INTERNATIONAL ASSOCIATION OF YOUNG LAWYERS

Hotel Projects for the next generation: What are the key factors for foreign investors in order to ensure a successful running hotel business?

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GENERAL REPORTERS

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<u>Introduction</u>:

In general, new hotel projects nowadays really change the daily life and the face of a city. Suddenly, the city as a whole is upgraded to a new stage of growth and status of prosperity, often combined with spectacular next generation urban architecture style. As a result, and as AIJA people perfectly know, 21st century networking, recreation, business and socializing places are born that inspire us and often allows us to celebrate unforgettable events as a genuine leap into the future of our profession.

For the Annual Congress 2015 in London, the Real Estate Commission is planning to prepare a Workshop with the hot topic *"Hotel Projects for the next generation: What are the key factors for foreign investors in order to ensure a successful running hotel business?"*. Our aim and wish is to compare and share views from different jurisdictions with regard to transactions types, market situation, legal and common hotel business structures and, last but not least, we would like to discuss the effects of the financial crisis in that context.

Below you will find the summarized answers and results with regard to our **QUESTIONNAIRE** which we collected from in total 8 National Reports.

I.- MARKET SITUATION / TYPE OF TRANSACTIONS / MIXED USED TYPE

1.- Give a brief overview of the hotel sector market situation in your country (or region): Specifically, what are the current trends and/or what are the main targets for investors? What are the general expectations for the near future?

On the whole, it can be said that the hospitality market is progressively recovering from the past financial crisis. Nowadays, this recovering process is leaded by international investments of well-known hotel chains (e.g. Hilton, Marriot, Motel One, etc.). Furthermore, the investments are mainly made in existent buildings, rather than in new constructions, and generally focused on luxury hotels. The principal aim of these investors is a sustainable return, value preservation and a certain prestige.

Apart from the big chains, nowadays it is very hard for new hoteliers to invest in a new hotel because of the tough barriers they have to overcome. To succeed in this market, new hoteliers need a high level of expertise and a good knowledge of branding; they also have to be able to deal with seasonality, a big competitively and, in a lot of countries, with a strong currency.

In future, it is expected that investors will more be looking for lower and upper-mid range hotels with less complications but standards nearly as high.

2.- What type of transactions are the most usual in your jurisdiction (development, purchase, sale, lease, management agreement, sale & lease-back, franchise, etc.) ?

The most common transactions in the hotel business, of course strongly depend on the particular country and its special characteristics. However, on average, the direct sale & purchase agreement (either asset or share deal) is the most usual transaction used to acquire a hotel. Nevertheless, management agreements are on the raise gaining more and more importance due to less risk assumption.

3.- Are there mixed use types (Hotel & Residential or Resort/Relaxing facilities, condo-hotels/condominium, etc.)? If so, please describe some typical schemes you know about or which you find interesting to share. Please describe pros & cons, if so, of one structure compared with others.

There exist a lot of mixed use types of hotels (e.g Joint Ventures, Apartment Hotels, Hotel&Spa, Hotel&Resort, etc.) but the most common one is the *Condominium Hotel*. In this type of hotel the units are individually owned, even by private persons, but with the possibility to place the individual owned units in the hotel rental program where it is rented out like any other hotel room.

In most holiday destinations, the hotel type that is gaining importance is the Hotel-Resort organised in bungalows or the Apartment Hotel. Those allow customers to have the comfort and convenience of serviced accommodation with the freedom, space and privacy of their own house or apartment.

We also can see the emergence of new types of Hotels, like the *Fusion Hotel*. This Hotel is a hybrid lodging concept, offering rooms of different sizes and standards.

4.- Is the off-plan project always a common scheme to follow or is it an out of date concept?

Off-plan projects are very common in many countries because it allows buyers to have the benefit of increasing prices without having to pay a mortgage, property taxes or maintenance fees. However, investors in off-plans have to take also into account its possible risks:

a. If property values starts to fall before the construction is completed, the lender may reduce the value of the loan or even deny financing, particularly if the buyer is buying the property as an investment rather than as a home. The buyer may be contractually obliges to buy the property at the original price and thus must make up for the short-fall from other sources or risk being sued if the buyer pulls out and the promoter sells the property at a lower price.

b. The constructor may go out of the business before the construction is completed and the buyer may not be able to recover advanced price.

c. The finished property may not meet the buyer's original expectations, either of subjective reasons or because of material defects.

5.- Are new projects involving renewable energy popular in your country? Are those more attractive than standard projects even though they are more expensive? Do they involve lots of clauses which can be considered "*condicio sine qua non*" for the signing of the contracts?

