

# The Causes and Consequences of Condo Hotel Conversion in Waikiki, Hawaii

by

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**ABSTRACT**

This paper explores the causes and consequences of the recent conversions of hotels into ‘condo hotels’ in Waikiki, Hawaii, through an examination of local and national real estate trends. Condo hotels result from the conversion of hotels to individual condominium units operated as a hotel. In the last few years forces driving a national residential real estate boom have carried the concept of the condo hotel to the forefront of the public’s imagination. For developers, the model of hotel conversion offers numerous advantages and has proven an effective bridge between risk adverse lenders and developers seeking project financing. Developers and condominium buyers alike value the services and branding hotel operations can bring to a property. In Waikiki, condo hotels operate as a vehicle for the renovation and reinvention of aging hotel stock. The product has proven exceptionally popular, yet the wholesale conversion of aging hotel stock could have both positive and negative consequences for Waikiki or similar communities. While condo hotels can upgrade a region’s accommodations infrastructure, some allege it has the potential to disrupt local employment and undermine tax revenues. Others fear demographic changes and social displacement not unlike the controversy over apartment conversions in the 1970s. No doubt conversion of large numbers of hotels into condo hotels will result in change but that change needn’t produce a negative outcome.

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## **Table of Contents**

<b>Introduction</b>	<b>6</b>
<b>Chapter 1: Background</b>	<b>9</b>
<b>Chapter 2: Introduction to Waikiki</b>	<b>16</b>
<b>2.1: Geographic Definition</b>	
<b>2.2: Economic Contribution</b>	
<b>2.3: Development History</b>	
<b>Chapter 3: What is a Condo Hotel</b>	<b>27</b>
<b>3.1: Definitions</b>	
<b>3.2: Condominium and Hotel – A Mixed-Use Model</b>	
<b>3.3 Condominium Hotel – Condominium Ownership of a Hotel</b>	
<b>Chapter 4: Example Case: The Waikiki Hotel Exemplar</b>	<b>37</b>
<b>4.1: The Hotel</b>	
<b>4.2: The Owner</b>	
<b>4.3: The Developer</b>	
<b>4.4: The Management Company</b>	
<b>4.5: The Buyers</b>	
<b>4.6: The Guests</b>	

<b>Chapter 5: Causes of Conversion</b>	<b>48</b>
<b>5.1: Waikiki’s Aging Hotel Stock</b>	
<b>5.2: Buyer Demographics</b>	
<b>5.3: Investment Attitudes</b>	
<b>5.4: Pricing</b>	
<b>5.5: Home Ownership</b>	
<b>5.6: Advantages Over Competitors</b>	
<b>5.7: Financing</b>	
<b>5.8: International Buyers</b>	
<b>Chapter 6: Consequences of Conversion</b>	<b>66</b>
<b>6.1: Legal Liability</b>	
<b>6.2: Management and Governance</b>	
<b>6.3: Unbundling of Property</b>	
<b>6.4: Taxation</b>	
<b>6.5: Hotel Inventory</b>	
<b>6.6: Economy and Employment</b>	
<b>Conclusion</b>	<b>92</b>
<b>Bibliography</b>	<b>95</b>



## **Introduction**

In the last decade years this country has witnessed one of the strongest and most prolonged rises in the real estate markets ever recorded. A combination of indigenous and immigration demographics, low interest rates, and a national shift in attitudes toward home ownership have contributed to an unprecedented rise in residential values. This seemingly insatiable demand has placed pressure on land resources and existing housing stock and encouraged developers to seek creative means of introducing new product. Low interest rates have brought the costs of ownership down to a level such that more Americans can afford to purchase not only their primary residence but second home and investment properties. In Waikiki and other regions with high concentrations of hotels, demand for second-home and investment product has emboldened developers to pursue poorly performing hotels with the intention to acquire and convert into condominium hotel ownership, also known as ‘condo hotels.’ This paper will address both academic and lay pieces that explore the causes and consequences of condo hotels in Waikiki within the framework of an emerging national phenomenon.

It is not surprising that the condo hotel concept has taken off in places like New York, Florida, and Hawaii where condominiums have been an acceptable form of ownership for decades.<sup>1</sup>

Condo hotels have been a legal form of ownership since the 1960’s with the passage of the first condominium legislation; however, despite some experimentation with the ownership structure

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<sup>1</sup> Warner, Arthur. *Condominium: Concept, Control, Consumer Acceptance*. Research Report, July 11, 1976. College of Business Administration University of South Carolina (Columbia SC) p 29. Warner addresses local markets but references those in Hawaii and New York.

over the years the concept went largely unnoticed until recently. Treading a fine line between real estate and a security, Waikiki condo hotels serve a dual role for many buyers as a second home and an investment product. For the buyer the product is an affordable, low-maintenance, and high-amenity alternative to single family or conventional condominium second-home ownership. For hotel owners, condominium hotel conversion offers a high value opportunity to transfer ownership of marginal hotel properties. For both developers and lending institutions, the upfront sales of condominium hotel units mitigate development risk and in the case of new construction, provide the basis for financing ground-up hotel construction. The result is what some have called an “unprecedented alignment of economic interests of developers, consumers, hotel operators, and lenders.”<sup>2</sup>

Hotel conversions represent only a small percentage of condominium creation nationally.<sup>3</sup> Given that condo hotels are limited to a few regional markets and have only become more widespread in the last four to five years there is limited quantitative data to undertake rigorous analytical studies. Despite this, in communities where conversion has occurred, some concerns regarding the consequences of hotel conversions have emerged in the lay press. In Waikiki, the 3,331 condo hotel rooms represent just under 10% of the 31,717 total lodging units for the area. Of these 3,331 units, industry sources estimate between 300 to 900 units have been permanently removed from the short-term hotel rental pool in Waikiki.

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<sup>2</sup> Butler, Jim and Maisnik, Guy. “Condo Hotels: Marking Them Work Involves Challenges and Rewards.” *Urban Land* Urban Land Institute (ULI). February 2005 p.32. See also comments by Regent Street Advisors in Parets, Robyn Taylor. “Why Condo Hotels are a Hot Concept.” *National Real Estate Investor*. May 1 2005. p.89.

<sup>3</sup> For more on the current wave of residential condominium conversions refer to Gose, Joe “Condo Conversion Craze.” *National Real Estate Investor Online*. Jun 1, 2004.

Unlike previous housing conversion debates which dealt with tenant displacement or gentrification, most hotels in Waikiki or elsewhere do not house longer-term residents who would need to relocate. Hence it could be surmised that any contention regarding conversion might be tempered.<sup>4</sup> In fact, equally important issues arise such as what will be the effect of wholesale conversions of hotels into individually-owned condominiums on the local economy – especially in communities wholly reliant on tourist activity? In other words, whereas conversion of apartments to condominiums raises issues of displacement of tenants, conversion of hotel rooms to condo hotels potentially results in displacement of guests. In communities such as Waikiki, South Florida, and to some extent New York City, hotel keys not only represent tourist lodging but basis by which tourists can experience and consume local goods and services. Therefore, to many, the conversion of hotel keys to condominium units threatens not only the supply of short-term tourist housing but eventually undermines the fundamental drivers of local and state economies.

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<sup>4</sup> The scenario might be different were the hotels in question single room occupancy (SRO) or rooming-house properties which sometimes can serve as transient housing for those who cannot afford or cannot find more permanent residential housing. On occasion, the sale, demolition or conversion of such properties can stimulate a community debate. See Lobbia, J.A. “Down in the Old Hotel Tower & Tenements: Landlords Trade Tenants for Tourists at SROs.” *The Village Voice* (New York, NY) September 30, 1998.

## **Chapter 1**

### **Background**

There is a substantial collection of academic and industry literature regarding condominiums as form of ownership. Condominium ownership exists in all forms of real estate products including commercial, industrial, retail and residential properties. While the legal structure for condo hotels has been in place for many years, only recently have numbers of condo hotels risen to levels where public interest has been aroused. Condo hotels have been an inventory component to Waikiki's housing stock for decades although only recently have the numbers of condo hotels begun to elicit discussion in the lay and academic press. Since 2000 approximately 2300 of Waikiki's 31,717 hotel rooms, or seven percent of total lodging inventory, have been converted to condo hotel rooms.

As a result of mostly newspaper and industry publication coverage of this recent trend in Waikiki and other locations such as New York and Florida, there is not a great deal of historical or academic literature on condo hotels. There is some literature on resort condominiums which focuses on development techniques and the legal framework of seasonal-use condominiums, but the properties which they detail were never operated as full service hotels... Hotel literature addresses the financing, development and operational aspects of the industry but few articles delve into the condominium conversion or ownership of these properties. In the past older hotels

have been converted to apartment buildings or residential housing but only recently have fully operating hotel properties been structured under condominium ownership.

Starting from the 1960's, when the first condominium legislation was passed, articles and books have addressed, among many other topics, the optimal location, financing, design, construction, marketing, and legal framework of what was then a new structure of ownership. The next decade witnessed greater acceptance of the condominium idea and more widespread construction and conversion of condominiums in national markets. According to Michael J. Whinihan's retrospective 1984 AREUEA Journal article entitled "Condominium Conversion and the Tax Reform Acts of 1969 and 1976,"<sup>5</sup> legislative changes (notably, reduced rental housing tax benefits) combined with market forces to provide an important stimulus for the residential condominium conversions of the 1970's and 1980's.

The legal, development, and management issues surrounded condominium development are amply addressed in Keith Romney's 1974 *Condominium Development Guide: Procedures, Analysis, Forms* which includes a useful section on resort condominiums.<sup>6</sup> The condominiums on which Romney focuses may be characterized as resort retreats with condominium developments such as his example of a seasonal mountain resort. Although the property is managed for owners as a resort and a rental pool may be established, the product and its

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<sup>5</sup> Whinihan, Michael J. "Condominium Conversion and the Tax Reform Acts of 1969 and 1976." *American Real Estate and Urban Economics Association (AREUEA) Journal* Vol 12, no. 4, 1984. pp 461-472.

