing bank news and fears of recession, restricted capital and tightened underwriting requirements. This raised borrowing costs, stifling acquisitions and causing those who had to refinance to seek extensions at the cost of equity pay downs and other credit enhancements. For those buyers still braving the market and trying to acquire assets, it seemed like a vast majority of transactions died because sellers were still holding onto high valuations and buyers were not able to source the capital to make the deal work.

With fears of troubled commercial properties looming, non-traded real estate investment trusts (REITs) saw a lack of funding in 2023 and many investors wanted out. This resulted in the need to sell off properties, often at a discount, to increase shareholder value. Publically traded REITs also saw decreased stock prices and the need to sell properties to increase value.

With 2024 comes some good news – interest rates are trending down, but will it be enough? Many are turning to alternative lending sources such as private investors and seller financing to provide equity. Sellers who want or need to sell are looking at creative solutions such as short-term loans of equity in the buyer. Private equity is also eying real estate more than ever. Take, for instance, the latest car wash craze in Michigan. Private equity is now seeing upside and opportunity in brick and mortar.

It is predicted that many loans are coming due in 2024 and lenders want to be paid off. They do not want the keys and seem unwilling to continue to kick the can down the road. Receiverships are on the rise as banks are no longer willing to work with the borrowers and find this a more palatable option than foreclosure. This could all result in investment opportunities for buyers, as borrowers and receivers will look to sell distressed properties. As interest rates go down, opportunity buyers hopefully will find 2024 a year to get back in the game. The imbalance between the inflows and outflows of funds in non-traded REITs appears to be getting smaller allowing them to start looking at acquisitions once again.

The pandemic accelerated many consumer trends and created new ones. Experiential retail was the buzz pre-Covid, and that trend is more in demand now than ever before. Previously, retail was not a highly sought after asset class as investors saw the declining value of enclosed malls and shied away. Now, however, investors are taking a new look as certain retail is proving to be recession proof and consumers are flocking toward live, work, play centers. Centers anchored with grocery stores, pharmacies and gas stations are getting a new look. The rise in demand for experiences supports a positive outlook for hotels in desirable mixed-use environments.

Post-pandemic we have seen a rise in hybrid and 100% remote work arrangements. This has led to an increased demand for extended stay hotels. Many workers today are traveling for a number of months each year or taking advantage of remote work on Fridays and Mondays and traveling more over long weekends. This traveling workforce is driving up demand for extended stay and live, work, play destinations. They are looking for hotels with numerous amenities where they can work, exercise, shop and eat. A mixed use retail center with a hotel caters to these workers. They can work in their extended stay hotel, exercise in the gym, catch a movie, go out to eat and pick up their prescriptions without getting in their cars.

The retail consumer is also flocking to these mixed-use environments for the same experiences. Mixed use experience centers are great for date nights, girls nights and family nights. Customers can take a stroll through the center on a beautiful evening, do some shopping, and grab dinner and a movie. Families can let the kids run around and blow off steam while mom and dad enjoy a drink and shopping. Many retailers now cater to experiences and provides families and groups of friends the opportunity to create something, cook, get make-overs, swim and go bowling together. Mixed use experience centers are destinations.

Pre pandemic, many commentators were predicting that online shopping would be the death of brick-and-mortar stores. However, to the contrary, many retailers are seeing just the opposite. Customers are returning to brick and mortar and retailers are starting to see a rise in demand especially in first-class centers. Shoppers appreciate the in-person shopping experience. They are putting more value in touching goods and trying them on over the convenience of shopping on-line. Customers like the personal touch provided by store clerks and the ability to ask questions. Retailers continue to evaluate their square footage and a number are going to a smaller footprint, but they want to be in the premier high traffic centers. Retailers are seeing more value in being at the right location. Mixed use experience centers provide the foot traffic and energy retailers are seeking.

Mixed use experience centers provide a great back drop for meeting hoteliers' are retailers' green and social responsibility initiatives. Many such centers are built with green fields and walking paths that cater to the traveling workforce and families alike. Mixed use centers are like a community that can hold events to support local charities and partner with local organizations to create a positive impact. Housing multiple asset classes under one roof also lessens the environmental toll of new construction, advancing urban sustainability.

With the Federal Reserve anticipating that it will cut rate at least three times in 2024, many are predicting that capital markets will stabilize and capital will be more readily available. Transaction volume should pick up in the second and third quarters of 2024 and hopefully lenders will loosen their requirements. The lack available financing and increased construction costs have dampened new construction projects for several years. But now, consumer demand for new sustainable experiences and live, work, play environments, along with the availability of capital in 2024 may kick start some new construction/reconstruction projects. Underperforming properties will likely change hands, creating opportunities for investors to breathe life into them by performing deferred capital improvements or repurposing the properties into something more desirable.

2024 is posed to advance mixed use experience centers featuring hotels. While securing the entitlements and approvals necessary to add a hotel to your center will likely seem insurmountable at times, and the operational challenges can a headache, if you can make the puzzle pieces fit together, the rewards can be abundant. Retail is resilient and with the right hotel flag to boost the centers image and attract customers, experiential mixed-use centers anchored with a hotel are a win-win. The consumers and the traveling workforce of 2024 are seeking experiences, convenience, social responsibility and an environment where they can live, workshop, eat and play. If you haven't yet, it's time to check in and check out the community that mixed use centers have to offer.