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Is it time to change in-room technology standards?

How the crisis will affect luxury in 2010

Editorial input from 25 hotel industry CEOs
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The Ecole hôtelière de Lausanne (EHL) is the co-publisher of The Hotel Yearbook. As the oldest Hotel School in the world, EHL provides university education to students with talent and ambition, who are aiming for careers at the forefront of the international hospitality industry. Dedicated to preparing tomorrow’s executives to the highest possible level, EHL regularly adapts the contents of its three academic programs to reflect the latest technologies and trends in the marketplace. Since its founding in 1893, the Ecole hôtelière de Lausanne has developed more than 25'000 executives for the hospitality industry, providing it today with an invaluable network of contacts for all the members of the EHL community. Some 1'800 students from over 90 different countries are currently enjoying the unique and enriching environment of the Ecole hôtelière de Lausanne.

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Boutique DESIGN New York, a new hospitality interiors trade fair, will coincide with the 94-year-old International Hotel/Motel & Restaurant Show (IH/M&RS). Designers, architects, purchasers and developers will join the hotel owners/operators already attending IH/M&RS to view the best hospitality design offerings as well as explore a model room, exciting trend pavilion and an uplifting illy® networking café.

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HFTP provides first-class educational opportunities, research and publications to more than 4'800 members around the world. Over the years, HFTP has grown into the global professional association for financial and technology personnel working in hotels, clubs and other hospitality-related businesses.

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Bench Events host premier hotel investment conferences including the International Hotel Investment Forum; the Arabian Hotel Investment Conference and the Russia & CIS Hotel Investment Conference. Bench Event's sister company, JW Bench, is a benchmarking company that has launched the Conference Bench and the Productivity Bench. An industry first, the Conference Bench, measures performance data for conference space in hotels throughout Europe.

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Founded in 1922, Cornell University’s School of Hotel Administration was the first collegiate program in hospitality management. Today it is regarded as one of the world’s leaders in its field. The school’s highly talented and motivated students learn from 60 full-time faculty members – all experts in their chosen disciplines, and all dedicated to teaching, research and service. Learning takes place in state-of-the-art classrooms, in the on-campus Statler hotel, and in varied industry settings around the world. The result: a supremely accomplished alumni group-corporate executives and entrepreneurs who advance the industry and share their wisdom and experience with our students and faculty.

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With an exclusive focus on global hospitality and tourism, Hsyndicate.org (the Hospitality Syndicate) provides electronic news publication, syndication and distribution on behalf of some 750 organizations in the hospitality vertical. Hsyndicate helps its members to reach highly targeted audience-segments in the exploding new-media landscape within hospitality. With the central idea ‘ONE Industry, ONE Network’, Hsyndicate merges historically fragmented industry intelligence into a single online information and knowledge resource serving the information-needs of targeted audience-groups throughout the hospitality, travel & tourism industries… serving professionals relying on Hsyndicate’s specific and context-relevant intelligence delivered to them when they need it and how they need it.

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Over the course of the last six decades, WATG has become the world’s leading design consultant for the hospitality industry. Having worked in 160 countries and territories across six continents, WATG has designed more great hotels and resorts than any other firm on the planet. Many of WATG’s projects have become international landmarks, renowned not only for their design and sense of place but also for their bottom-line success.
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THOUGHT LEADER

Shaun Hannah

WATG's director of sustainability talks about how the recession has impacted green design.

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LEGAL CHALLENGES IN 2010

Rescuing damsels in distress

When an economic downturn brings about project failures and delays, and lenders, owners and investors suffer disappointments of various degree of odor and depth, legal consequences may not be far behind. ROBERT SCHLUP, Partner in the Zurich office of SONNENSCHEIN, NATH & ROSENTHAL LLP, kindly agreed to walk us step-by-step through the potential minefields out there in 2010.