<sup>6</sup> Romney, Keith and Romeny, Brad. *Condominium Development Guide*. Warren, Gorham & Lamont (Boston, MA). 1983. This publication is continually revised and supplements are published on a regular basis. Resort condominiums (often in seasonal locations such as mountain resorts) are addressed though there is only slight mention of condo hotels.

implications arguably differ from the large scale conversion of existing hotel ownership in Waikiki from corporate ownership to individual room/key ownership in an operating hotel. Nevertheless, elements of structure, management, and legal considerations of resort condominiums remain relevant to the framework of condo hotel conversion in Waikiki today.

Works such as Romney's *Development Guide* serve as a framework for the understanding the mechanics of development, other authors have focused on the impact and implications of condominium development and conversion. Starting with the wave of conversions that took place during the 1970's and 1980's researchers began to address the longer term issues associated with condominiums such as land or property use and community dislocation. In the eyes of some observers during this period wholesale apartment conversions appeared to threaten the social fabric of neighborhoods and potentially disrupt the quality and character of entire cities and towns. Some believe that in today's Waikiki and other communities, the conversion of hotel inventory into condominiums has the potential to undermine the local tourist-based economy. As hotels are converted into condominium ownership it is possible that fewer available hotel rooms will result if owner use is high thereby providing fewer options for visiting guests. But in the 1970s it was the conversion of existing housing stock, especially when relating to neighborhoods where affordable housing or former rent-controlled properties were being transformed on a grand scale that became a contentious issue. Displacement of individuals from affordable rental housing and changes in the character of communities no doubt resulted, but the effects can be viewed as both positive and negative - while communities did change, home

ownership became a reality for many who might not otherwise been able to afford a single-family home.

Several studies examined the effect of apartment conversion in cities such as Brookline, Massachusetts. Dinkelspiel, Uchenick and Selesnick, in *Condominiums: The Effects of Conversion on a Community* (1981) concluded that “conversion has not markedly changed the socioeconomic character of most (though not all) neighborhoods.” Even so, conversion of a substantial number of apartment buildings in an area will raise a broad range of difficult issues for the community and present a series of conflicts for it resolve.<sup>7</sup> In addition to social displacement, Dinkelspiel’s study reviewed the potential changes in tax revenues, use of services, and the longer-term demographics of Brookline as an example community. Unless a significant number of families with children were to replace existing residents the authors found that “a community is not likely to have to respond in any major way to conversion in terms of the services it provides.” Although findings of different community studies vary and to some extent the debate still persists, most understand that the process of residential condo conversion has benefits and deficits on both the individual and the community level. In essence, most have come to accept that conversion reflects free-market forces which govern commerce in this country. While apartments are an important revenue source for their owners it would be fair to say that apartments are not as an industry the drivers of economies. Hotels, on the other hand, can play a key role in the fiscal health of communities reliant on tourism.

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<sup>7</sup> Dinkelspiel, John, Uchenick, Joel, and Selesnick, Herbert. *Condominiums: The Effects of Conversion on a Community*. Auburn House Publishing Company (Boston, MA). 1981. P. 147. For further discussion see also: Moe, Kari. *Analysis of the Condominium Conversion Debate*. A study prepared for the Boston Neighborhood Network. March 5, 1981. Additionally Boroff, Janey Bishoff. *The Market Dynamics of a Condominium Conversion from a Supply Perspective – A Town in Turmoil*. Thesis: MIT DUSP 1979.

Just as much as been written regarding fundamentals in condominiums and conversion so also has much been written regarding the dynamics of hotel markets and operations. Recent academic literature has focused on consumer demand stratification and occupancy such as Gat's *Journal of Real Estate Finance and Economics (JREFE)* article "Toward a Theory of the Intraurban Market for Hotel Services," (1998). Gat's article attempts to predict which hotels in a given area are likely to empty or full given their offering of hotel services and client demand. Hotel services and product differentiation are no doubt contributory forces to success or failure of existing hotel ventures in Waikiki... Whereas in the 1980's Waikiki offered high-end, mid-priced, and budget hotel options for visitors, in the last decade neglect and physical depreciation degraded many mid-priced hotels to budget status creating a gap in supply differentiation. These mid-level (now budget hotels) have been prime candidates for conversion. While this subject gives some clues as to the forces encouraging conversion in Waikiki it is clear that many contributory factors are at hand and most buyers of condo hotel units have little consideration of product differentiation when making a decision to purchase.

Aside from poor differentiation, hotel conversion in Waikiki is also the result of a legacy of excess supply, much of it built years before in periods of growth and speculation. In their 1998 study in *Real Estate Economics* Wheaton and Rossoff review the continued inadequacy of the supply side of the hotel sector to efficiently meet demand cycles.<sup>8</sup> Although there is evidence of a "very strong market cycle," in place measured growth in line with demand, the supply side of

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<sup>8</sup> Wheaton, William, Rossoff, Lawrence. "The Cyclic Behavior of the U.S. Lodging Industry." *Real Estate Economics*. 1998 Volume 26, 1: pp 67-82.



the industry tends instead to move forward in response patterns that are “slow and hence prone to instability.” The authors note that “quicker response by rents and sooner supply deliveries are necessary to smooth the cycle and stabilize the model.”<sup>9</sup> Conceivably, the underlying rush to convert hotels into condominiums in Waikiki is a free market adaptation to supply ‘new’ renovated and repositioned product quickly to market demand. Renovations of existing hotels need little if any new zoning relief or difficult to obtain permitting, and can be back on the market within 9-18 months. What significant renovations do require is funding. As will be discussed, condo hotels fill this need through presales to individual owners. Individual buyers currently pay a premium per square foot over what hotel operators can justify on a cash flow basis. By providing a renovated model unit to drive sales, developers can sell out a hotel property quickly and apply commitments to secure financing for renovations. This process arguably creates a more efficient market with better differentiated product and heightened response time since hotel units emerge quickly after refurbishment and rent out at a higher premium to meet demand.

There are news articles that address many of the potential drivers for the recent trend of condo hotel construction and conversion nationally; however, there are few published in-depth academic works focused on the recent wave of condominium hotels. According to several contacts, hotel conversion to condominium hotels in Waikiki specifically has been a notable trend since the late 1990’s with an acceleration of activity since around 2003. Initially, it is fair to say that few articles resulted during the early part of this trend either locally in Waikiki or

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<sup>9</sup>Wheaton, William, Rossoff, Lawrence. “The Cyclic Behavior of the U.S. Lodging Industry.” *Real Estate Economics*. 1998 Volume 26, 1: p 81.

nationally due to lack of public awareness of the product – which was by many viewed as a ‘white elephant’ real estate product or investment. In recent years the emergence of condominium hotel product in several markets nationally has brought more public and some academic attention. It is important to note that in the process of research it is apparent that a number of research works on the trend are currently being prepared especially regarding Waikiki. Of particular significance is an ongoing study commissioned by the State of Hawaii, to be compiled by Joseph Toy of the private consulting firm Hospitality Advisors LLC, on the effects of hotel conversion on Oahu. Although several news articles suggest that the study would be complete in April of 2005, at the time of this publication the project had not yet been finished – a state economist expects the study to be available at the end of August 2005.<sup>10</sup> If available before binding this material may be added as an Appendix attachment.

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<sup>10</sup> Clearly there is ample indication that this is a topic of concern for the government, businesses, employees, and citizens of Waikiki. A similar study had been commissioned by the private organization American Association of Resort Developers (ARDA) regarding the impact of conversion for the island of Maui. At the time of completion of this paper the State of Hawaii study had not yet completed; however, this material may be added as an appendix attachment.

## **Chapter 2**

### **Introduction to Waikiki**

#### 2.1: Geographic Definition

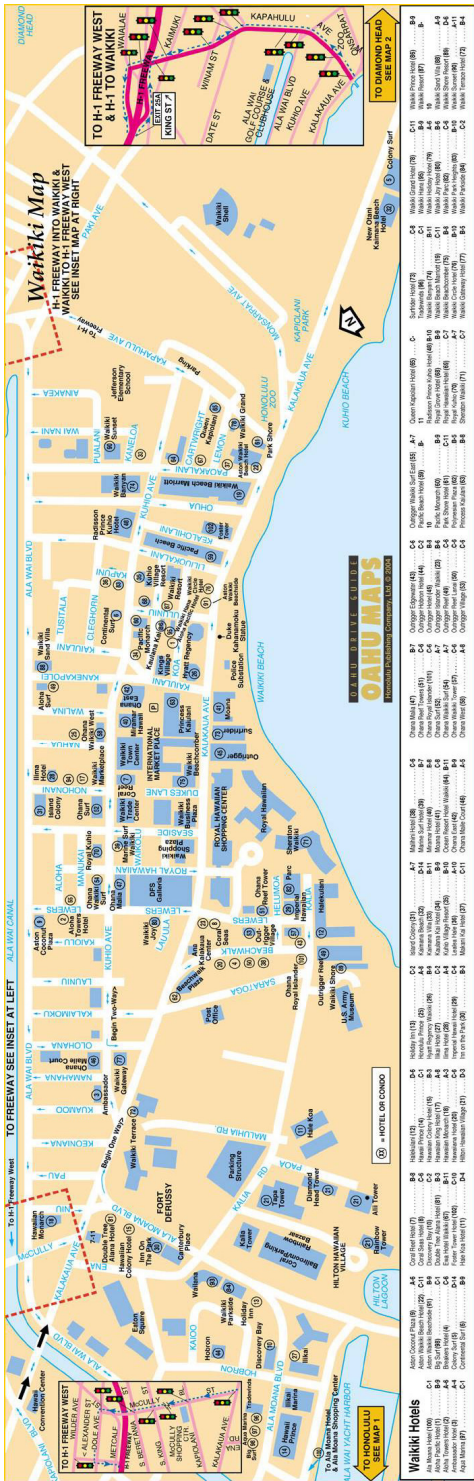
From a geographical perspective Waikiki is a district within the City & County of Honolulu, located on the south shore of the island of Oahu. The area, delineated from Honolulu's land mass by man-made brackish canals, known as the Ala Wai, is comprised of roughly 1 square mile (600 acres) and represents about 1/100th of 1% of the state's land area.<sup>11</sup> Waikiki is typically considered the land circumscribed by the Ala Wai to the north and the ocean to the south, but many would also include the adjacent Ala Moana hotel, yacht club, and convention center as inclusive. Land characteristics of the area include sandy beachfront (with sand replenished by the city from nearby island of Molokai), former low lying swamp and beachfront lands with dredge fill from the canals.

