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A growing relationship
Currently, there are 333 mixed-use projects with retail in the United States in which hotels are on or near site, according to CoStar Portfolio Strategy.1 (See Table 1.) Retail occupies 130.1 million square feet of this space, while hotels comprise 73 million square feet.

Also, CoStar Portfolio Strategy separately reports that development of hotels within one-third of a mile of a shopping center has picked up to its highest point since 2008. Just as the global financing crisis hit that year, there were an estimated 507 such hotel projects. As of Q2 2018, there were 218 such hotel projects already built with another 251 under construction. Another 131 are already projected for 2019. (See Chart 1.)

How hotels impact retail real estate
Aside from hotels’ own inherent aspects, retail real estate landlords need to consider how they will affect their own operations.

Traditionally, outside urban centers, hotels sought high-visibility locations near specific attractions or highways. Now, with shopping centers changing into drivers of experiences (e.g., escape rooms, ax-throwing, food and beverages), hotels represent an extension of the experiences that guests seek and serve as additional drivers.

In retail real estate projects where hotels form part of the mix, pro formas will be essential to the asset value in the time horizon sought by lenders and equity partners.

Besides influencing initial feasibility and design considerations, marketing helps determine how hotels can partner with brands, and/or act as additional touchpoints for center retailers as living catalogues/showrooms.

As developers and hotel operators weigh a project’s feasibility and projected return on investment, cost issues will factor into whether they should redevelop a retail property while adding hotel and/or other uses, or develop an entirely new project or master-planned community.

Permitting and reciprocal easement agreements can play a determinative role in hotel planning and construction.

Management agreements should spell out the major terms of a hotel-retail partnership, including the role of the hotel operator.

Unique synergies can be created by the relationship between hotels and retail real estate—synergies that should become more noticeable with new projects and research.

Table 1
U.S. Mixed-Use Project Universe with Retail and On- or Near-Site Hotels

<table>
<thead>
<tr>
<th></th>
<th>Count</th>
<th>Total SF*</th>
<th>Retail SF</th>
<th>Office SF</th>
<th>Hotel SF</th>
</tr>
</thead>
<tbody>
<tr>
<td>All Projects</td>
<td>333</td>
<td>339,279,823</td>
<td>130,126,199</td>
<td>90,959,150</td>
<td>73,022,159</td>
</tr>
<tr>
<td>Projects with Retail and at least Apartment + Hotel</td>
<td>126</td>
<td>175,100,965</td>
<td>55,056,505</td>
<td>45,102,137</td>
<td>30,383,462</td>
</tr>
<tr>
<td>Projects with Retail and at least Office + Hotel</td>
<td>295</td>
<td>307,121,089</td>
<td>118,202,138</td>
<td>90,959,150</td>
<td>66,146,936</td>
</tr>
<tr>
<td>Projects with Retail + Apartment + Office + Hotel</td>
<td>88</td>
<td>142,942,231</td>
<td>43,132,444</td>
<td>45,102,137</td>
<td>23,508,239</td>
</tr>
</tbody>
</table>

* Total square footage (SF) could include other uses than retail, hotel and office. Source: CoStar Portfolio Strategy

Lessons Learned
With development of new hotels within one-third of a mile of a shopping center rising steadily this decade, understanding of the hotel-retail real estate relationship has become increasingly important:

- As shopping centers focus more on experiences, hotels represent an extension of the experiences that their guests seek and serve as additional drivers.
- In retail real estate projects where hotels form part of the mix, pro formas will be essential to the asset value in the time horizon sought by lenders and equity partners.
- Besides influencing initial feasibility and design considerations, marketing helps determine how hotels can partner with brands, and/or act as additional touchpoints for center retailers as living catalogues/showrooms.
- As developers and hotel operators weigh a project’s feasibility and projected return on investment, cost issues will factor into whether they should redevelop a retail property while adding hotel and/or other uses, or develop an entirely new project or master-planned community.
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Unique synergies can be created by the relationship between hotels and retail real estate—synergies that should become more noticeable with new projects and research.

1 This database includes mixed-use projects greater than 250,000 square feet of gross leaseable area (GLA), with at least 10% of square footage dedicated to retail and less than 20% to industrial properties.

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additional driver. An amphitheater or outdoor environment in the center could serve as a setting for a concert, with the hotel providing accommodations for guests/listeners, for example.

A hotel will be only one component of a center’s tenant mix, which is shaped around particular market conditions. Still, a hotel cannot be viewed in the same manner as a traditional center tenant—not only because it is not a retail use, but because the center owner would find it beneficial to own the hotel even as it partners with a hotel developer and operator to navigate the property’s development and operations process.

Key to working out the relationship between retail real estate and hotel personnel are clearly defined terms related to common area maintenance (CAM). That will affect such considerations as what constitutes the hotel grounds and the party responsible for maintaining it; defined sections for hotel parking; and whether daily cleanliness is the responsibility of the hotel or of the shopping center as a result of defined CAM. If the hotel is owned by the shopping center, then this is likely to be spelled out similar to the leasing agreement with any other tenant.