From deep in the fourth quarter of 2009, we look ahead to 2010 with cautious optimism. While many believe that unprecedented opportunities will present themselves in 2010, the landscape of the hotel industry has drastically changed and those who are at once both careful and patient will be best positioned to take advantage and seize these opportunities.

Opportunities in distressed assets

Many smart players in the hospitality industry have been waiting on the sidelines, ready to capitalize on the opportunities brought about by the anticipated economic recovery. Taking advantage of those opportunities, however, may be trickier than in the past.

Buying distressed assets

Given the startling number of loan defaults on hotel assets in 2009, and as more owners default on their mortgage payments in the upcoming year or are unable to refinance maturing debt, the market is likely to be flush with hotel assets being offered for sale in 2010.

Purchasers need to be mindful, however, that in addition to the usual risks and issues associated with buying a hotel property, there are unique risks associated with purchasing distressed assets. For example, because of the economic challenges, required maintenance or equipment replacement may have been deferred. Similarly, during the past year the brands have in many cases relaxed brand standard requirements, working with owners to weather the crisis. However, to avoid a permanent lowering of brand standards, we expect that when the financial performance of hotels recovers somewhat, owners will be required to address deferred maintenance and other costs and expenses associated with the ramp-up and return to pre-collapse brand standards.

Accordingly, care should be taken when performing economic diligence on an asset to ensure that the operating expenses reflected in an asset’s books and records accurately reflect the expenses associated with operating the property in accordance with brand standards. It will be important for a buyer to understand whether the operating expenses are temporarily understated if, as a cost saving measure, the brand allowed the owner to trim staff or otherwise reduce services and amenities at the property. Buyers do not want to be caught in the middle of the inevitable disputes between owners and brands in which owners argue that the reductions should be made permanent and the brands respond that their willingness to accommodate owners during the difficult times should not work to the permanent detriment of the brand. These disputes are likely to be messy and very fact-intensive, unless at the time the concessions were made, the brand and the owner were very careful to document the extent to which the owner is being allowed to deviate from strict compliance with brand requirements and for how long. In our experience, this level of documentation has been the exception rather than the rule.

For projects that were in development or renovation and under construction when the economic crisis arose, the evaluation of title to a distressed asset may be more difficult. Unpaid contractors may assert rights to lien or charge the property to protect their right to payment. A buyer will need to consider not just what it will take to acquire the asset and complete the work, but what will be required to satisfy the demands of contractors who are asserting their legal rights against the property.

In some cases, these disputes have spilled into the courts, making the problems even more intractable. Buyers will have to evaluate the wisdom of wading into a property that could result in being dragged into a costly court fight. Similarly, buyers will need to be sure that development permits or governmental approvals have not lapsed with the passage of time. It is not uncommon for municipalities to require developers to achieve certain milestones for development, construction, and opening as a condition of allowing a project to proceed. If a project was delayed for any length of time, buyers should confirm that any development permits have not been impaired as a result and that completion of the development as originally contemplated continues to be permitted.
The desperation brought about by difficult economic circumstances can result in parties ignoring or deferring legal obligations in a way that would never be considered during «normal» times. Therefore, buyers of distressed assets should be especially careful when performing due diligence to ensure that the owner and operator have not defaulted in obligations to pay third parties that could result in legal liability or proceedings. These could include obligations to vendors, employees, taxing authorities, labor unions, and pension and retirements funds.

Management opportunities at existing properties

Given the economic downturn and the continued sluggishness in the construction credit markets, management opportunities for new projects will remain scarce in 2010. Instead, many new management opportunities will likely come from conversions or re-flagging of existing properties. However, managers will need to be mindful of the potential pitfalls associated with taking over management of a distressed asset, including the possibility (or even likelihood) that hotel owners lack sufficient funds to carry-out the re-branding or other refurbishment process. Moreover, managers interested in speaking with owners of properties that are subject to an existing management agreement need to be careful not to expose themselves to a claim of anticompetitive behavior (as is discussed more fully below).