A map of the area including the locations of the majority of hotels is included on the following page.

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<sup>11</sup> Waikiki Business Improvement District Website: <http://www.waikikibid.org/>

# Map Of Waikiki



## 2.2: Economic Contribution

About 19,000 people claim residency in Waikiki (from 14,000 residential units) which on an average day hosts 70,000 visitors and 37,500 employees. The real property use composition of Waikiki reflects its 20th century legacy as a ‘place of hospitality.’ The area’s focus on hotels, retail, entertainment, and other service industries constitute approximately 75% of the businesses on Waikiki.<sup>12</sup> Many non-resort related business, such as investment groups, still maintain offices in Waikiki as it is considered an important high visibility location that rivals ‘downtown’ Honolulu. The Hawaii Department of Business, Economic Development and Tourism (DBEDT) has estimated Waikiki’s 2002 contribution to the state economy from its nearly 1,600 businesses in **Table 1: Contribution to Hawaii’s Economy 2002**. Within the limited confines of this area, Waikiki generates half of the state's visitor industry expenditures, up to 13% (\$5.2 billion) of the Gross State Product, 8-10% of all jobs, and 12% of all taxes.<sup>13</sup> DEBDT notes that Waikiki business alone paid out an estimated \$807 million in wages for 2000. A good portion of these wages find their way back into the Waikiki economy resulting in a greater “induced impact” of visitor related expenditures.

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<sup>12</sup> DBEDT: *Establishments in Waikiki 2000*. Of 1607 establishments on Waikiki, 1208 are classified as: Retail Trade; Accommodations & Food Services; Arts, Entertainment and Recreation; or Real Estate and Rental Leasing.

<sup>13</sup> Waikiki Business Improvement Website: <http://www.waikikibid.org/>

**Table 1. Contribution to Hawaii's Economy by Statewide Visitor Industry and Waikiki, 2002**

Measure of Tourism	Statewide Visitor Industry Contribution to Economy		Waikiki Contribution to State Economy	
	Number	Percent of State Economy	Number	Percent of State Economy
<b>Direct Impact<sup>1</sup></b>				
Gross State Product (GSP) <sup>2</sup>	NA	NA	NA	<b>NA</b>
Civilian Jobs <sup>3</sup>	122,219	17.0%	55,610	<b>7.7%</b>
State & Local Taxes (\$millions)	\$776.3	21.6%	\$353.2	<b>9.8%</b>
<b>Direct and Indirect<sup>4</sup></b>				
GSP <sup>4</sup> (\$millions)	\$7,973.6	17.3%	\$3,628.0	<b>7.9%</b>
Civilian Jobs <sup>3</sup>	160,787	22.3%	73,158	<b>10.2%</b>
State & Local Taxes (\$millions)	\$949.3	26.4%	\$431.9	<b>12.0%</b>

NA: Not Applicable.

<sup>1</sup> Measures the impact of visitor expenditures on only those firms that sell directly to visitors.

<sup>2</sup> In this Input-Output analysis, direct and indirect GSP are not readily separated.

<sup>3</sup> Civilian jobs include wage and salary jobs plus self-employed but exclude non-civilian military jobs.

<sup>4</sup> Measures the impact of visitor expenditures through all firms that contributed to goods and services sold to visitors.

**Source: DBEDT.**

According to the 2000 Census, the visitor housing industry, with approximately 32,000 rooms in high-rise hotels, resorts, and residential complexes, constitutes about 20% of all businesses in Waikiki. In addition, visitor housing in Waikiki represents nearly 90% of all of Oahu's rooms, and 45% of the states total inventory (**Table 2: Inventory of Visitor Units , 2002**). Thus, not only does this industry define much of the architecture and land use in Waikiki, it represents a

key foundation for the local economy. In 2002 condominium hotels represented a small but notable portion (about 10%) of Waikiki’s total visitor units and nearly 97% of all such product on Oahu. Conventional hotels supply the majority of visitor housing units in Waikiki and over half of the state’s hotel rooms may be found in Waikiki.

**Table 2. Inventory of Visitor Units, 2002**

Type	Waikiki	Oahu		State	
	Number	Number	% in Waikiki	Number	% in Waikiki
ALL UNITS	31,717	36,457	<b>87.0%</b>	70,783	44.8%
Apartment/hotel	212	307	<b>69.1%</b>	414	51.2%
Bed & Breakfast	0	28	0.0%	485	0.0%
Condominium Hotel	3,331	3,442	<b>96.8%</b>	15,731	21.2%
Hostel	153	213	71.8%	339	45.1%
Hotel	27,505	31,442	<b>87.5%</b>	49,442	55.6%
Indiv. Vacation Unit	147	269	54.6%	1,704	8.6%
Other	369	756	48.8%	2,668	13.8%
<i>Number &amp; percent of above units classified as Registered Time-share</i>	921	981	93.9%	4,967	18.5%

Source: DBEDT, 2002 Visitor Plant Inventory

### 2.3: Development History

Waikiki's location has always been valuable resort real estate. The native Hawaiian definition of 'Waikiki' translates into 'sprouting water' which references the area's pre-colonial history as a place of springs, fishponds, streams, and gardens. The area was a royal domain used by native rulers as a place of relaxation, healing, and rejuvenation.

The last hundred years in Waikiki has been a history dominated by development. After the American business-interest backed 1893 overthrow of the Monarchy by the United States Government Waikiki's royal cultural past was largely ignored as mainland corporate interests focused on extracting exportable goods, such as sugar cane, from the islands. By 1901, Waikiki as a resort destination was reborn in an area adjacent to former royal grounds. Captain William Matson opened the Moana Hotel, Waikiki's first hotel, as a stopover for passengers on his luxury steamship line, known as the Matson Navigation Company.<sup>14</sup> The introduction of this high-end hotel establishment in Waikiki grounded the location as a prestigious resort location in the imagination of overseas visitors. From the early 1900's through the end of the 1920's Waikiki hosted well-heeled notables from around the world who came to experience the South Pacific and a 'gateway' to Asia.

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<sup>14</sup> <http://www.answers.com/topic/moana-hotel>



During the Second World War and the post-War period Hawaii became both a destination and a stop over point to Asia for US servicemen. The combination of the post-War boom economy, statehood, and the rise of air travel fueled dramatic growth of Waikiki as a tourist destination for all Americans. Waikiki in the 1950's and 1960's saw tremendous growth in visitors and hotels to Waikiki. Historian Don Hibbard in his book *The View of Diamond Head: Royal Residence to Urban Resort (1994)*, notes that visitors to Hawaii (who nearly all passed through Waikiki) in the mid-1950s numbered around 100,000 annually; yet, by 1959 that number had increased to 250,000. By 1964 the number had ballooned to 500,000 annually with hospitality services racing to keep pace.<sup>15</sup> Moreover, new options for visitors and investors in Waikiki's resort economy emerged with Act 180, the nation's first condominium law, which passed the Hawaii's state legislature in 1961. The Ilikai hotel, constructed in 1964, was Waikiki's first residential condominium and hotel complex with over 1000 units. Interestingly, the project was originally conceived entirely as residential resort condominiums but due to the novel nature of the product did not sell well enough to justify devoting the entire complex to condos so both hotel and condominiums exist within the same campus.<sup>16</sup>

Condominium development in Hawaii exploded in the 1970's through the 1980's and skillfully crafted sales pitches to vacationers in 'paradise' ensured many units were sold to absentee owners not intimately connected to the stewardship of development on Waikiki.<sup>17</sup> Most new construction was not well regulated and the city lacked a comprehensive zoning and open space

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<sup>15</sup> Hibbard, Don and Franzen, David. *The View From Diamond Head: Royal Residence to Urban Resort*. Editions Limited Publishers (Honolulu, HI). Second Edition 1994. pg. 143.

<sup>16</sup> [www.shellvacationsclub.com/shownews.html?id=171](http://www.shellvacationsclub.com/shownews.html?id=171)

<sup>17</sup> Press Release - Aston Hotels and Resorts: A 60 Year History:

[http://www.hotel-online.com/Neo/News/PressReleases1998\\_2nd/Aston50Years\\_Apr98.html](http://www.hotel-online.com/Neo/News/PressReleases1998_2nd/Aston50Years_Apr98.html)

plan. By the mid-1970's Waikiki's tropical resort character and remaining open space was at risk of being crowded out by high rise hotels. It was in response that the city established the Waikiki Special District (WSD) in the mid-1970's to curtail unregulated development. In effect the WSD prevented a great deal of additional development such that only 29 permits for new buildings or major renovations were issued under the WSD between 1976 and 1996.<sup>18</sup>

In his book *The Renaissance of Honolulu: The Sustainable Rebirth of an American City* (2004), the former Mayor of Honolulu, Jeremy Harris, laments that during the 1970s "with direct airline flights, tourists flocked to the islands, and Waikiki scrambled to keep up. Unfortunately the City's planning process was slow to respond, and Waikiki, which could have been developed as one of the world's finest cultural resort destinations, was allowed to develop haphazardly. The result was a disaster and the word "Waikiki" in many people's minds became synonymous with "bad development."<sup>19</sup>

Harris also explains that through the 1970's and 80's agriculture and military spending in the Hawaii declined leading Oahu's economy to become largely dependent on tourism as its primary economic driver. Japan's economic boom, like that of the post-War United States economy, sent record numbers of leisure travelers to Hawaii. Hawaii and Waikiki in particular became favored investment locales for both large and small Japanese investors who snapped up Oahu real estate during the late 1980's to early 1990's. It is estimated that \$18 billion USD from Japan poured

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<sup>18</sup> Lierman, Mark;Schmidt, Ken; Peirson, *Waikiki Zoning: The Waikiki Special District (WSD)- Polishing Hawaii's Jewel* City and County Honolulu. (Honolulu HI) 1998.

<sup>19</sup> Harris, Jeremy. *The Renaissance of Honolulu: The Sustainable Rebirth of an American City* City and County of Honolulu Publishing, (Honolulu, HI) 2004. P.83.

into Hawaii Real estate during these years – with a major proportion of that investment in Waikiki land and hotels.<sup>20</sup> Though some upgraded their newly acquired property many Japanese investors held their investments for anticipated appreciation gains that, for many, did not materialize.

