Right, Construction of the Westin Hotel at the Denver International Airport

Airports Hotels: Laying the Foundation for a Synergistic Relationship

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Hotels have always been located near transportation hubs. Centuries ago, travelers sought accommodation and refreshment in inns strategically located along the road network to provide a place for man and beast to recharge and refresh. As carriages and stagecoaches gave way to railroads, and sail yielded to steam, hostelries sprang up around rail depots and the docks.

In the middle of the 20th century, flying became the favored mode of long distance transportation; fares declined and long trips to exotic destinations were suddenly within reach of the masses. In 1960, 62.3 million people boarded flights within the United States; 53 years later, 826 million people took off. With the growing number of travelers, hotels sprang up around most airports, and airport hotels emerged as an important sub-segment in the lodging industry, originally needed to provide accommodation for airline crews and passengers and later becoming an important convenience offered near most airports. Several major international hotel brands were founded or have been owned by airlines, including InterContinental (Pan Am), Hilton International (TWA) and Westin (UAL).

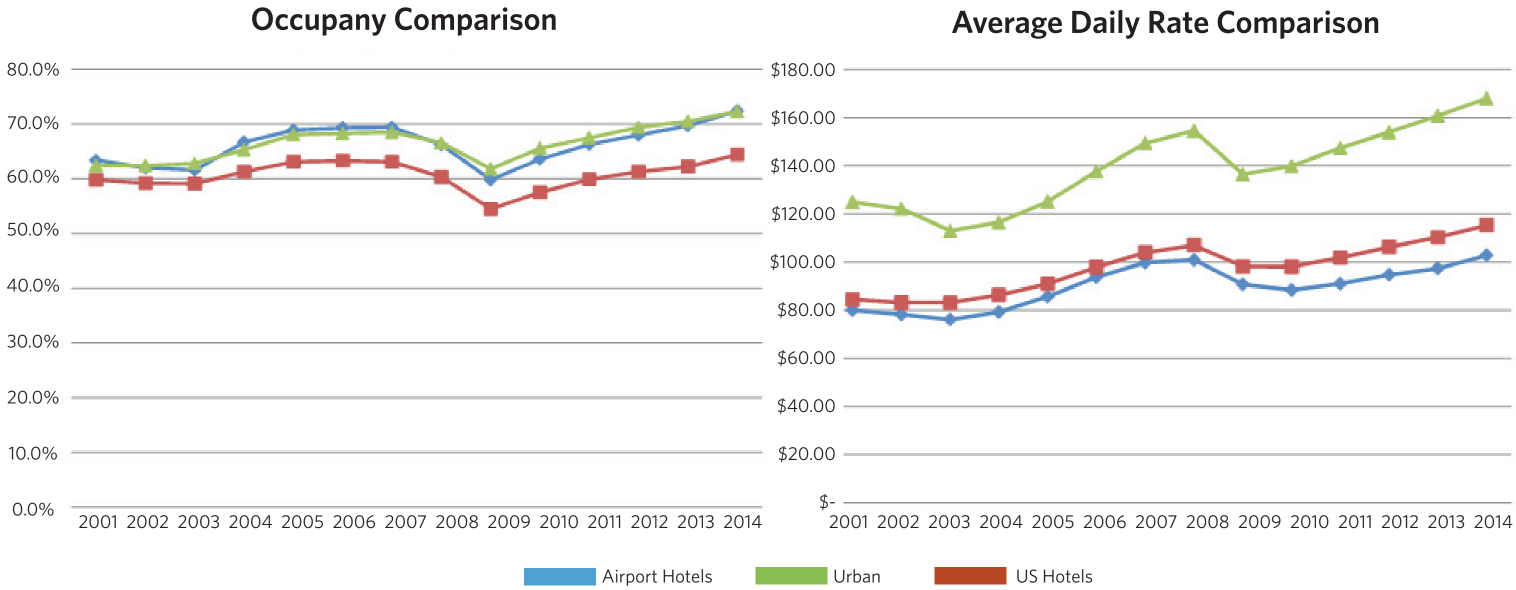
The number and type of hotels that can be supported around airports varies widely by market, and while airline passenger movement is an important consideration, it is not the only hotel demand driver. Local and regional transportation patterns also influence the need for accommodations. Passengers with early morning flights frequently seek accommodation near the airport to avoid traffic delays in congested urban areas or in rural areas where long drives to the airport are common. In addition, major airports frequently serve as central meeting destinations for various groups. And of course, airlines contract for rooms for their crew and passengers stranded due to overbooking or mechanical delays. Unexpected winter weather issues frequently benefit airport-area hotels, particularly in the north - notably, on average approximately 25 percent of airlines' annual cancellations occur in January and February, sometimes leaving passengers scrambling for accommodations near the airport.