Hotel financing

Although much has been made of the potentially unprecedented opportunities that will be available to hotel owners and investors during the economic recovery, that enthusiasm has been tempered by the current unavailability of credit and the uncertainty about how tentative capital markets will be in their return to the hotel space. While no one can know for sure what commercial terms will be available for hotel financing transactions when the credit freeze thaws, we are confident that the terms offered by the capital markets in 2010, still smarting from the turmoil of the last 18 months, will be markedly different than in 2007 and early 2008.

Financial covenants: LTV and DSCR

The high leveraged debt available in the 1990s and early 2000s was a major contributor to the severity of the global economic crisis. As the crisis worsened and consumers and business travel fell off precipitously, properties struggled to generate enough revenue to pay operating expenses, let alone debt service. As a result, property values suffered previously inconceivable reductions and hotel owners saw their equity evaporate. With no equity to protect and little hope for recovery in the short term, many hotel owners simply stopped repaying their loans. This only exacerbated the vicious cycle of declining asset value. We expect that lenders, many of whom are struggling to sell the hotel projects that they reluctantly took back from borrowers, will require significantly greater equity participation from owners and developers. This greater equity requirement will make it far more difficult for borrowers to walk away from projects and, therefore, serve as a buffer against future economic shocks.

We expect 50 %-60 % loan-to-value/loan-to-cost ratios to be commonplace. This is a significant change from the 75 %-85 % LTVs/LTCs that were common before the current financial crisis.
Moreover, these loan-to-value calculations will reflect today’s market prices for hotel assets, which are substantially reduced from their 2007 levels. Consequently, developers and owners need to be prepared to bear much more of the risk associated with owning, developing, and operating hotel and resort projects going forward.

Similarly, in 2010 debt service coverage ratios will likely be significantly greater than the 1.2:1 or 1.25:1, which were common prior to the downturn. Unlike other property types that are dependent upon revenue generated from stable, long term leases, hotels generally have greater cash flow volatility as a result of the daily need to re-rent inventory. During boom times, this proves to be extraordinarily beneficial to a hotel’s profitability because rates can be increased quickly as a market heats up. However, during recessionary times this places increased stress on compliance with DSCR tests and other financial covenants. Lenders are likely to require a greater buffer against short-term revenue reductions resulting from economic events.

_Nondisturbance_

Few issues underscore the sometimes contentious relationship between owners and operators, on the one hand, and lenders, on the other hand, as nondisturbance. The brands bring undeniable value to a project. Lenders, being cautious by nature and mindful of the prevailing belief that an unencumbered hotel has greater value than a hotel that is subject to a branded hotel management agreement, generally want to give themselves maximum flexibility to change the operator of the hotel, bring in a new brand, or even reposition the hotel if the lender is forced to take possession.

For many years, nondisturbance was seen as a non-negotiable requirement for certain brands and was commonly given in connection with higher end property lenders so long as the third-party operator was reputable. However, in light of the dramatically changed economics of ownership, it remains to be seen whether this trend will continue.

Although branded operators can be expected to initially ask for non-disturbance, they may show more flexibility on projects with lower LTV ratios. Previously, operators insisted on getting non-disturbance where there was little equity in the project and, therefore, the risk of a foreclosure was higher, but some brands were willing to waive the absolute requirement for non-disturbance and permit owners only to use commercially reasonable efforts to obtain non-disturbance when LTVs were below 70%. Similarly, lenders who feel more secure because of the significant equity stake an owner has at risk may be less insistent on retaining the right to terminate the operator and the brand.

_Greater scrutiny of intangibles; avoidance of development risk_

Lastly, intangible aspects of a transaction are likely to be given much closer scrutiny as part of the lender underwriting process next year. As lenders grow risk averse, we expect that they will be far more reluctant to be exposed to any significant development or conversion risk. As a result, we anticipate that lenders will consider to a greater extent factors beyond mere financial underwriting concerns. These matters will include the experience and proven record of past successes of the development and ownership teams, the location of the project, the reliability of the brand or concept, the strength of management, and the capital.