By the end of the 1980's Waikiki was simply "... an aging beach resort, and visitors were not returning. Public infrastructure was shabby and private sector retail and hotel stock had not been upgraded in many years."<sup>21</sup> Older hotels, especially those not fronted on the beach, became strictly 'tourist' hotels geared towards inexpensive package group tours. It was becoming apparent that Waikiki's tired hotels and resorts lacked the destination pulling power to compete with other resort locations. This fragile reliance on tourism became 'painfully apparent' when the Japanese bubble economy burst in the mid-1990s.<sup>22</sup> Any improvement capital that might have been drawn from overseas owners vanished as Japan's economy was sent reeling from a combination of banking crises and a global recession. With fewer tourists and absent mainland and Japanese capital many hotels in Waikiki went into serious decline. Condominiums fared no better. The repercussions of legislative changes to treatment of real estate under new tax codes and the domestic savings and loan lending crisis further undermined the condominium market.

In recent years the city and business owners have made cooperative efforts to actively improve Waikiki and revive the tourist trade. Although occupancy rates for Waikiki hotels are at Hawaii

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<sup>20</sup> Daysog, Rick. "Isle Real Estate is Bleeding Bargains: Opportunity Investors are Snapping Up Commercial Properties at Big Discounts." *Honolulu Star Bulletin*. April 9, 1997.

<sup>21</sup> Harris, Jeremy. *The Renaissance of Honolulu: The Sustainable Rebirth of an American City*. P.86

<sup>22</sup> Harris, Jeremy. *The Renaissance of Honolulu: The Sustainable Rebirth of an American City*. P.85

state averages, the average daily room rate (ADR) for keys in Waikiki was \$111 compared with \$141 statewide (DEBDT) indicative of excess supply, poor upkeep, and greater numbers of budget product. City efforts including public works upgrades and sponsorship of cultural events have brought life back to the beaches, restaurants, and retail corridor of the area. However the city cannot govern the refurbishment of privately held hotels. As visitor numbers rise to an anticipated 8 million visitors in 2008 public and private interests are pursuing a more upscale tourist clientele with greater per day expenditures and longer stays.<sup>23</sup> Ideally, equal or greater total tourist expenditures with correspondingly fewer visitors competing for beaches, snorkeling, and even city parking is the intended outcome.

To better attract this higher-end clientele hotel operators are making best efforts reintroduce some of the glamour associated with early 20th century Waikiki resorts by upgrading facilities. Few developable lots exist and the combination of fragmented ownership and longtime hold-outs inhibit many grand-scale projects. Tougher zoning, a legacy of the WSD, also prevents much new development in Waikiki. Lastly, overbuilding from the 1980's and early 1990's created excess inventory of hotel rooms. Owners have instead turned to renovating existing structures, tearing down fully depreciated buildings, or pursuing creative means of reinventing their inventory such as the conversion of hotel stock into condominium hotels so that renovations can be made more financially feasible. According to a study undertaken by the American Resort Development Association and Hospitality Advisors LLC, from 2000 to 2004, 2687 hotel rooms

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<sup>23</sup> Natarajan, Prabha. "Can Hawaii Handle 8 Million Guests." *Pacific Business News*. Vol 43. No. 15. June 17 2005. p 1 and 39.

from 14 properties were converted to condos in Waikiki.<sup>24</sup> Older hotels, and typically those ‘mid-market’ tourist hotel locations set back from the beach are prime conversion targets. Repositioning property as condo hotels promises benefits to the owners, developer/converters, buyers, and managers of this newly rediscovered real estate product.

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<sup>24</sup> Dicus, Howard “Hotel Conversions – Not for Timeshares.” *Pacific Business News*. American City Business Journals Inc. May 20, 2005.

## Chapter 3

### What is a Condo-Hotel?

‘Condominium hotel’ is used to describe a number of different ownership structures combining elements of residential condominiums and hotel property. Regrettably, not only is the term applied to several different real estate products, but these products also may also be referred to by several different names. For example, ‘condo hotel’ could mean a condominium with hotel services as part of a hotel complex; or, a hotel with individual condominium ownership.

#### 3.1: Definitions

Generally, a condominium hotel or ‘condo hotel’ is a condominium building professionally operated with hotel services and amenities but with individual unit/key ownership.<sup>25</sup> The property’s management, often an experienced national or regional chain, is thus separate from its ownership, whom may be individuals or small investors.

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<sup>25</sup> Some cities, especially those with high infiltration of condo-hotels such as Treasure Island, Florida, have established a legal ordinance definition of the product as “the hybrid ownership arrangement whereby individual owners belong to an association that rents the units when owners are not occupying them.” But these definitions were adopted in order for the city to control the property’s use. Civic ordinance explains that these “rentals, and even stays by owners cannot be long term: there must be new occupants at least six time a year, and owners themselves can stay in the units no more than 90 days in a year.” Furthermore, the ordinance adds that condo hotels remain subject to tourist-tax collections. This more specific description of a condo-hotel is an example of one locale’s attempt at clarifying the ownership and management structure of the product but should not be considered a blanket definition for the category. See Paul Swider’s article. “Legal Review Sought on Condo-Hotel Rules.” *St. Petersburg Times (Florida)*. March 27, 2005, p. 7.

Numerous variations on a basic format exist. For example, a condo hotel might be a component of a mixed-use property with retail, residential, hotel and commercial office space. Alternately, a condo hotel might be a single mixed-use building which includes residential condominium units with hotel services and a conventional hotel. Another example, common to Waikiki, would be a single property whose rooms are owned individually as condominiums but are collectively run as a hotel by a management company. Overall, each condo hotel example usually incorporates some unique elements of management and ownership of spaces and operations. This is especially true for the conversion of existing hotels, which may have specific amenities, individual characteristics, or other legacies that must be incorporated in the legal structure of the condominium association. Although many models exist two primary forms of condominium hotels may be identified – the mixed use condominium *and* hotel model and the condo hotel property where the hotel *is* a condominium.

### 3.2: Condominium and Hotel – A Mixed-Use Model

Condo hotels may be the result of new construction – often as part of a larger hotel development project that might benefit from the financing advantages of including condominiums into the development scheme. In these developments the condominiums are essentially owner-occupant housing with hotel amenities, as opposed to hotel rooms placed in a pool of short-stay hotel keys. Individuals buy these condominiums largely as high-end pied a terres or primary residences and units are more likely to be one, two, or three bedrooms in size. Unit owners are not expected to place their units into the hotel key pool and in fact may not be able to do so given the short-term

nature of overnight stays. From the unit owners' perspective the condominiums are financed, managed, insured, and taxed as conventional condominium units in any similar fully residential property. These units may be considered investor units for the purposes of financing (higher rate, greater principal down) or may fall under owner occupant guidelines (lower rate, greater loan value possible). Therefore, this condominium hotel model may be considered a mixed-use luxury hotel, consisting of hotel keys and condominium units that are viewed as separate entities. The result is really a condominium *and* a hotel though they are sometimes still referred to as 'condo hotels,' a term which in Hawaii, often implies a different operating structure.

The Setai in Miami with its combination of five-star luxury hotel with a 40 story condominium tower is a prime example of the mixed-use condominium and hotel. As with many such projects the pre-construction sales of the condominium units (which begin on the 15<sup>th</sup> floor of the building) underpinned the financing of the entire complex which includes a five-star hotel. A valuable component of the desirability of these units is that residential unit owners have access to the hotel's restaurants, room service, "lavish" spa and health club, and all guest amenities. Marketing literature reminds the reader that "whether you are a condominium resident or a guest of the hotel, everything is available and all things are possible."<sup>26</sup>

The yet-to-be-built Mandarin Oriental in Boston boasts 150 hotel keys mated with ultra luxury residences. In 2005 sales brokers relate that pre-sale prices in the complex fetched around \$1600-\$1800 per-square-foot while similar quality and location product, such as 360 Newbury

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<sup>26</sup> Setai Websites: <http://www.setai.com/> and <http://www.setaicondo.com/> and <http://www.setai.com/hotel.shtml>



Street, without the branding power or hotel amenities of the Mandarin garnered around \$1100-1200 per-square-foot.

Full residence condominiums side-by-side with full service hotel product are not limited to new construction developments and conversions of existing hotels may include these mixed-use residences. Higher per-square-foot sales of condo units coupled with a more amenable financing process for the hotel developer and lower project risk for the banks remain strong incentives for a mixed-use approach in either setting. The Plaza Hotel in New York City, for example, was sold in 2004 to developer El-ad properties. El-ad planned a major renovation in order to create 200 for-sale luxury condos intended for primary or second home residences, coexisting with 150 five-star hotel rooms and services to be owned and managed by the developer. Though part of the same historic building, condominium units were situated to have the highest value views while hotel rooms and retail spaces filled out the remainder of the property. The combination of hotel services, condominium location, and the notability of the Plaza are expected to result in some of the highest per-square-foot sales values in New York. Other hotel operators such as W Hotels, Ritz Carlton, Hilton, Westin, and Marriott hotels are also currently expressing interest in future development and management of hotels with a condominium component to capitalize on the value of this symbiotic relationship.

