



SMITH TRAVEL RESEARCH

Mixed-Use Hotels: Adjustments to a Proven Winner

By Chase Melnychyn - HVS Canada

Over the last decade, a new form of development has emerged in the hotel industry: the mixed-use hotel. From a lodging perspective, a mixed-use development combines a traditional hotel with a number of other uses. The popularity of mixed-use hotels has increased, as they have shown to create more value and outperform traditional stand-alone developments in certain circumstances.¹ This form of development has a variety of advantages for its multiple stakeholders, but it also presents certain challenges from both a planning and operations perspective.

Overview

Traditionally, hotels consisted of a stand-alone real estate property containing guestrooms, in-house amenities, and food and beverage services. Today, hotels may act as only one component of a much larger development. The most common form of mixed-use development for the lodging industry is a full-service hotel with high-density multi-level condominium units. Since this model was established, mixed-use developments have continued to diversify, with the additional tenants including one or a combination of the following: shopping centres, retail stores, office space, high-density residential units, restaurants and lounges, spas, and entertainment centres.

Benefits

From a hotel standpoint, a mixed-use development is attractive because of the high construction costs associated with traditional stand-alone projects. When traditional stand-alone projects are not financially feasible to develop, a mixed-use development allows capital to be raised from a variety of sources. The pre-sale of residential condominiums early in the development process makes capital available to help pay development costs. Mixed-use developments also allow for the increased diversification of risk, which is especially important in today's economic climate. Investors are able to spread the risk out over multiple business models in varying industries.

As the development of all the components is normally completed over the same time period, economies of scale can often be achieved from a building standpoint. Once the building has opened, economies of scale are also realized from an operations perspective through the sharing of various amenities (e.g. parking and recreational facilities within hotel/condominium developments). Security surveillance, HVAC systems, and plumbing can also be shared to lower expenses.

The mixed-use aspect can further enhance the appeal of a hotel to potential guests.

The additional components, whether it is a spa, an entertainment centre, or office space, can help induce more demand to the hotel. For this to happen, there must be a complimentary relationship between the real estate components. For the development company and its tenants, the ultimate goal is to get the individual to spend as much time as possible within the property. This is the basis for the "work, live, play" concept. Multiple components are combined in one property to create convenience and retain as much business as possible from an individual who would otherwise be spending his or her money at an off-site location.

Challenges

The mixed-use concept also presents challenges and obstacles from both a development and operations perspective. The additional components can add financial and physical complexity and also increase timelines and a sense of uncertainty throughout the development process.²

From the initial stages of development, issues regarding the timing and coordination of planning the various components can arise. Opening a hotel can be a difficult process in itself, but having to adhere to the development plans, timelines, and specifications of the other



real estate components can compound the complexity. Although it is usually most beneficial for all the components of the mixed-use development to open at the same time, unexpected delays may result in staggered opening dates.

Before the development of a mixed-use hotel project begins, the financing to build must be obtained. This task is often significantly more complicated for a mixed-use development than a traditional stand-alone hotel in terms of expense and time frame. Tiered capital structures involving multiple lenders and an array of equity partners often complicate the financing process for mixed-use development projects.³

For many mixed-use projects, the various components are financed separately. The different debt sources and equity partners may have separate timeframes and goals to their financing structures. Condominium components may have investors with shorter time horizons than the individual or company financing the hotel or retail component of the development. These differing interests can create significant challenges and therefore need to be addressed in great detail to all relevant stakeholders.²

One of the main issues experienced with multiple lenders is that all the various components produce different cash flows at different times and for varying terms. For example, condominium ownership begins receiving revenue when the units begin to be sold, often before any development takes place. In contrast, a hotel does not start realizing any financial benefits until it opens and even then still requires approximately three years to ramp up to stabilization. These differences cause the complexity of inter-creditor agreements to increase exponentially. In regards to inter-creditor agreements, it must be determined who gets priority if the developer defaults or which lenders have the right to approve certain project-related matters.²

Because service levels are the foundation of the hotel industry, the idea of a mixed-use development can be worrisome, as so many aspects of the guest experience have the potential to be controlled by someone else. If something negative happens to a guest at one of the restaurants or retail stores in the building, he or she may not distinguish between the different entities, thus inadvertently creating a negative impression of the hotel.