_Protecting yourself from tortious interference/unfair competition claims_

Ownership groups are starting to be presented with potential opportunities to acquire existing hotel properties, unencumbered by management or franchise agreements. Similarly, managers are being approached by hotel owners that are looking to re-brand their underperforming assets or at least bring in a different manager. Interested parties, however, must proceed with caution when engaging in discussions and negotiations with those existing owners to either acquire or take over the management or franchising of a property. Potential owners and managers need to be sure that, in their haste to seize an opportunity, they do not inadvertently expose
themselves to the risk of entanglement in a messy tortious interference or unfair competition claim.

*Actions to avoid*

While the specific elements and precise name of such claims will vary from country to country and jurisdiction to jurisdiction, the crux of such claims – including both an unfair competition claim (as it is commonly known in Europe) or a tortious interference claim (as it is commonly known in the United States) – involve a party (in this case, the potential new owner or manager) intentionally interfering with the existing contractual relationship of two other parties (in this case, the existing hotel owner and the existing hotel manager).

Generally, a tortious interference claim or unfair competition claim requires proof of the following elements: the existence of a contract, the interfering party’s knowledge of such contract, the interfering party’s intentional inducement of a breach of such contract, and a breach of the contract by the induced party. There are measures, however, that potential owners and managers can take to protect themselves before commencing discussions and negotiations with an existing owner for a property that has an existing manager in place.

*How to protect yourself*

Potential owners or managers, as applicable, should confirm that the existing owner has the unequivocal right to terminate the existing management agreement or franchise agreement, and that the existing owner’s exercise of such termination right would not be a breach of the existing agreement. If the owner does not have the right to terminate, and does so anyway, the owner will be in breach of the existing management agreement and the would-be new manager or new owner may be subject to a claim that it induced the owner to breach the existing management contract. Therefore potential suitors need to do their diligence and develop a paper trail that substantiates that they have not done anything improper. We recommend obtaining a comfort letter from the existing owner confirming the following:

- The existing owner has the right to terminate the existing management agreement or franchise agreement pursuant to the terms of the underlying management agreement or franchise agreement (for example, pursuant to a termination on sale or a termination at will provision, on account of a default, or on account of a failed performance test). It is important to note that in certain cases, the right to terminate may be predicated upon compliance with contractual rights of first offer or rights of first refusal contained in the management agreement or franchise agreement.

- The existing owner has decided to exercise such termination right independent of any influence from the potential manager or owner, and without regard to any potential business arrangement that the existing owner and potential manager or owner may enter into.

- An agreement by the existing owner to indemnify the potential manager or owner for, from and against any claims that may be brought by the existing manager. Potential new managers and owners should be wary of any existing owner who is completely unwilling to provide such an indemnity. Although owners may initially resist providing such an indemnity, the risk associated with the indemnity is entirely within the owner’s control. If it has the present right to terminate and had made the decision to do so, there is little risk of potential liability.

*Resort residential real estate*

For close to a decade, hotel developers have relied on the sale of resort residential real estate to subsidize the development costs of associated luxury hotels and to allow for an early and profitable exit to the developer. While many smart industry analysts warned of the risks associated with this development model, including the creation of a glut of hotels that do not (and never did) make economic sense and overbuilt and unsold residential projects, the current economic crisis has exacerbated these problems.
No reliance on residential product

Five years ago, the promise of a quick sale of residential resort property at premium prices (relative to development cost) as a means of reducing debt to a level that could be supported by hotel operations was viewed as the panacea for the high cost of luxury development. Many speculated that luxury development could only happen if it were accompanied by for-sale residential product. Today, however, the market for resort residential product has collapsed and is not likely to recover significantly in 2010.