### 3.3: Condominium Hotel – Condominium Ownership of a Hotel

A second condominium hotel structure consists of a property operated and leased as a hotel whose rooms are owned by individual owners. For hotel customers the appearance of the property and their guest experience is not materially different than that of any hotel. Individual unit owners usually have the option to place their rooms into a rental pool, occupy their units themselves, or both but the property as a whole is operated as a full-service hotel. Pooled individually-owned condominium units comprise the hotel itself - as opposed to condominiums and hotel rooms independently being part of a mixed-use hotel project. This product is also known outside of the United States as an ‘aparthotel’ and has been a successful way of financing projects in South America and parts of Europe for a number of years.<sup>27</sup> To provide the hotel character the condominium hotel is operated and flagged by a hospitality management company who ensures that rooms are advertised, booked, and cared for along established guidelines consistent with a conventional hotel. Unit owners hold a deed to their property, are responsible for monthly management fees, taxes, and insurance but are entitled to a portion of the proceeds from room short-term to medium term rentals. Percentage proceeds vary as do management fees depending on the operator and the level of services provided. The operating agreement between owners and the management company may or may not be require that rooms to be placed into the pool to let. Rental revenues are most often split evenly (50-50) between the management and the individual owner. Although most residential condos require only a 6-8% management fee,

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<sup>27</sup> Downey, James F. “The Aparthotel: A Useful Tool for Investors and Developers.” *Cornell Hotel and Restaurant Administration Quarterly*, August 1991; 32, 2.pp. 53-55. Interestingly there is another product common to Canada’s mountain resorts offering ‘strata’ ownership similar to condominium hotels in the US. See Withiam, Glenn. “HSOs: Return of the Condo, Canadian Style.” *Cornell Hotel and Restaurant Administration Quarterly*, April 1998 Vol 39, Issue 2, pg 15.

condo hotel units are management and advertising intensive. Management companies must actively recruit guests on a daily basis; operate a front desk, full hotel services, and staff; and supply all the building services necessary to keep the property a desirable and functioning location. Isolated literature suggests that in some hotels the receipts are pooled and divided among participating owners on a pro-rata basis instead of on an individual room basis. It is important to note though that during the course of research in Waikiki no hotels were identified with this form of profit sharing.<sup>28</sup>

Owners may elect to reside in their unit as a second home or sometimes primary residence, instead of placing the property into a rental pool; however, in many states owners may not claim the condo hotel unit under homestead exemptions. Similarly, in certain properties, as a result of operating agreements or city ordinances, there are also limitations on the number of days on an annual basis owners may use the property as a residence. A qualitative review of the literature suggests that this type of condominium-owned hotel typically arises from existing hotel conversions while mixed-use condominium hotels more likely result from new projects seeking a luxury identity and more stable financing. The following table attempts to outline some of the general characteristics of each of the two most common formats of condominium hotels from the perspective of the buyer/owner.

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<sup>28</sup> Butler, Jim and Maisnik, Guy. "Condo Hotels: Making Them Work Involves Challenges and Rewards." *Urban Land*. Urban Land Institute (ULI). February 2005 p.32.

**Table 3: Mixed-Use Condominium Hotels vs. Condo Hotel**

<b>Category</b>	<b>Mixed Use Hotel and Condominium Model</b>	<b>Condo Hotel Operations Model</b>
<b>Definition</b>	<b>Residential Condominium with Hotel Services</b>	<b>Hotel Rooms Owned as Individual Condominiums and Operated as Hotel</b>
Individual Unit Ownership	Yes	Yes
Length of Stay	Permanent or Long Term	Short or Vacation
Use	Primary Residence or Pied a Terre	Second Home/Investment
Location Type	Resort Areas, Urban Areas	Resort (most)
Location Examples	New York City, Florida, Chicago, Boston	Waikiki, some Florida
Type of Mortgage	Primary Residence or Investor	Investor
% Down	Variable But as Low as 5%	Typically 35% +
Unit Configuration	Studio, One-, Two-, Three-Bedroom Units	Typically Studio or One Bedroom
Construction	New (most common)	New or converted
Hotel Amenities	Yes	Yes
<b>Hotel Leasing Pool</b>	<b>No</b>	<b>Yes</b>
<b>Hotel Leasing Services</b>	<b>No</b>	<b>Yes</b>
Other	Higher Parking Ratio	Lower Parking Ratio May Not Include Kitchen

Hotels conversions are not limited to these two models of condominium hotels but these two models represent the most common variations on the condo hotel theme. In Waikiki, most condo hotels are the operations model where properties are run as hotels but owned as condominiums. Options for owners exist limited only by zoning, imagination of the owners/developers, and their legal team. For example, some conversions or new construction hotels will feature time shares

ownership instead of full unit ownership; however, only a small number of hotels have been converted to timeshare use in Hawaii.<sup>29</sup> Timeshare conversion would likely result in a more marketing intensive program given that multiple buyers must be convinced of the benefits of partial ownership versus one for every condo hotel suite.

Unless zoning is prohibitive, condominium hotels can be further converted to conventional condominium associations – a process which entails changing the operating structure so that the organization runs solely as a condo association without hotel management or leasing. This is also an unlikely scenario given that multiple owners must agree to the new structure and individual interests can be disparate especially given investment and use objectives. Other incarnations of hotel conversions might include a complete rethinking of the product category such as developer Peter Savio's new concept for some Waikiki hotels of 'condo-dorm' conversions, with the property operated as a dormitory and leased either individually or to a university, to allow small investors to take advantage of much needed housing in the Honolulu area.

In Hawaii, especially in Waikiki, the majority of condominium hotels are the result of existing property conversions, often from mid-market hotels set back some distance from the beachfront. A strict zoning and permitting process, tight land supply, and recent excess supply of aging hotel rooms have contributed to the conversion of existing hotels over new construction in Waikiki. According to local developer considered one of the pioneers of condominium conversion in

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<sup>29</sup> Dicus, Howard. "Hotel Conversions – Not for Timeshares." *Pacific Business News*. American City Business Journals Inc. May 20, 2005.

Hawaii, under most hotel conversions the individual rooms become separately deeded while some common areas are either retained by the developer for income (retail or restaurant spaces), sold to a third party, or may become part of the condominium association. Often pool space and parking is under common association ownership especially since parking ratios are lower than 1:1 for units – by permitting only rental parking the needs of guests can still be accommodated.

Another hallmark of Waikiki’s conversions is that since units are existing hotel rooms and suites there are few if any 2 or 3 bedroom condominium units unless they are created by combining rooms. Combining rooms to widen product offering may not pay off in the end since many purchase the units for investment as hotel rooms and the per-square-foot sales of ‘studio’ units usually exceed the per square feet sales for larger units. Furthermore, combining units adds to the cost and complexity of renovation.

Lastly, conversions, especially in Hawaii, may be fee simple or leasehold.<sup>30</sup> Anecdotal evidence from conversations with those in the industry suggests that leasehold conversions may take longer to sell out and re-sales may not approach appreciation in equivalent fee simple properties.

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<sup>30</sup> Hawaii is one of the few states where both fee simple and leasehold ownership of land is commonplace. Leasehold structure has its origins in the pre-United States era in Hawaii. Under the Hawaiian monarchy no individuals owned the land outright; instead they owned the right to a share of what they produced from the soil. A high chief could reclaim land rights at any time. During the reign of Kamehameha III in the 1800s it was decided that the governance could award fee simple titles to all commoners who occupied and improved any portion of the lands. Government land was also made available for purchase by commoners and foreigners who bought up tens of thousands of acres of agricultural land. Over the years much land has been converted to fee simple ownership, however leasehold ownership is still controlled by the individuals and corporate descendants of this era. Refer to <http://www.teresatico.com/presentations/history-of-land-acquisition/> The website describes an annotated history of land use and ownership in Hawaii’s recorded history by attorney Theresa Tico.

While condo hotels may already be an unfamiliar product to some, condo hotel units with leasehold interest instead of fee simple proves to be an unfamiliar product to many.

Each converted hotel in Waikiki is unique, but there are certain characteristics that make certain hotels more likely to be converted than others. For instance, hotels with deferred maintenance, poor branding and marketing, and less desirable locations are prime targets. Ideally, the developer can identify a property that can be repositioned or restored to its highest and best use. To better understand the process and players in the conversion of Waikiki hotels consider the simplified example in the following chapter.<sup>31</sup>

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<sup>31</sup> This example is a composite of conversions and serves only to illustrate collective the decisions and options for the different parties involved in condominium conversion of hotels in Waikiki.

## Chapter 4

### Example Case: The Waikiki Hotel Exemplar

The following is an example hotel conversion that serves to illustrate the conditions and considerations of players in a typical Waikiki condo hotel deal. The example is a composite of recent conversions.

#### 4.1: The Hotel

The **hotel** is a 60,000 square foot, 12 story, 60 key property from the late 1960's, located 3 blocks from the beachfront in Waikiki. While restaurants and shops are very close, the beach and ocean views are absent from the property. The property does feature a pool and small gym, restaurant space, and parking but suffers from a small lobby, lack of architectural presence or brand/flag distinction, and no exterior grounds to lend any ambience to its resort location. The layout and décor of the rooms are dated, rooms have first generation central air conditioning with history of maintenance and mold issues, and some rooms have respectable views (yet even these have been infringed up by other developments over the years). The property sits very close to the lot lines, exceeds current FAR and height requirements, and renovations cannot easily be



attempted on only a portion of the building – the whole property must be shut down and upgraded at the same time.

#### 4.2: The Owner

The **owner** is an overseas investment group and a subsidiary of a larger corporation. The subsidiary acquired hotel in the late 1980's, witnessed several years of strong appreciation in property values, but both values and ADRs dropped precipitously in the early 1990's before the owners could sell the property. Corporate consolidation and debt restructuring of the parent country during the 1990s in conjunction with lower occupancy and rates prevented the company from reinvesting in the property through much of the 1990s. In order for the hotel to achieve profitability again a consultant has suggested that the hotel needs to be completely renovated, reinvented, and repositioned in the marketplace. Even now, in 2003, the owner cannot afford to shut down, rebuild, or adequately renovate the property. Worse, in the last several years construction raw materials and labor costs have skyrocketed. Several large luxury condominium projects adjacent to Waikiki are also keeping all local construction companies busy and bids high. Furthermore, the parent company has come under pressure from home to liquidate assets not related to its core competencies and the hotel has been quietly placed on the market. A few bids from hotel operators and investors were received; however, a premium bid, nearly 20% higher than the bids from hotel operators, was presented by a local developer.

### 4.3: The Developer

The **developer** is an experienced condominium converter with established contacts in the local finance and construction industry. The developer knows he or she can bid higher than most hotel operators since the sale price will not be indicative of the cash flows of the hotel but as the property's potential value as a conversion with a higher and best use. The higher bid is analogous to the difference between what an apartment operator can pay for a residential property versus what a condominium converter can offer based on sales per square foot. In the case of the apartment operator their offer is based on cash flow and capitalization rates necessary to account for the risk and opportunity cost of capital whereas the condominium converter need only consider the short term carrying costs of acquisition until sell out of the units. The converted is also selling the units mostly to owner occupants who place a greater value on their own use of the property and expected appreciation than on cash flow considerations.