Besides mandatory legal requirements on renewable energies, most Hotels use renewables energies as a marketing tool, especially in luxury projects, in order to stand out in such a competitive market. The obtained benefits to the environment are mostly secondary.

One reason that prevents more investment in renewable energies is the high costs. Projects involving renewable energies are much more expensive than standard projects. The main opinion of most of the national reporters is that Hotels would invest more money in this type of energies if the Governments would support more this type of projects.

6.- Lawyers and Project Managers: Do they work well together or is there friction between them?

The main opinion of the national reporters is that it depends entirely on the project and the persons involved. The usually frictions between them are regarding risk management, completion of deadlines and fee levels.

7.- Are there favourable tax or other promotion plans for resorts for elderly people in your country?

The majority of countries do not have any tax or other promotion plans for elderly people. However, the general society is aging and, for this reason, legislators of many countries are planning to introduce specific regulations to favour this part of our society.

II.- BUYING AND SELLING THE HOTEL BUSINESS: PLEASE DESCRIBE THE MAIN SCENARIOS WHEN IT COMES TO A HOTEL ASSET OR SHARE DEAL SITUATION.

1.- Please describe the pros & cons or simply the differences to keep in mind when the "Hotel Business" changes ownership – the answers may contain legal as well as practical aspects.

When it comes to acquire a Hotel Business, the two most used types of transactions are: An asset deal or a share deal. In the first one, the buyer acquires certain assets of the company, whereas in the second one, he acquires the stock of the same.

In both transactions, the buyer has to be careful with all types of liabilities that could arise. For this reason, it is important to carry out a full due diligence process in order to obtain a reliable report of all the necessary information to asses and fix objectively the possible liabilities. In some countries, it is set by law that certain liabilities cannot be waived.

From a real estate law perspective, most countries have Land Registries that are deemed to be correct and consistent with the actual legal status of the real property. In other countries, it is not the state but the owner himself who needs to (continuously) update the Land Registry. In general, the buyer can rely on the included information of such registers when he acquires a property linked to a Hotel, at least with regard to an acquisition process in good faith.

Finally, there are a lot more issues to consider when buying a Hotel, e.g. (a) complex tax issues relating to a change of ownership; (b) if the current contracts will or will not automatically be transferred to the new owner, (c) antitrust issues, competition matters, etc. All these aspects are regulated in every state in a different way, so the buyer should carefully check that aspects in advance (due diligence process).

2.- In cross-border situations: Tell us about your experience or lessons learned when it comes to local differences and how to deal with these situations (e.g. are there some peculiar legal or cultural aspects, which investors should keep in mind when they want to invest in hotel business in your country?)

Generally speaking, in cross-border stations it may be possible that hotel chains international technical standards cannot be implemented in some countries. Likewise, the hotel chain may be faced with additional requirements which they had not expected. In connection therewith, maintenance, repair and renewal obligations are different from one country to another.

Some countries have also restrictions on acquisitions of land by people who are not citizens or permanent residents, or by corporations and associations controlled by them.

When acquiring lower mid-range Hotels, it is usual that these Hotels have been run by families during the last decades. The sale of such assets carries in itself a substantial emotional aspect and often the seller only reluctantly agrees to sell. This is another aspect to deal with when acquiring this type of Hotels.

Finally, as said in the previous questions, foreign exchange, tax issues, antitrust law, labour laws, etc., have to be considered because they change from country to country.

3.- Have you had lots of M&A transactions involving Hotel Projects in your country in the last two years?

After the financial crisis, during the years 2010 to 2013 a few hotels changed hands. However, this trend is gradually reversing and, since 2014, M&A transactions have been increased in the vast majority of countries.

III.- HOTEL BUSINESS STRUCTURE - MANAGEMENT AGREEMENT/LEASE AGREEMENT/FRANCHISED OR ALL MANAGED BY THE OWNER?

1.- How would you describe the usual hotel business structures in your country. Who are the key parties/players involved and who is responsible for which part of the running business? (For example, in case the owner is responsible for everything, that means he owns the building and also owns & operates the hotel business – please give a short overview.)

All the national reporters stated that in their countries are generally two types of hotel business structures: the hotel chain and the family business.

On the one hand, usually hotel chains are owned by one entity and managed through a management or lease agreement. This is the best way of passing all the risks to the owner but keeping a regular cash flow.

Those chains are normally located in big cities and in the centre.

On the other hand, family hotel businesses are typically small hotels. The owner of that hotels are generally owner of the building (the Hotel) and responsible for its management. Family hotels are controlling the vast majority of the lower and middle hospitality market, there are only few big family Hotels that are also in the upper hospitality market. Those big family Hotels have been usually family owned for decades and will neither be sold nor rented out.

These Hotels are normally located in a secondary location rather than in the centre.