While an airport may support many hotels, those located closest to the terminals and with the easiest access have a clear locational advantage over their competitors in most markets. Thus many hotel developers seek to develop hotels on the airport premises, and prefer if possible to actually be linked to airport terminals. Airport management teams have the responsibility of determining whether to allow the development of hotels on the airport grounds, where these hotels should be located, how they should be linked to the terminals and the business structure of the hotel development. Because land around many airports is in short supply, and most airports were developed many years ago, many airport management teams have limited experience in developing hotels. Other airport management teams benefit from (or conversely struggle with) decisions taken by predecessors. To help avoid some pitfalls we have observed in the past, we present general guidance concerning critical decisions that must be taken by airport management teams during the hotel development process.

Feasibility: Does the project make economic sense?

Determining whether the airport and the surrounding area generate enough lodging demand to support additional hotel development should be one of the first steps in the development process. Prior to commissioning engineering or design studies, a preliminary market demand study should be commissioned. Hotel consultants examine airport and area growth patterns, existing supply and demand patterns and the rates achieved by existing hotels in the area. Ultimately, the consultants present an overview of critical hotel performance metrics in the area and projections of growth. Critical hotel metrics include annual occupancy (the percentage of existing hotel rooms in the market that were actually sold), Average Daily Rate "ADR" (the average rate actually paid for each room sold, calculated by dividing room revenue by total rooms sold for a given period) and Rooms revenue Per Available Room "RevPAR" (total guest room revenue divided by the total number of rooms available). If the market appears strong enough, the consultant can provide an estimate of the number of additional rooms that may be supported or the performance and profitability of a hotel of a particular size.

Although occupancy levels in airport locations are frequently above the industry average, the ADR in airport locations is frequently somewhat lower than downtown



locations or overall industry averages, as illustrated in the adjacent charts, which compares the occupancy and ADR performance of all US hotels, airport hotels and urban hotels over time. Data was provided by Smith Travel Research (STR), which compiles hotel industry performance data; STR's database includes approximately 2,300 hotels located at or near airports.

Hotels may be classified in a number of ways, most commonly based upon services offered, room rates and location. Full-service hotels include restaurant, lounge and meeting facilities and have traditionally included bell service and room service. Limited-service hotels traditionally provide only a room and bath for a night, and do not provide food and beverage facilities, although in recent years many limited-service properties have adopted the practice of providing a free breakfast to patrons. Examples of limited service brands include Days Inn, SpringHill Suites by Marriott, Hampton Inn and Comfort Inns. Full-service hotels are more complicated and expensive to operate than limited service facilities; traditionally the rooms department of a hotel is far more profitable than the food and beverage and other departments. Traditional full-service hotel brands range from luxury brands such as Four Seasons hotels, to upscale properties such as Marriott or Hilton hotels to mid-market properties such as Holiday Inns. In recent years a hybrid product has emerged; many of the major lodging brands now offer a "select-service" offering that provides a comfortable room, smaller and fewer meeting rooms and a limited restaurant facility that may not provide three meals on a daily basis. Examples of select service brands include Hyatt Place, Courtyard by Marriott and Hilton Garden Inns.

Hotel construction costs vary widely depending upon location, type of hotel, size and services offered. Excluding land and working capital, the average cost of per unit of developing a full-service hotel in the United States was approximately $236,900 in 2014. Based on 2013 figures, after all operating expenses were paid, hotels in airport locations had 32.5 percent of revenue available to pay property taxes, insurance, ground rental, mortgage interest, amortization, capital expenditures and a return on the owner's investment. Hotel developers focus on performance metrics including profitability of nearby properties and growth projections to determine if the project is likely to meet their return on investment objectives.

Location

Well-maintained hotels that are physically connected to airport terminals generally achieve higher occupancies and ADRs than their off-site competitors. This performance premium makes intuitive sense; if guests must board a shuttle bus to reach their hotel, an extra minute or two on a shuttle will be balanced against other issues such as brand preferences, loyalty program affiliations and internet reviews. Thus, if the airport is seeking to provide the most convenient travel experience possible, or maximize hotel revenues, a convenient, direct terminal connection is clearly preferable. But potential hotel operating premiums must be weighed against possible future airport expansion – and the likelihood that a hotel site will be the best location for new terminal gates, runways or other priorities. Several airports proceeding with terminal or runway expansion projects have been forced to reacquire hotel properties in the path of these improvements (frequently at a premium), through eminent domain or buyout negotiations; a process that is easier to contemplate on a forty- or fifty-year-old structure than on one that is still relatively new.