In our example, the developer also knows that the hotel owners do not have the legal expertise, capital, contacts, or marketing skills to do the conversion themselves. Funding for the developer's projects has been through a partnership with a mainland investment group located in a market where housing and land prices have been extremely strong. The mainland money wants an entrée to the local market but does not want to enter into Hawaii's notoriously slow and difficult ground-up development process or the anti-development sentiment that can accompany it. As the Hotel Exemplar is already standing there is no entitlement risk and less construction

risk. The property will still need to be refurbished but that process is much less materials and trade intensive than a ground up project. Furthermore, because the property is already constructed and operational a sample unit can be prepared and the property can be marketed on site. Both developer and the investment group see the opportunity to extract the highest and best use from the property as it stands. Overall, the developer plans an acquisition, with renovations, with re-positioning and re-branding of the product as a condominium hotel. Sample considerations for development include the following:

**Waikiki Hotel Exemplar**

<b>Selected Line Items</b>	<b>Amount</b>	<b>\$/SF (60,000 sf)</b>	<b>\$/Unit (60units)</b>	<b>% Gross Rev</b>
Gross Sales Hotel Suites	\$ 20,000,000	\$ 333.33	\$ 333,333	100.0%
Gross Value Parking	1,080,000	18.00	18,000	5.4%
Other Revenues	(480,000)	(8.00)	(8,000)	-2.4%
<b>Gross Revenues</b>	<b>\$ 20,600,000</b>	<b>\$ 343.33</b>	<b>\$ 343,333</b>	<b>103.0%</b>
<b>Sales Expenses</b>	<b>(1,350,000)</b>	<b>(22.50)</b>	<b>(22,500)</b>	<b>-6.8%</b>
<b>Net Sales Revenues</b>	<b>\$ 19,250,000</b>	<b>\$ 320.83</b>	<b>\$ 320,833</b>	<b>96.3%</b>
Property Acquisition	\$ 11,000,000	\$ 183.33	\$ 183,333	55.0%
Hard Construction	2,000,000	33.33	33,333	10.0%
Indirect / Soft Costs	1,800,000	30.00	30,000	9.0%
Debt Interest / Fees	800,000	13.33	13,333	4.0%
Contingency	175,000	2.92	2,917	0.9%
<b>Total Costs</b>	<b>\$ 15,775,000</b>	<b>\$ 262.92</b>	<b>\$ 262,917</b>	<b>78.9%</b>
<b>Gross Profits</b>	<b>\$ 3,475,000</b>	<b>\$ 57.92</b>	<b>\$ 57,917</b>	<b>17.4%</b>
		22.0%		

The developer expects to acquire the property for \$11 million and undertake an approximately \$4 million restoration of the property which will include much needed capital improvements, such as upgrading the HVAC components; as well as welcome aesthetic enhancements, including new

furniture, floorings, and appliances (TV, refrigerators, internet). The 14 month renovation work is expected to proceed concurrent with marketing of a sample unit. The developer will take deposits and request for units from a floor plan with anticipated average sell out price at around \$333,000 per unit with a range of \$150,000 – \$395,000. Closing will occur as units reach completion of renovations.<sup>32</sup>

The developer knows buyers expect rooms to generate some sort of income when not in use by the owner. When the hotel is back in operation one might expect stratification of room rents just as in any hotel where higher floors and better views command higher prices. Therefore the developer models the sell-out pricing structure based on location and desirability. Such as scale might look something like the following chart where unit floor plan and locations are designated by A, B, C, D, and E on each floor. It is assumed that higher floors harbor the best views. When rooms are placed in the rental pool they are selected at random for guests however, guest

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<sup>32</sup> Recent conversions include the Ala Moana Hotel on the edge of Waikiki. This conversion is also the largest single conversion in Hawaii to date. The property was sold by Japanese firm Azabu USA in October of 2004 for \$85 million then underwent an ongoing renovation (expected to be complete mid-2006) with the first rooms released for sale July 2005. (Staff. “Ala Moana to be Converted to Luxury ‘Condotel’” *The Associated Press State & Local Wire* February 12, 2005). The hotel includes amenities such as a fitness center with steam and massage rooms, restaurants and lounges, room service and housekeeping, 24 hour valet, and concierge. Sales literature promises “Hawaii’s ultimate tropical urban lifestyle, yours to own.”

According to Andrew Gomes in his July 2005 article for the *Honolulu Advertiser*, Crescent Heights, the developer, currently holds over 3,000 deposits at \$10,000 each from which it selects buyers randomly ‘like a lottery,’ for only 1,150 rooms at prices set by the developer. Buyers may indicate which line and floor they wish their rooms to be but cannot select individual rooms at deposit. If they are chosen they may be given the chance to view the available rooms and select their choice based on availability. Buyers have a 30 day right of rescission. Rooms are delivered furnished and alteration of room design or contents requires authorization from the condominium association.

After sale buyers have the option of placing their unit in a rotating rental pool with profits split between owners and management. Monthly maintenance fees approach \$400/month for these units. Studio units average about 250-350 square feet and have been placed on the market at around \$120,000 and higher in the first round (usually the least expensive round). One bedroom units are approximately 560 square feet and fetch around \$500,000 or just under \$1000 per-square-foot. A broad assumption of \$85 million renovation, marketing, and carry costs, with a sell-out of \$200 million (1150 rooms at average price of \$175,000 per unit) suggests a profit in the range of \$30 million for the developer.

requests for specific rooms or views are typically honored - hence rooms with views are listed at higher prices from the outset at sale not only for their location but, to some degree, as it relates to future cash flows.

**The Waikiki Hotel Exemplar  
Condominium Price Grid**

<b>View Type</b>	<b>City/ Ocean View</b>	<b>Ocean View</b>		<b>Mountain View</b>	
<b>Unit Type<sup>33</sup></b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>E</b>
<b>Upper Floors</b>	\$350,000	\$395,000	\$375,000	\$350,000	\$325,000
	to	to	to	to	to
<b>Lower Floors</b>	\$175,000	\$200,000	\$200,000	\$175,000	\$150,000

In order to obtain the highest pricing for the product the developer also knows that he or she must align the project with a properly matched management company. The management company not only brings brand credibility to the upfront sales, but in the long run ensures

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<sup>33</sup> Unit type refers to one of seven different condo floor plans that exist in Waikiki Hotel Exemplar.

successful operations and rentals which are keys to the projects' success. In essence, unit buyers not only are purchasing rooms but part of an operating business whose success or failure is in the hands of the management company.

#### 4.4: The Management Company

The **management** company operates a number of other conventional and condominium hotels in Hawaii and brings a brand name to the table. The management company has established expertise in advertising, booking, and day-to-day operations and brings wholesale value to the unit owners. In the sales process, the management company serves an important role of answering buyers inquiries about its services and what might be market expectations of rent and occupancy rates. Were the developer to answer these questions the information could be construed as investment advice and the property could be viewed as a security, not real estate. Securities issues as they relate to condo hotels may be found in the Consequences chapter.

Management also will be involved in assisting the developer set up the right operations structure for the project and will assume administration of the condominium post-conversion. This is an important step in the process since management operates the facilities and runs the 'front desk' responsibilities of customer relations, guest services, and booking. Monthly management fees, independent from the 50-50 revenue split typically between owners and management, will likely run about .50 cents to \$1 per square foot depending on service level.<sup>34</sup> In addition to monthly

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<sup>34</sup> Max, Sarah. "Condo Hotels have all the Amenities of a Five Star Resort, Without the Hassle of a Check Out Time." *CNN/Money Online*. March 4, 2005.

fees management also receive 50% of rental revenues for their services. For the management company the project represents another branding opportunity and the ability to extend their franchise and control a greater number of keys (and potentially pricing power) in Waikiki.

#### 4.5: The Buyers

The **buyers** of the units have heard about the conversion for some time in the local papers and have seen the marketing literature. Buyers are composed of many different individuals with different reasons for interest in ownership, but many are between 35-50 years old.<sup>35</sup> Some are locals looking to purchase an investment property and are hoping to get in on first round pricing, expecting several rounds of price increases before a property is completely sold out; others are repeat vacationers to Hawaii looking for a hassle-free second home purchase. Some buyers may also understand that since the hotel condominium is in a commercial community zone, the same person (owner, guest, or tenant) cannot stay more than 18 months out of 3 years with 12 consecutive months.<sup>36</sup>

Most buyers also view the purchase as a turnkey investment or second home – after all with the rental pool there is the option to have maintenance, booking, and tenant relations handled by someone else. Buyers understand that they will have to assemble a greater down payment (35%+) for closing and expect a slightly higher rate (average 1 percent higher) given that the banks view all of these units as ‘investor’ purchases. Buyers can select their own lender or use

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<sup>35</sup> Greene, Joel From data and notes available at [www.condohotelcenter.com](http://www.condohotelcenter.com).

<sup>36</sup> Conversation with marketing broker for a Waikiki condominium hotel, June 2005.

one of the pre-approved lenders such as Chase, Countrywide, Pacific Access Mortgage, and Wells Fargo. Some of these closing costs, which buyers expect to have offset by rental income, are reviewed below. Ultimately, many buyers are expecting some appreciation such that sales in the future will be significantly higher than today's purchase price.

**The Waikiki Hotel Exemplar**  
Buyer Financing Options – Investor Purchase of Smaller Unit (A or D) <sup>37</sup>

Value	\$175,000	\$175,000	\$175,000
Program	3/1 Arm	5/1 Arm	30 Year Fixed
Loan to value	65%	65%	65%
Loan amount	\$113,750	\$113,750	\$113,750
Rate	5.000%	5.875%	6.875%
APR	5.125%	6.000%	7.125%
Term (in months)	360	360	360
Points	1.000%	1.000%	1.000%
Total points	\$1,138	\$1,138	\$1,138
Estimated other closing costs	\$3,029	\$3,029	\$3,029
Estimated prepaid items	\$1,200	\$1,269	\$1,350
Down Payment	\$61,250	\$61,250	\$61,250
<b>Estimated cash to close</b>	<b>\$66,617.00</b>	<b>\$66,686.00</b>	<b>\$66,767.00</b>
Principal and interest	\$610	\$673	\$747
Real property taxes	\$75	\$75	\$75
Maintenance/Association fees	\$275	\$275	\$275
<b>Estimated monthly payments</b>	<b>\$960</b>	<b>\$1,023</b>	<b>\$1,097</b>

<sup>37</sup> All purchases are considered investor loan by lender regardless of second home or investment intentions.