Things To Consider

The components that are included in a mixed-use development are critical to the feasibility of the project. All the components must make sense together for the development to be successful. To decide what components to include, one must first understand who the end user will be, the kind of location in which one is building, and what facilities and complimentary uses are nearby. A hotel developer also needs to ask which brand is appropriate and what guest segment to target based on who will be using the other facilities in the development. Once a hotel developer understands the clientele that will utilize the office, retail, or entertainment space, he or she can strategically choose not only a brand for the hotel, but also a service tier (limited-service, full-service, extended-stay, etc.).

Complimentary uses are an important aspect of mixed-use developments. It would not make any sense to combine a 5-star boutique hotel with low-end retailers and a casual family restaurant. The components of the development should be mutually supportive so that they add value to one another.⁴

From a hotel standpoint, it is important to complete an in-depth analysis of who the potential guest will be so that the property can be aligned with the real estate components and the brand that will best meet the target market. Tom Anderson, Executive Vice-President and Chief Real Estate Officer at Wyndham Worldwide,

explains that "limited-service brands can benefit from restaurants, whereas food and beverage may be less important for a mid- or upscale hotel."² Anderson goes on to say that matching a project to the right location is crucial in determining overall success.²

Emerging Trends

The trend towards mixed-use development is expected to continue into the future. Over the last year, the economic slowdown has had enormous impacts on the hotel industry, reducing demand and drying up financing. The recession has also affected the other components commonly found in mixed-use developments, including the retail industry and the residential market.

According to a 2009 report issued by Ernst & Young, mixed-use development may be subject to "an adjustment" this year as a result of the slowdown in the residential sales market.² This slowdown in the residential sector has caused many projects to be delayed or even scrapped. Traditionally, the residential component of mixed-use developments generates the bulk of the money as compared to the hotel portion. With the softening of the residential market, this gap has recently started to narrow, making returns more equal. In order to adapt to the changing climate, developers are looking to reconfigure mixed-use developments to make them financially feasible in the current market. The report by Ernst & Young suggests that the hotel, condo, and retail development will likely make way for hotel components mixed with a combination of rental apartments and office facilities.²

Aside from an adjustment to the components of a mixed-use development, new styles of hotels included in mixed-use developments are also expected to emerge. Traditionally, hotels in mixed-use developments have been full-service or boutique in nature. With the tightening of credit markets, the new limited-service



"lifestyle" brands may look more attractive to an investor than large expensive full-service properties. Lifestyle brands often cater to a specific demographic and contain unique designs that appeal directly to it. Examples of lifestyle brands include W by Starwood and Indigo Hotels by InterContinental. Ernst & Young expects limited-service lifestyle brands to become more commonplace in the next few years because these products are less costly to develop.⁵

Zoning bylaws for various municipalities have played a role in the continued development of mixed-use properties. An example of this has taken place in downtown Vancouver. Due to the high density of multi-unit residential development in the inner core, zoning requirements in certain situations have

called for some form of commercial development to accompany the residential portion. In many cases it has been found that a hotel portion rather than office space would bring more value to the entire project. As a result, many new hotels in the Vancouver downtown have been part of mixed-use developments, such as the Shangri-La which opened in early 2009.

Mixed-use development is expected to continue to present a popular option for areas of urban renewal. Along with providing new development, they generate pedestrian traffic and 24-hour activity in the area as a result of their variety of uses. In an attempt to further mixed-use development in certain areas, municipalities often make various tax exemptions available to developers.

Conclusion

Mixed-use developments offer the benefits of lower financial risk, economies of scale, and advantageous complimentary uses. To establish a successful mixed-use development, all the components must compliment one another. Through mutually supportive uses, hotels and their various counterparts are able to create a competitive advantage.