**Hotel parking requirements** will not only vary by virtue of individual municipal ordinances but also because of how their visitors differ from those of shopping centers. While shopping centers were traditionally designed with 4.0 to 4.5 spaces per 1,000 square feet of GLA in mind—with adjustments for particular uses—hotels figure the number of their parking spaces per guest room. Nevertheless, dual-use accommodations required by cities may mitigate some of these differences, as peak parking periods overlap for shopping centers (which tend to run during the day) and hotels (which occur from 8 pm to 6 am). Instead of having hotel spaces empty during the day, the retail component can use them during that time, and vice versa at night.

**Hotel financing: securing funds seizing opportunities**

As retail real estate looks at using hotels as part of the mix, working with seasoned hotel operators and developers is crucial because not only can they be used to secure financing, but to more accurately model hotel pro formas. The **operational pro forma** will be crucial to the asset value in the time horizon that the lenders and the equity partners are looking for as well.

Cap rates tend to be 100 basis points higher for hotels than for retail assets because of the operating asset component (i.e., there’s less certainty with respect to long-term modeling). As with other property types, hotel financing involves nuances that need to be understood before projects can be launched with assurance. Differences can arise even among types of hotel projects.

For new development of traditional hotels, for instance, the lending environment is tightening, as equity requirements have become more stringent. Creative financing can fill the gap, whether through mezzanine debt, property-assessed clean energy (PACE) financing, or other types of novel products. Lenders are more likely to consider, after more than 100 months of consecutive growth in Revenue Per Available Room (commonly called RevPAR), when supply will overtake demand and begin to cause challenges, and new hotels generally receive only 50% in loan-to-value (LTV) financing. The equity environment for acquiring as opposed to developing hotels is more favorable, with LTVs running approximately 65-70%. As with all assets, interest rates are rising. Terms can run from 20 to 25 years.

Whether for new development or acquisitions, the different merits of local and national banks need to be considered. Moreover, equity needs to be approved by the brand. Whether it is Hilton, Marriott or IHG, they will perform background checks to make sure that the particular owners will be good partners.

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* The hotel parking data can change according to location; suburban municipalities might require a 1:1 parking ratio of parking spaces per guest room, while this might be less rigorous in an urban core, as there is limited available space, more use of mass transit, and/or Uber and Lyft ride-sharing alternatives. That also decreases traffic. In downtown San Diego, the requirement is 1:3 parking spaces to guest rooms. According to the Second Edition of Shared Parking (ICSC, 2005): “While ratios of 1.25 spaces/room (for overnight guests and employees) continue to be used for business hotels on weekdays, a lower ratio of 1.18 spaces/room is now recommended for such hotels on the weekends, and reversed ratios of 1.18 and 1.25 spaces per room are recommended for weekdays and weekends, respectively, at leisure hotels.” A third edition of this title with updated data will be released this winter. Parking Requirements for Shopping Centers (ICSC, 1999) provided recommendations for the 4.0-4.5 parking ratio range quoted above.
It is also important to work with a lender that understands hotels. Some lenders will not touch the hospitality industry because they do not understand it; it has too many moving parts. It is also important to have a company that understands reports issued by STR (an American company that tracks supply and demand for the industry) and pro formas based on a hotel operations model.

Furthermore, a brand can be a benefit to financing. If a landlord is looking at an independent hotel, a soft brand could be an option for lender comfort.

Marketing considerations

The nature of guests will also come into play when considering the synergies between the hotel and retail components of a project: for instance, are the guests tourists intent on leisure or oriented toward corporate business or a nearby destination, such as a hospital or university? Traditionally, the ideal visitor mix has been 60% corporate and 40% leisure, but that tends to vary by location. For instance, if the hotel is located in a corporate park, that may not be as attractive to leisure visitors.

Feasibility studies performed in advance can help developers understand who they are targeting and why. That may also affect the hotel’s design. For example, business travelers in general are less inclined to want bathtubs anymore but may need connecting rooms to facilitate meetings, while people visiting an ill relative might want extended-stay hotels that would provide for their long-term comfort and a kitchenette.

Beyond these initial feasibility and design matters, marketing plays a role in determining how hotels can partner with brands to sell their goods and/or act as another touchpoint for center retailers as living catalogs/showrooms. The modern furniture and home decor retailer West Elm now has several hotel properties where it sells its products, for instance. DogHouse Hotel and Brewery, the Columbus, Ohio–based unit of the Scottish brewer Brewdog, is a 32-room beer hotel where visitors can wake up in a brewery. Bulgari’s partnership with Marriott increases the ability of the retailer of fine jewelry, watches and luxury goods to reach an upscale clientele. MUJI, a Japanese retailer with merchandise ranging from stationery to apparel, has opened two hotels in China with more planned, and IKEA also has a hotel in Sweden.

No matter what form these retail-hotel concepts may take, the need exists to balance guest expectations for hotel experience and brand recognition with profitability. High expenses may be incurred in terms of furniture, fixtures and equipment; ordering supplies and equipment; and overall design. Developers of such properties may need to decide at some point whether they are seeking to be notable hotels or marketing arms for their products and services.