2.- In the event of a management agreement, i.e. the owner owns the building and the hotel business, what are the most important clauses or aspects to be structured or dealt with (duration, fees, liability of the management, operating risks, etc.)?

The specific content of a management agreement depends always on the negotiating parties. However, the most typically (and important) clauses that can be found in a management agreement are as follows:

a. Rights and obligations of the owner and the operator.

b. Operating fees: It contains the operator's remuneration from the owner. Base fees typically range from 2% to 4% of total revenue. The parties may also estipulate incentive fees for the management.

c. Non-compete clause: The owner makes sure that no other property with the same brand is allowed to open in a certain radius.

d. Confidentially: Both parties agree to hold Confidential Information in confidence in accordance with the terms of the agreement.

e. Liability of the management: The damages that the management will be obligated to provide to the owner under the terms and conditions stipulated in the contract have to be clearly specified. Linking to that, management usually includes a clause that clearly distinguishes the responsibilities to be assumed by the owner and operator.

f. Maintenance: It includes issues regarding periodic maintenance and renovations of furniture, equipment and building, in accordance to the relevant brand standard.

g. Dispute resolution, governing law and jurisdiction: The parties have to choose to solve their problems either in front of a court jurisdiction, go to mediation or in front of an arbitral court. In this clause both parties usually also concrete the governing law and jurisdiction applicable to the agreement.

h. Termination clause: Usually the parties negotiate a 15-year initial term, plus two 5-year rollovers. With independent non-branded operators, initial terms may be 5 to 10-years, but also include specific termination clauses such as termination without cause, termination on sale or performance termination.

3.- In the event of a lease agreement, i.e. the owner owns the building but not the hotel business, what are the most important clauses or aspects to be structured or dealt with (duration, rent, early termination rights, change of control clauses, pre-emption rights, etc.)?

The specific content of a lease agreement depends on the negotiating parties. However, the most typically (and important) clauses that can be found in a lease agreement are as follows:

a. Rights and obligations of both parties

b. Rental payment: Rents could be fixed and increased annually by inflation, variable, likely based on total hotel revenues, or hybrids.

c. Term of the lease: Standard lengths differ from country to country. Frequent minimums are 10-20 years, though even longer terms from 30 to 40 years can be found.

d. Capital expenditure: Hotel lease agreements must specify which party is responsible for major expenses, typically responsibility of the owner. The lease agreement might require the lessee to reserve 2% of revenue for facilities maintenance.

e. Furniture, Fitting & Equipment: There are two possibilities:

- The lessee brings the FF&E and is responsible for the replacement.
- The lessee receives the lessor's existing FF&E and when the lease ends they turn an equivalent amount plus inflation. In this case, the lessee is responsible for replacements.

f. Sublet and assignment: Allowing sub-letting might help the lessees risk management, but it is infrequently granted because the lessor leases their asset to known operators for specific reasons.

g. Rent & Security Deposits: Hotel agreements require bonds, which are often equal to one or two years of rent. Notwithstanding, many owners accept letters of credit or bank guarantees instead of a deposit.

h. Insurance and risk protection: The lessee generally must carry public liability insurance on the building. It is also very common to specify who is liable for what type of risk.

i. Hotel purchase options or pre-emption right: Often a clause is incorporated which stipulates that the lessee has the option to purchase the Hotel either at the end of the lease term or after a specified period. The pre-emption right is the right to buy a property in the event the seller (in this case the lessor) decides to dispose of it during an agreed period.

j. Dispute resolution, governing law and jurisdiction: The parties have to choose to solve their problems either in front of a court jurisdiction, go to mediation or in front of an arbitral court. In this clause both parties usually also concrete the governing law and jurisdiction applicable to the agreement.

4.- In the event of a franchise system, what are the most important clauses or aspects to be structured or dealt with (contractual relationships and parties involved, etc.)?

The most typical clauses that can be found in a franchise system are:

a. Rights and obligations of both parties

b. Franchise and royalty fees: Whereas the franchise fee is a one-off fee covering all of the terms stipulated in the agreement and financing all of the ingredients needed to launch and sustain a franchise outlet, the royalty fees is an ongoing contribution that the franchisee has to pay to remain part of the franchise system. It is unlikely that franchise fees will be reduced a "ramp up" in fees over the initial years can often be achieved.

c. Area of protection or non-competition: Hotel owners are very interested in negotiating this type of clause in order to prevent the opening of a competing hotel of the brand within their property's market area. The scope of the restrictions varies from agreement to agreement.

d. Exclusivity: With regard to the previous clause, the franchisee wants to have the exclusivity for a certain territory.

e. Term and renewal: The franchise is granted for a specific term and may provide for a renewal option or the option of the franchisor to take over the operation of the franchise hotels upon expiry of the term.