A wide variety of mixed-use options are available for development. The models are constantly changing in response to the ever-evolving market. New combinations will continue to emerge to better serve the needs of specific markets and demographics. ▲

FOOTNOTES:

- 1 Joseph Rabianski et al., "Mixed-Use Development and Financial Feasibility: Part 1 - Economic and Financial Factors." *Entrepreneur* (Spring 2009), Retrieved June 1, 2009, from <http://www.entrepreneur.com/tradejournals/article/199628080.html>
- 2 *Ibid*
- 3 Clifford Risman, "Financing Hotel Mixed-Use Development Projects." *The Third Annual Hospitality Law Conference* (2009).
- 4 Andrea Ashfield, "Perfect Blend." *Hotel Management* (April 6, 2009), Retrieved June 1, 2009, from <http://www.hotelmanagement-network.com/features/feature52529/>
- 5 Ernst & Young Global Real Estate Center, "Top 10 Thoughts for the Hospitality Industry" (2009), Retrieved June 1, 2009, from http://www.vfmlleonardo.com/media/pdfs/01-032009/Top%2010%20thoughts%20for%20the%20travel%20industry%20-%20ey_0902.pdf.

May 2009	Number of Rooms	Occupancy Rate (%)		Average Room Rates (in \$CAD)		RevPAR (in \$CAD)		Room Supply	Room Demand
		2009	2008	2009	2008	2009	2008	% chg	% chg
Nova Scotia Area	1,313	43.7%	52.8%	\$97.68	\$92.33	\$42.69	\$48.75	1.8%	-15.8%
Halifax, NS	4,184	66.4%	77.6%	\$130.03	\$141.45	\$86.34	\$109.77	3.9%	-11.1%
Montreal Downtown	10,315	63.7%	69.3%	\$139.55	\$149.26	\$88.89	\$103.44	3.1%	-5.2%
Montreal Area	2,361	54.3%	60.5%	\$105.01	\$105.42	\$57.02	\$63.78	0.0%	-10.1%
Quebec City, QC	3,843	59.4%	79.4%	\$141.88	\$164.91	\$84.28	\$130.94	0.0%	-25.2%
Quebec Area	4,466	54.4%	54.0%	\$127.10	\$126.16	\$69.14	\$68.13	0.0%	0.7%
Toronto Downtown	14,465	68.4%	80.8%	\$147.06	\$191.07	\$100.59	\$154.38	1.1%	-14.4%
Toronto North/East	6,793	58.5%	67.4%	\$110.22	\$120.07	\$64.48	\$80.93	1.4%	-11.9%
Toronto Airport/West	8,245	58.8%	71.2%	\$109.95	\$118.92	\$64.65	\$84.67	2.4%	-15.4%
Ottawa, ON	6,743	78.4%	79.9%	\$143.10	\$143.13	\$112.19	\$114.36	2.6%	0.7%
Ontario East	4,458	52.3%	56.8%	\$107.23	\$106.51	\$56.08	\$60.50	0.0%	-7.9%
Windsor/ Ontario SW	2,700	52.7%	56.9%	\$113.02	\$108.27	\$59.56	\$61.61	11.5%	3.3%
London/ Kitchener	2,873	52.5%	59.4%	\$98.59	\$104.84	\$51.76	\$62.27	0.0%	-11.6%
Ontario North/ Thunder Bay	2,211	66.3%	65.3%	\$96.73	\$93.66	\$64.13	\$61.16	0.0%	1.6%
Ontario NC/ Sudbury	4,870	52.5%	58.6%	\$102.98	\$101.29	\$54.06	\$59.36	2.9%	-7.8%
Niagara Falls, ON	9,372	58.9%	62.7%	\$127.15	\$131.51	\$74.89	\$82.46	0.1%	-6.0%