Given the above monthly payments for the buyer to break even, the new owners must earn this money back in rent or through personal use. Since the management take is 50-50, in actuality the unit needs to generate approximately \$2000 each month, or double the estimated monthly payments of between \$960 and \$1097. A brief overview of internet rates of similar condo hotels suggests an estimated rent for this type of room at average rent of \$130/night. Therefore, over a 30 day rental month the unit need to be occupied at least 15 days to break even on debt service (assuming fixed rates), management fees, and the other incidental costs of ownership. A safer assumption would also include the opportunity cost of down payment capital, the ‘consumed’ time the owner lives there (i.e. the value of the owner’s use of the property), and the contingency for assessments or capital costs. Assuming Hawaii’s average occupancy of Waikiki hotels at around 70%,<sup>38</sup> or about 20 days each month, the investment would cover costs and generate some residual cash flow ( $\$130 \times 20 = \$2600/\text{month}$ , with a \$2000 carry + \$250 contingency and \$150 opportunity cost of 3% on down payment capital leaves about \$200 monthly income). Depending on one’s investment perspective the purchase can still be perceived as worthwhile investment. Buyers explain that they are not ‘throwing away money’ on hotel rooms, may take some deductions of interest and depreciation on their tax returns, may take a small profit off the table from rentals, and most importantly they participate in appreciation.

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<sup>38</sup> Hawaii DEBDT 2002 data.

#### 4.6: The Guests

When complete, **guests** will select the hotel from national tourist services such as booking agencies or even internet sites like Expedia or Travelocity. The hotel will be marketed as any other would, albeit with renovated rooms and services and may include a new brand name. Pricing is still attractive to guests who needn't stay directly on the beach. Rates will also be geared toward the target market which includes slightly longer stay tourists and families so that turnover is lower for the property. Guests will not likely notice any difference in the hotel rooms or their stay experience.

## **Chapter 5**

### **Causes of Conversion**

The conversion of hotels into condominium hotels in Waikiki may be characterized as a local trend that reflects an emergent national and perhaps global, phenomenon. The same market forces that are prompting construction and conversions on the mainland and beyond reverberate in Waikiki. From an Island perspective one might also argue that in reference to Hawaii's early adoption of the condominium hotel model, it is in fact the mainland that echoes Hawaii's lead.

Like the condominium boom of the 1970's and 1980's when large numbers of condominiums were constructed and converted nationally, the current wave of hotel conversions and newly built mixed-use condominium hotels is not driven by one stimulus alone. Instead, market forces encouraging growth can be attributed to quantifiable sources such as buyer demographics, finance structure and environment, and a rising residential property market. Yet, of equal or greater importance are qualitative shifts in the public's perception of investments, real estate ownership, and aspirations for one's lifestyle. Fundamental to the conversion trend, it is the buyers of the individual units drive the marketplace – the developers, banks, and management companies are merely scrambling to meet customer demand.

## 5.1: Waikiki's Aging Hotel Stock

Individual owners and hotel operators have good reason to want to upgrade facilities and reposition hotels. The global recession of the 1990's and the Asian economic crisis struck severe blows to the local tourist and real estate economies. In recent years, the city of Honolulu and State of Hawaii have made efforts to ensure that the demand for hotels and tourist services remain stable in Waikiki and the rest of the Islands. Aggressive tourism marketing abroad and on the mainland, sizable capital improvements in Waikiki's streetscape, and a collective effort from the local business community all seek to improve both the image and the experience of Waikiki.

Nationally, the recent cyclical downturn of the hotel industry, the psychological effects of terrorist threat, and the result of a naturally inefficient market between supply and demand led to poor returns and excess hotel inventory in the past few years.<sup>39</sup> In areas such as New York, the Florida Keys, and Waikiki, a combination of aging and excess hotel stock has forced owners to re-evaluate their property and consider options outside of conventional hotel operations to generate revenue. In New York City, given the age of many of the existing hotels such as the 100 year-old Plaza, by selling to converters owners not only achieve a liquidity event at a premium to hotel bulk sales "but are saved having to invest in substantial capital improvements to keep hotels operating competitively."<sup>40</sup>

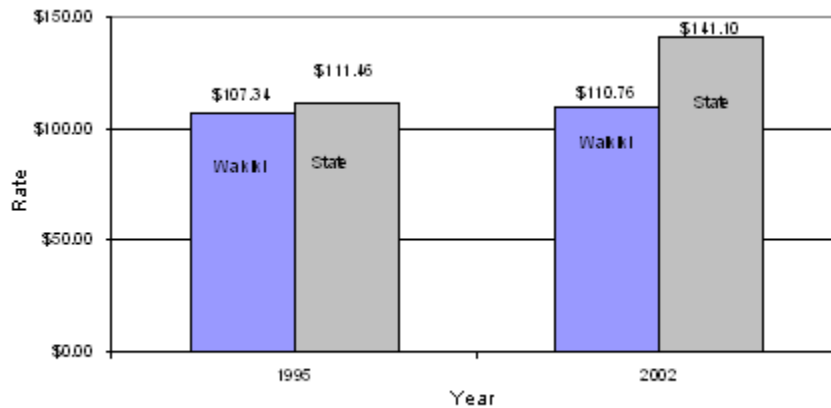
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<sup>39</sup> Wheaton, William, Ross, Lawrence. "The Cyclic Behavior of the U.S. Lodging Industry." *Real Estate Economics*. 1998 Volume 26, 1: pp 67-82.

<sup>40</sup> Staff. "NYC Hoteliers Seduced by Condominium Conversions." *Business Travel News*. March 21, 2005.

In Waikiki the situation is not much different, according to DEBDT, the occupancy rate for hotels in 2002 was 70.3%, about one percentage point above the state average and nearly two percentage points over the 2001 level for Waikiki. Yet the average daily hotel room rate in Waikiki was well below the state average in 2002. Waikiki's average hotel rate was \$111 for the year compared with a state average of \$141 and the average Waikiki rate for 2002 was down \$6 per room from 2001, compared to a \$4 decline statewide. As **Figure 1** indicates, Waikiki room rates have increased much more slowly than the state average over the past seven years.

**Figure 1. Average Hotel Room Rates**



Source: Hospitality Advisors LLC

Lodging industry professionals cite older hotel stock, resulting in a greater number of de facto budget hotels, as a contributing factor. For more than a decade, Waikiki developed an unhealthy product gap where luxury properties and true budget hotels survived the mid-market properties, many of them owned by cash-strapped Japanese companies, fell. According to Joseph Toy of Hospitality Advisors LLC, the multiple renovations taking place in Waikiki today at

conventional and condo hotels are the result of “a repositioning of the whole Waikiki product.”<sup>41</sup> Outrigger President David Carey stresses that local government needs to consider offering hotels incentives to renovate and upgrade properties, “the state needs to step up to the plate and determine how to make this market more stable.”<sup>42</sup>

The attempt is being made all over Waikiki to redevelop and reinvent the hotels. Some funding is being done without the aid of conversion such as Aston’s Waikiki Beach Hotel which underwent a \$30M renovation and took the Japanese-owned hotel property from a customer base of 85% inexpensive group tours from Japan to higher price point mostly young and hip US West Coast travelers.<sup>43</sup> For other owners selling out and allowing condo conversion to fund renovations of hotels may be an equally attractive choice and involve less renovation risk and market exposure. According to an interview with an industry property manager, RevPAR has ‘shot up’ post conversion in hotels that underwent repairs and renovations.

Another characteristic of Waikiki’s existing hotel stock is driving conversion. Hotel owners know that to truly reposition their investment many of these circa 1960’s and 1970’s properties will need to be demolished and rebuilt to modern tastes and standards. Only large hotel groups, such as Outrigger and its new Beach Walk project, typically have the funding and risk diversification to achieve this. More importantly conversations with local developers and converters confirms that property owners cannot rebuild or markedly upgrade the property to the

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<sup>41</sup> Choo, David. “Waikiki Redux: New, Exciting Renovations Up and Down Waikiki Mean a Lively Future for the Once-Tired Resort Area.” *Hawaii Business*; January 01, 2003

<sup>42</sup> Schaefer, Allison. “No Rooms at the Inn.” *Honolulu Star Bulletin*. March 13, 2005.

<sup>43</sup> Choo, David. “Waikiki Redux: New, Exciting Renovations Up and Down Waikiki Mean a Lively Future for the Once-Tired Resort Area.” *Hawaii Business*; January 01, 2003

same size and scope as the existing structure due to modern setbacks, current building codes, and cost. According to a 1998 study by Mark Lierman, GIS analyst for the City and County of Honolulu, “fully one-half of all hotel establishments in Waikiki today are non-conforming uses; approximately 52 percent of the buildings in Waikiki today have too much floor area; more than 90 percent of the buildings in Waikiki today are assumed to be non-conforming structures for one reason or another....Waikiki was largely developed prior to the adoption of the WSD (Waikiki Special District).”<sup>44</sup> In other words, the current realities of development Waikiki dictate a re-use of existing product and one way to achieve this with limited risk and brisk sales is to convert to condominiums.

## 5.2: Buyer Demographics

Much as been attributed of the sheer numbers and spending power of the ‘baby-boom’ generation. Born in the 1940’s, 1950’s, and 1960’s these individuals have had the good fortune to experience some of the strongest economic growth years this country has witnessed. This generation is now in their peak-earning years looking ahead to retirement or semi-retirement in the next two decades. Interestingly, given the condominium legislation in the 1960’s, this is also the first generation that saw the advent of the condominium structure of ownership and as such has no conceptual difficulty accepting condominiums versus any other form of real estate. In fact, literature from the 1970’s, when the ‘baby boom’ generation would have been first entering the housing market, suggests their demographic was a strong component of the first ‘condo

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<sup>44</sup> Lierman, Mark; Schmidt, Ken; Pierson, *Waikiki Zoning: The Waikiki Special District (WSD) - Polishing Hawaii’s Jewel*. City and Country of Honolulu Department of Land Utilization (Honolulu, HI).1998.

craze' of the time. Like research works noted earlier regarding conversion impact, Sternlieb and Hughes' *Condominium Conversion Profiles: Governmental Policy (1975)* examined the social displacement and policy implications that were feared from widespread disruption of apartment stock. The authors describe 'changing demographics' of the time as a key driver of the condominium market.