Project feasibility: new development vs. redevelopment

In weighing a project’s feasibility and projected return on investment, the developer and hotel operator will need to consider whether they should redevelop a retail property while adding hotel and/or other uses or develop an entirely new project or master-planned community.

Developers are seeking profitable projects that fit within their time horizon, or anticipated hold period (i.e., the time frame in which an investor holds a hotel). The operator needs to ensure that the proposed metrics are real and will meet the developer’s objectives, requirements for partners and lending, and the like.

Sometimes, retail redevelopment may be more cost-effective because it involves not building from scratch but rather adapting an existing structure. But some hotel brand requirements may pose difficulties, such as windows in every guest room. A vacant big-box might not be able to accommodate this. Likewise, a pool can pose problems. Furthermore, guest bathrooms might entail additional plumbing requirements above and beyond the retailer’s.

Build-to-suits can lend themselves to smaller footprints or the latest brand standards. On the other hand, new development may be subject to challenges involving the general contractor, builder and sub-availability. Commodity costs are significantly increasing construction expenses, making redevelopment more appealing.

Impact of specific site matters on planning and construction

Every site is unique, and a hotel’s specific siting is determined by local factors. Nevertheless, certain considerations often apply more broadly beyond a specific project.

Permitting would come after a part of the shopping center had been rezoned for hotel use. Hotel-specific permits for a potential pool, occupancy permit, liquor license and F&B permit would be required aside from whatever permits may exist for the shopping center itself.

Reciprocal easement agreements (REAs) may lie at the crux of the issue for existing shopping centers because the center may need to partner with the former retailer or buy out the pad, if possible.

From a planning and construction perspective, a major impact would be on adaptive reuse of existing structures so as not to curtail the retail components of this site.

Hotel-retail partnerships and third-party management

The management agreement should spell out the major terms and conditions of a hotel-retail partnership, including the term, fee structure (base, incentive, other), accounting structure, budget approval process, termination process and trigger, and perhaps the restricted operating radius. Insurance requirements are particularly crucial, in terms of who holds the insurance and what types of insurance are needed.

The management agreement should especially detail the role of the operator. If the agreement clearly states that hotel employees are the employees of the operator, then the operator should have fully vested control over them. This maintains clarity for the employees, and the management company will designate a specific individual to maintain a line of communication with ownership. The owner can focus on broad aspects of operations, using monthly financial statements to monitor how challenges are being rectified and to hold the operator accountable when necessary.

Similar to other partnerships, the hotel-retail relationship will involve contributions, distributions, ownership, decision-making, dispute resolution, critical developments and dissolution.

Because managing a hotel differs markedly from managing a shopping center, property management and leasing for the retail component should be kept separate from the hotel. When each party can focus on its separate component, they can combine to increase asset value.

Cross-branding opportunities come into play during marketing. These efforts require approval by brands, which can be sensitive about logo use. If a retail developer wants to promote that
it has a particular hotel and wants to use its logo, some type of arrangement must be made between the parties. These efforts may be addressed in the franchise agreement, but will probably need to form part of the ongoing relationship with the brand.

Third-party management is intended to ensure the efficiency and profitability of hotel operations. Although a shopping center owner may be reluctant to work with two management companies (if it does not manage the retail portion itself), a hotel operator can help maximize the long-term asset value for the hotel component.

Other aspects of retail landlords’ collaboration with the brand and operator

Operators should be incentivized to maximize both revenue and gross operating profit because they are maximizing expense management as well as revenue management. With a reputation to uphold, the brand will want to partner with shopping center owners and locations with good upside potential.

If the brand is offering key money, then the tradeoffs should be considered and whether that represents the best use of capital.

A healthy, open relationship between the shopping center owner and the operator is essential. Owners need to become familiar with the terms of the management agreement and understand that the operator is working to maximize asset value.

Conclusion

The relationship between hotels and shopping centers is still in its growing stages, and the resulting amount of research documenting it is sparse. But one source suggests the unique synergies that can be created by it. According to a March 2013 report by the Los Angeles-based firm JMJB: “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 20-40% [emphasis ours]. And the associated hotels also get a boost in Revenue Per Available Room (RevPAR) of 30-40% over hotels in their competitive set.”

Avenues for future research on hotels and retail real estate

One element of hotel operations in which little hard data exist is the cost of living wage vs. employee turnover. Turnover costs need to be thoroughly analyzed to help owners and operators understand their investment in employees, its benefits and ancillary elements.

Second, more hard data would be welcome on the long-term impact and value-add of hotels in retail centers. Few examples exist of how this model works, and those examples are short-term rather than long-term.

More data and analysis would also help shopping center owners answer definitively a fundamental question: would they be better off simply selling a pad and having another company build and manage a hotel? More long-term research might support an alternate scenario: having the shopping center developer build and own the hotel while hiring another company to operate it effectively.

ICSC Research would like to thank Marc Potash for sharing the insights that inform this article.


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