Lenders, who had expected to receive significant payments on development and construction loans from the sale of residential units, are now the reluctant owners of those units and are saddled with the property assessments associated with those units. Moreover, because the amount of debt on the projects remain high, debt levels exceed the amounts that hotel operations can reasonably sustain. As a result, we do not expect hotel lenders to advance credit with such a degree of reliance on future sales of residential resort real estate. To the extent a lender is willing to provide development financing for resort residential projects, we expect that pre-sale requirements will be greatly increased. Moreover, we anticipate that the borrower will be required to have the demonstrated ability to make significant payments in the debt, even if the residential buyers do not fulfill their commitment to purchase a unit.

Branded residential

Operators have also become increasingly skeptical of lending their brand and management skills to the residential component of a luxury resort. The allure of placing their brand and « touch » on the residential portion of a luxury resort project has quickly vanished, as operators now find their brands being dragged through the mud in contentious litigation brought by unhappy buyers. In some cases, the operators themselves are knee-deep in the litigation. The legal claims run the gamut from ordinary complaints about defective workmanship to assertions that the salespersons made promises about certain economic returns, the availability of amenities (that it is no longer feasible to construct) or the completion of the project by a certain date (which is no longer achievable).

Similarly, many owners and operators are now regretting their agreement to manage on behalf of the unit buyers the various associations and bodies corporate that inevitably represent the owner and, in many cases, control critical components of the project. Once seen as a good technique to stay close to the unit owners and influence their thinking about the operation of the projects, these associations have grown increasingly hostile and the agreement to manage the association is viewed as merely another source of potential liability. Operators are now indicating that they will be far more discerning about the residential projects to which they will lend their name.

However, learning from the past is one thing, but undoing the harm that has already been done and mitigating future losses is quite another. One of the issues owners and operators will likely face in the coming year, is how – if at all – they can « unwind » ill-advised branded residential decisions or at least reduce the long-term damage associated with those projects.

Unwinding and repositioning mixed-use projects

Owners and operators will face many challenges in trying to unwind or reposition broken mixed-use projects. Actions taken by an owner and operator in the development of a project may later serve to limit the options of an owner or operator trying to change the use or nature of a project. Historically, the question for hotel developers faced with an economically challenged project was, « What should I do? » However, because of the complex nature of the projects, the equally important and more difficult question is, « What can I do? » The additional layer of documents and the obligations they impose, as well as the large constituency of owners, may limit the options that a developer has in trying to formulate a workout strategy.
While each project is unique, here are some preliminary steps that owners and operators should undertake to determine how much flexibility they have:

- Examine applicable legal and zoning requirements, as well as the conditions contained in any zoning approvals or permits (for example, are there limitations on owner usage that would prevent or be inconsistent with a desired repositioning? Or, if the project is being developed in phases, is there an obligation to build a minimum number of units that is no longer economically feasible?);

- Review the project governing documents to determine what prohibitions or promises as to the nature of use of the project and amenities exist; and

- Determine what representations and disclosures were made to residential purchasers and commercial tenants in purchase agreements, leases, advertisements, or otherwise so that operators and owners can know what actions can be taken without liability (because unit owners were given notice that they might occur);

- Examine what the owner’s and operator’s contractual obligations are to third parties (if the operator agreed to manage the association of homeowners and entered into a contract directly with that group, is it terminable upon the termination of the underlying hotel management agreement?);

- For projects that have not yet opened, determine whether there is an ability to rescind purchase contracts to give greater flexibility with repositioning or selling the asset;

- If a project is already open and some (but not all) of the units have already been transferred, determine whether it is feasible to provide services to a limited group of owners and operate the remaining units as dedicated hotel inventory or whether providing those services will prove economically ruinous;

- In the case where the development is not going to be completed as originally planned, operators need to determine whether the portion of the project that will be completed is sufficient to provide the minimum amenities to meet the requirements of the brand and, if not, is the operator prepared to unbrand the property and face the potential wrath of the unit owners and resulting potential damage to the brand?

This list is not exhaustive, but even based upon these limited considerations, it is obvious that these issues are fiendishly intertwined and not susceptible of easy resolution.

Operators will be far more discerning about the residential projects to which they will lend their name