Ontario Central	3,854	52.2%	56.8%	\$109.65	\$109.47	\$57.24	\$62.18	1.7%	-6.7%
Mississauga, ON	4,597	56.5%	64.0%	\$105.05	\$110.42	\$59.35	\$70.67	-1.5%	-12.9%
Winnipeg, MB	3,410	69.5%	71.0%	\$109.27	\$108.36	\$75.94	\$76.94	0.0%	-2.1%
Regina/Saskatoon, SK	2,454	64.9%	69.8%	\$115.78	\$108.05	\$75.14	\$75.42	3.2%	-4.0%
Calgary, AB	8,529	64.6%	74.0%	\$147.23	\$154.11	\$95.11	\$114.04	-1.0%	-13.6%
Edmonton, AB	8,932	65.7%	75.6%	\$125.61	\$127.72	\$82.53	\$96.56	2.7%	-10.8%
Alberta North Area	3,482	44.0%	60.2%	\$151.76	\$154.69	\$66.77	\$93.12	4.5%	-23.6%
Alberta South Area	8,734	52.0%	59.8%	\$138.06	\$139.31	\$71.79	\$83.31	2.4%	-10.8%
Vancouver Downtown	8,445	74.1%	83.3%	\$172.61	\$186.13	\$127.90	\$155.05	2.1%	-9.2%
Vancouver/ Burnaby Area	2,128	62.1%	80.0%	\$121.67	\$126.72	\$75.56	\$101.38	4.9%	-18.5%
Richmond-Surrey/ East Area	3,993	62.9%	78.0%	\$116.75	\$127.19	\$73.44	\$99.21	0.0%	-19.3%
British Columbia Area	5,971	45.2%	52.0%	\$122.06	\$123.90	\$55.17	\$64.43	0.2%	-12.9%
Kamloops/ Kelowna Area	4,860	55.3%	63.7%	\$112.55	\$111.52	\$62.24	\$71.04	0.5%	-12.8%
Vancouver Island	4,328	64.3%	70.9%	\$127.27	\$133.38	\$81.83	\$94.57	1.9%	-7.6%
Provinces									
Alberta	31,629	57.0%	66.3%	\$129.71	\$130.90	\$73.93	\$86.79	2.1%	-12.3%
British Columbia	31,283	58.4%	67.1%	\$123.45	\$127.41	\$72.09	\$85.49	1.3%	-11.8%
Manitoba	4,300	60.4%	61.7%	\$97.07	\$93.78	\$58.63	\$57.86	0.1%	-2.0%
New Brunswick	4,724	46.9%	50.0%	\$106.88	\$102.59	\$50.13	\$51.30	2.5%	-3.7%
Newfoundland	1,833	77.3%	75.7%	\$118.06	\$119.73	\$91.26	\$90.64	0.5%	2.6%
Nova Scotia	5,497	55.3%	64.0%	\$117.98	\$124.28	\$65.24	\$79.54	2.7%	-11.4%
Northwest Territories	204	INS	INS	INS	INS	INS	INS	INS	INS
Ontario	77,911	57.4%	64.9%	\$115.01	\$124.42	\$66.02	\$80.75	1.3%	-10.4%
Prince Edward Island	949	59.8%	54.2%	\$93.90	\$88.63	\$56.15	\$48.04	0.0%	10.3%
Quebec	26,538	56.6%	64.9%	\$120.00	\$128.23	\$67.92	\$83.22	1.4%	-11.5%
Saskatchewan	6,611	60.5%	65.8%	\$106.47	\$98.33	\$64.41	\$64.70	2.0%	-6.2%
Yukon Territory	784	44.8%	50.2%	\$98.35	\$94.95	\$44.06	\$47.66	-2.1%	-12.7%
Canada	192,263	56.5%	63.3%	\$117.11	\$121.38	\$66.17	\$76.83	1.4%	-9.4%

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Canada	192,263	51.6%	55.9%	\$114.63	\$116.02	\$59.15	\$64.86	1.4%	-6.5%

DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

*If you have any questions regarding this publication please send a message to bmacdonald@hvs.com
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