Structure

Hotel developments can be structured in a number of different ways from an ownership perspective; with ground leases and management contracts being the most common. Each structure has both financial and operational advantages and disadvantages.

Ground Leases

Many hotel sites are leased by airports to developers who build, operate and maintain the hotels; the airports continue to own the land and collect a ground rent, while the developer owns the improvements. At the end of the lease term, the land and improvements revert to the airport. The advantage to airports of a ground lease structure are that the lessee bears the risk of development cost overruns and operating shortfalls; however the development team requires a substantial reward for the assumption of this risk. In addition, the airport must relinquish control of the property for a lengthy period, and financing sources require robust non-disturbance agreements. Hotel investors are concerned with ensuring that they can make an adequate return on their investment and ensuring the marketability of the property so that they will ultimately be able to sell the property to another investor. Potential hotel buyers and their financing sources always consider the remaining term of ground lease properties, thus lengthy initial terms followed by several renewal terms are typical in ground lease structures. Typically, a term of at least 50 years (which may consist of initial and renewal terms) ranging to 99 years is required. Renewal options tend to be negotiated and exercised well in advance; the leaseholder requires certainty to maintain the marketability of their asset. In several cases, additional capital improvements to the hotel have been negotiated as part of the renewal negotiations.

Hotel ground leases have been structured in a number of different ways. Rent structures vary very widely, frequently some form of base and percentage rent is negotiated. Developers often require substantial rent concessions, particularly in the initial years of operation to facilitate payment of debt service and provide some return on investment as the hotel gains traction. Based on current market conditions, it is difficult for a private developer to pay substantial ground rents and provide an acceptable return to equity. Relatively few full-service hotels have been developed in recent years; the return on most full-service hotel investments is

Right, The Grand Hyatt Hotel at the Dallas-Fort Worth Hotel is integrated into Terminal D

simply not commercially acceptable. Investors generally require a return to equity of between 12 to 20 percent; new development hotel projects are considered risky, and thus would require returns in the mid to higher end of the range.

Other issues that need to be considered are how the airport management wants to constrain the operator or developer. A hotel lease should include definitions of acceptable standards of operation including brand, facilities, services and maintenance/capital improvement requirements – particularly in properties that are connected to terminals and thus reflect more directly on the airport.

Airport Owned Hotels

A number of airports own terminal hotel properties, particularly properties that are attached to the terminal facilities. Some advantages of airport ownership include long-term control over the asset, shorter management agreement terms and potentially higher returns. If the hotel site is needed for redevelopment, it will be far easier to redevelop an airport-owned property without a third-party hotel owner holding out for an advantageous lease termination payment. Airports that own hotels generally contract with a hotel operator to manage the day-to-day operation of the hotel; the hotel brand may come with the management agreement or may be contracted separately via a franchise agreement. Hotel management and franchise agreements can generally be negotiated for shorter terms than ground leases. Dealing with hotel operators can be challenging for airport management; few airports have the internal capability of evaluating, and if necessary, challenging operating budgets, capital improvement plans and marketing strategies. In general, we recommend that airports retain third party asset managers to oversee the operation and make recommendations with respect to budget ap-

Left, The completed Westin Hotel at the Denver International Airport

provals, senior management appointments and financial statement review.

Recent examples of airport-owned hotels include Denver, which is constructing a 519-unit Westin hotel as part of an expansion project which includes a public plaza and train station connecting the airport to downtown Denver. Dallas-Fort Worth opened the 298-room Grand Hyatt, which is integrated into International Terminal D in 2005 and the 404-unit Westin Detroit Airport opened in 2002. These projects were all financed by the airports through revenue bonds, which require changes to traditional hotel management agreements. Hotel operators are usually compensated based on revenue performance, usually in the range of two to five percent of gross hotel revenues, and compensation may also be partially contingent on the delivery of targeted operating profits. The traditional management fee structure emerged as an attempt to align ownership and operator objectives; as hotel performance improves the management company's fees increase, and if a hotel performs poorly, operator compensation declines. Airports that finance through revenue bonds are precluded from using the hotel industry's traditional structure and generally negotiate a flat fee structure varying by year based upon pre-construction pro-forma estimates; as a result operator compensation is not tied to actual hotel performance. Of course the cash flow to the airport from a hotel project is dependent on myriad factors. Aside from overall market forces and management, returns will be influenced by construction costs and how it is financed. The advantage of using airport revenue bonds is that debt service on the property will generally be lower, which enhances the feasibility of the project.