f. Early termination and liquidation damages: In case of an early termination of the agreement, the liquidation damages clause allows the franchisor to collect damages as a result of such termination. There usually way is both to reduce the amount of the damages as well as restrict the potential transactions that might trigger payment.

g. Key money: Key money is an up-front payment by a franchisor to a hotel owner. Hotel owners are typically excited about the prospect of getting additional funds, however, two things should be considered: First, key money is only paid after the Hotel opens (it does not provide funds for construction purposes). Second, key money is probably the most expensive money an owner will get; in return for this key money brands typically will be even less willing to negotiate important franchise agreement provisions.

h. Confidentiality: Every franchise agreement contains such a clause because franchisors do not want to disclose to competitor businesses designs, business procedures, formulas, business plans, etc., of their brands.

i. Assignment: it is normally established that none of the rights or obligations arising under the agreement may be assigned, transferred, sub-licensed, sub-contracted or otherwise dealt with by the franchisee without the prior written consent of the franchisor.

j. Dispute resolution, governing law and jurisdiction: The parties have to choose to solve their problems either in front of a court jurisdiction, go to mediation or in front of an arbitral court. In this clause both parties usually also concrete the governing law and jurisdiction applicable to the agreement.

5.- Please describe which one are the most common financial leverage or instruments to be arranged by the builders or investors?

In general, the most common financial instrument used is bank financing secured by mortgages. However, in countries where bank financing has been historically expensive, like Argentina, the most common financial instrument are trusts, in which the settlors and beneficiaries are investors who make contributions of money and/or land to the trustee to own the project and manage the assets to develop it by contracting with third parties the construction and development of the project or the sale of the project to third parties.

6.- Is a private equity scheme more common than traditional bank loans in your jurisdiction?

The most common scheme for hotel acquisitions still are bank loans. Nonetheless, in countries where bank financing has been historically expensive, a private equity scheme is more common than the traditional bank loans.

IV.- EFFECTS OF THE FINANCIAL CRISIS

1.- Please describe the effects of the financial crisis in your jurisdiction, if any. Are there a lot of forced sales scenarios? Give examples.

In general, all national reporters agree that the financial crisis has deeply affected the hospitality market. Moreover, it has been the hospitality market located in the countryside that has been affected the most. Despite the previous mentioned situation, there have not been significant forced sales in any country. Nevertheless, crisis led to several hotel closings. All in all, as mentioned above in I.1, the hospitality market is progressively recovering from the past financial crisis.

In connection with the above mentioned, Canada needs a special consideration. Canada did not suffer from the financial crisis like the other countries due to his special banking system. Canada's banking market is oligopolistic and tightly regulated under the watchful eye of a single, strong regulator. There also is no mortgage interest tax deduction. Moreover, there are a lot of incentives to pay the debt down faster, like a fixed-rate mortgages with anti-refinancing repayment penalties to protect lenders from interest rate drops. What has to be considered is that Canada did not completely sidestep the recession, but home loan default rates are much lower than in the other countries.

2.- Financing of hotel transactions – how does that work nowadays? (Which are the most obvious differences in contrast to earlier times? Which expectations and requirements do Banks have at the moment?)

Bank financing has become increasingly available but with a large amount of securities that the client has to deliver making it much more difficult to obtain a loan for hotel projects as for any other project. Those securities are, for instance, mortgages, insurances, bank or insurance guaranties, collaterals of 40-50%, etc.

3.- Litigations matters: Are many of the failed transaction resolved by arbitration or is traditional litigation used in your jurisdiction?

Both ways of resolving conflicts are used but in the last years arbitration has been used much more than the traditional litigation. The reason why it has become more common is because of its lower costs, rapidity, confidentiality and professional competence comparing to traditional litigation. The main areas were arbitration has increasingly been used is in international cross-border disputes and large domestic transactions.

In this context, it is fairly common to submit to an international arbitration courts like Paris, London and Vienna.

4.- In case a criminal proceeding is involved: Is there also a way to protect third parties involved without awaiting the decision of the Criminal Court?

This issue depends on each State and its particular procedural rules. The initiation of a criminal proceeding in most of the countries does not prevent the parties from initiating civil or other type of proceedings to obtain the relevant monetary judgement or awards.

5.- In your opinion: Is the crisis also a financial opportunity for speculators who can invest in "unfinished projects" with few resources?

The current economic situation could be a good opportunity for speculators to invest in "unfinished projects" in order to get a future economic turnaround. However, some of those unfinished projects remain unfinished for some reasons which are not just the lack of financing but, for instance, incorrect administrative decisions. For this reason, the speculators have to be especially aware when acquiring this type of projects.

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