Procurement Process

Once the desired structure is determined, airports generally issue Requests For Proposals (RFPs) incorporating the airport's standard terms and requirements, along with a brief description of the project. Some RFPs provide the developers with very little information regarding the proposed project and site and minimal guidance in structuring their proposals, and thus result in submissions that are difficult to compare and evaluate. Although usual procurement procedures must be maintained, a Hotel RFP is somewhat different from many of the other projects completed by airports, and the RFP should be carefully developed to ensure that all developers understand the project and the airport's requirements thoroughly and that all bidders are asked to provide the same information. The airport must provide clear definition with respect to the site, infrastructure, terminal linkages, height restrictions, required facilities, parking and any site-specific challenges. Background information with respect to the city and airport should be provided and an abbreviated market study (generally without operating projections) may be included. The preferred operating structure should be outlined, and all submitters should be required to submit a basic package of qualifications, including prior experience, financial wherewithal, and project team organization and resumes.

Proposals may be received that provide bids for either the requested structure or a proposed alternative approach, or in some cases both. A creative alternative approach may provide additional flexibility, so all proposals should be carefully evaluated against the evaluation criteria focusing on the ability of the bidding team to deliver the desired results, the reasonableness of their projections, and any suggestions they may have included. Ultimately, several teams should be selected as a short-list for further clarification and ultimately negotiation of an agreement. During the negotiating process, it is important for the airport to consider the effect of changes to the deal structure on yield to the airport and perform sensitivity analyses so that the implications to both parties are fully understood if the hotel is more or less successful than anticipated. Airport representatives need to be very wary of overly optimistic projections, and avoid using optimistic figures as the basis for downside sensitivity projections. Rather, sensitivity analyses should use realistic figures (generated internally or by independent consultants retained by the airport) to realistically assess both upside and downside risk and return scenarios.

Contract negotiation

Airports should recognize that the hotel industry is relatively volatile, and hotel assets are frequently sold; thus the parties to the deal are likely to change over time. In addition airports themselves are constantly growing and evolving. We generally recommend that our clients seek specialist legal advice with respect to hotel contracts as such contracts are complicated and the implications and risks associated with even seemingly innocuous clauses should be carefully evaluated. It is important to ensure that leases and management contracts specifically address issues that may seem unlikely to be contentious at the outset, but our experience indicates are likely to arise over the years, including maintenance and operating standards, buy-out provisions if the hotel site is required for redevelopment, exclusivity radiuses and interpretation of rent adjustment provisions. Either the hotel operators or airport management may wish to develop additional hotel facilities nearby over the lease term; consideration must be given to development restrictions, and weather such clauses should expire prior to lease expiration. Overly restrictive or lengthy exclusivity clauses or rights of first refusal could impede future development plans and should be carefully considered. Some airports have tied renewal terms to capital expenditures, recognizing that as lease terms expire, tenants have little incentive to maintain the facility and are inclined to "run the property into the ground." And the interpretation of "market rate" in lease contracts is often contested.

Oversight

Once the hotel is up and operating the airport is responsible for the oversight of the project. Obviously if the property is leased, the airport is not responsible for direct oversight, but it is important to ensure that all lease provisions, particularly with respect to maintenance and operating standards are enforced. Hotel profits can be inflated in the short term by reducing maintenance and capital expenditures, but over time such neglect may have a negative impact on the property's and potentially the airport's reputation. Such a strategy can also inflate the value of the property in a buy-out situation, thus the airport management should not allow such a strategy to persist. If the airport owns the property, it is important for the airport to supervise the hotel management company effectively. The airport will need to either hire a staff member with the necessary experience or engage a third party asset management firm specializing in hotels. Effective asset managers should have the skill and experience to question operating budgets, annual marketing plans and operating results. In addition, hotels require substantial maintenance and periodic upgrading; generally minor renovations will be required between the fourth and fifth years and more extensive renovations will be require between the ninth and 12th years of operation. An asset manager can help to ensure that these funds are spent most effectively on items that will maintain the hotels physical condition and market position rather than items that may be nice but not necessary.

Hotel facilities are an important amenity around most major airports and for those airports with on premise hotels, overseeing their development and effective operation can be a major challenge. Ensuring that the right team is in place to assist with market analysis, project development and finance, legal advice and asset oversight is a key issue to the short-term success of a project; however it is important to also consider unforeseen future needs of the airport, and provide some flexibility if needs or conditions change. ■

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