The work specifically profiles the 'principal purchaser' of a condominium as "a young household with a head whose median age is in the low 30's," which in 1975 would make these same individuals around 60-65 years old today.<sup>45</sup> Therefore today's 'baby boomers' are the individuals that constituted the 'changing demographic' these authors cite as the backbone of the conversion phenomena of the 1970's. The authors further explain that these buyers are part of a "dynamic growth sector of the American society" which is characterized by the "25 to 34 age group," now 55-64 years old and is, "expected to increase by almost 12 million people (46.1 pct) during the decade of the 1970s, secondary and tertiary are older individuals 50 and 60s from an 'affluent' household."<sup>46</sup> Compare this buyer profile to 2000-2005 condo hotel sales demographics related by industry professionals that suggest the average buyer of the product is between 35-55 years old, from an upper-median income background, seeking a hassle-free second home and an investment.<sup>47</sup>

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<sup>45</sup> Sternlieb, George. and Hughes, James. "Condominium Conversion Profiles: Governmental Policy." *American Real Estate and Urban Economics Association (AREUEA) Journal* Volume 3, Issue 3, 1975. pp. 70,71.

<sup>46</sup> Sternlieb, George, and Hughes, James "Condominium Conversion Profiles: Governmental Policy." *American Real Estate and Urban Economics Association (AREUEA) Journal* Volume 3, Issue 3, 1975. pp. 70,71

<sup>47</sup> As described by conversations with industry brokers and experts, July 2005.



As the population ages individuals have a tendency to seek warmer climates and an easier lifestyle. In a 2005 article detailing the shortage of residential housing in Hawaii, John McIlwain of the Urban Land Institute describes Hawaii as “perfect locale for again baby boomer’ second homes.” He also notes that ‘boomer second homes’ have grown by 109% in the 1990s with 6.5 % of all homes in Hawaii serving as second homes for seasonal use by non-Islanders; and that, “growth has only accelerated over the last four years, as Americans look for that ideal getaway in a wonderful location and that feels safe in times of trouble [such as post-9/11 terrorist attacks].”<sup>48</sup> It is no surprise then, that Arizona, Nevada, Florida, California, and Hawaii are experiencing dramatic residential growth.

### 5.3: Investment Attitudes

If the aforementioned 35-55 year old buyer profile is correct, condo hotels are generating interest from both the ‘baby boomer’ generation as well as a slightly younger segment of the population. Buyers in their 30’s, often with young families, are part of a generation that saw paper profits pinnacle and then dramatically collapse during the dot-com era. In a reactionary move many of these individuals have looked outside the stock market for safe-harbor investments with more stable returns. While popular books of the dot-com era had titles such as *Dow 36,000: The New Strategy for Profiting from the Current Rise in the Stock Market* (Glassman) or *The New Electronic Traders: Understanding What It Takes to Make the Jump to Electronic Trading* (Aspatore); popular books of the last five years include *Rich Dad Poor Dad’s: Real Estate Loopholes*, and *Trump: How to Get Rich* (Trump). In particular the *Rich Dad Poor Dad* series

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<sup>48</sup> McIlwain, John. “The Hawaii Housing Crunch.” *Multifamily Trends*, Urban Land Institute (ULI) Winter 2005.

not only strongly advocates homeownership as an investment vehicle but also brings more sophisticated investment tactics such as 1031 ‘Starker’ Exchanges to the public’s imagination.<sup>49</sup> The combination of low interest rates and rapid price appreciation of real estate between 2000 and 2005 has further perpetuated a cultural phenomenon of ‘own, not rent.’ More frightening, one often witnesses late night investment gurus pitching the idea that real estate investments ‘only go up in value.’

But in the last few years condo hotel units did increase in value. Appreciation can take place when units are purchased during pre-renovation sales and are frequently priced significantly higher by completion. Immediate ‘flip’ re-sales of these units can generate profits. However, a longer-term can also be profitable. Witness the sales within the Ilikai hotel, one of Waikiki’s oldest condo hotels. MLS records show that unit #714, a 500 square foot one bedroom, purchased in 2000 for \$225,000 appreciated well over four years to sell at \$465,000 in January of 2005. Unit #1841, another one bedroom of the same property, sold for \$350,000 in 2002 and traded hands again in 2005 for \$525,000. Lastly, the Ilikai’s 5000 square foot one bedroom unit #1535 sold for \$284,000 in 1999, \$347,500 in 2001, and for \$500,000 in 2005 achieving \$1000 per square foot. Some of this rapid appreciation may be attributed to the fact that in Waikiki, as in Manhattan or South Florida, converted hotels are located in areas where land is scarce, development is difficult, and demand is high.

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<sup>49</sup> 1031 Starker Exchanges are permitted in the purchase or sale of a condominium hotel unit and treated as any other property would under the terms of the Exchange. Under the ‘like-kind’ conditions of the Exchange a condo hotel unit needn’t be bought or sold in exchange for another condo hotel unit; instead, a condo hotel unit sale can be exchanged into the purchase of another investment property whether that be residential, commercial, industrial, or another condo hotel property. Similarly, the purchase of condo hotel unit can be the result of exchanged funds from the sale of any of these types of property. According to sales professionals 1031 exchanges have been used to buy and sell condo hotels in Waikiki. Interestingly, time share unit ownership sales and purchases may not participate in 1031 Exchanges.

Recent 2004 National Association of Realtors (NAR) data showed that one-third of all residential transactions were for investment properties and vacation homes. According to NAR Chief Economist David Lereah, in a March 2005 press release, “we’ve seen a shift over the last few years with a growing number of second-home buyers purchasing primarily for investment....our definition of second homes has changed with the buyer shift toward investment property....second homes are a much larger share than the conventional mind-set of them being mostly vacation homes.” NAR President Al Mansell further elaborated that “buyers are looking to diversify portfolio investments... this is now the most frequently cited motivation for purchasing a second home.”<sup>50</sup> Interestingly the questionnaire and census based NAR study also found that “86 percent of vacation home buyers do not rent their property compared with only 21 percent of investment buyers.” In the case of condo hotels the units are technically vacation homes but are viewed by buyers to a great extent as investments. In Waikiki, about half of the buyers are from outside the Islands and half of the buyers are locals. Anecdotal evidence suggests that local buyers either intend to flip the property over time or are looking for an investment close to home. A notable Hawaii State Economist concurs with developers and operators who state that a maximum of 5-10 percent of hotel rooms are kept from rental pools (one professional expected only 3-5%) indicating that most buyers must view their purchase as a form of investment.

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<sup>50</sup> National Association of Realtors ([www.realtor.org](http://www.realtor.org)), Press Release: “Second-Home Market Surges, Bigger Than Shown in Earlier Studies.” March 1, 2005

#### 5.4: Pricing

But the same rising residential market that attracts many to invest in real estate has also pushed values beyond what many families can afford for second homes. While a beach side cottage or country farmhouse would be a wonderful retreat they may also be priced beyond reach. When applied to Hawaii the pricing for a seaside cottage or mountainside ranch house are absolutely out of reach. For example, according to a May 2005 article in the *Honolulu Advertiser*, even the average single family home in Honolulu is priced at \$545,000 while new luxury condominiums, such as the nearly sold-out Hokua, ran from \$500,000 to more than \$5 million.<sup>51</sup> In contrast condo hotel prices for studios runs from around \$125,000-\$250,000 and one bedroom units \$175,000-\$375,000, with luxury one bedroom suites in condo hotels like the Ala Moana approaching \$500,000.<sup>52</sup> Although lower price point makes condo hotels more attainable the sales price per square foot, just under \$1000 in the Ala Moana, can be much higher. Overall, despite the per-square-foot costs, higher down payment and interest rates these condo hotel properties can be attractive alternatives especially when buyers consider the prospect of placing the units in a rental pool to help defray costs.

Harder to define is the value of the owner's use of the property as it contributes to perceived affordability; however, all sources relate that this plays a significant role in most buyers' decision to purchase. According to industry salespeople in Waikiki and mainland markets most

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<sup>51</sup> Staff. "Trump Tower Coming to Waikiki." *The Honolulu Advertiser*. State and Regional. May 7, 2005.

<sup>52</sup> Conversations with Honolulu based realtor and developers. Note that Ala Moana is newest development and is also being branded as a luxury condo hotel. See also Andrew Gomes "Ala Moana Units Sell Briskly." *Honolulu Advertiser* July 2005

buyers of condo hotel units expect to use their units themselves for a few weeks a year; but, as the head of a major management company admits that “use expectations are always less than actual [usage].”<sup>53</sup> Revenues from the rental pool are expected to help finance the owner’s use of the property. Thus the purchase price of a condo hotel is tempered by the expectation of owner use.

A member of the sales team for a recent Waikiki hotel conversion states that “I think the concept of owning a piece of property in Hawaii as a second home appeals to many people. It's in a great location for vacationing, and you don't have to worry about making hotel reservations at a high rate. People like the idea that they can use their units when they visit, and that the ownership may include an opportunity to place the units in a rental arrangement. This is more for a second home with an opportunity to rent it out.”<sup>54</sup>

Even if the property barely breaks even during ownership, the logic assumes that the owners will come out ahead with both the appreciation and enjoyment of the property. If one considers the cost of hotel stays, especially during high seasons when even vacancy can be difficult to find, the investment can pay off for buyers. Even so, in some instances the limits of this logic are often tested. One buyer of a Florida condo hotel justified his purchase, a \$355,000 studio unit that he cannot personalize and can only use a maximum of 28 days a year under the operating

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<sup>53</sup> Based on correspondence June and July 2005.

<sup>54</sup> Conversation with sales team member at Waikiki condo hotel Summer 2005.

agreement, as in accordance with his investment philosophy, "My philosophy is investing in something you can enjoy."<sup>55</sup> For 28 days a year.

### 5.5: Second Home Ownership

Overall, the 'affordable' pricing of condo hotels brings vacation home ownership, once perceived as a luxury of the affluent, to more mainstream buyers. While these condo hotel units will likely be used for several weeks of the year no doubt there is still cache among peers when one casually describes the recent purchase of a 'place in Waikiki.' In other locales on the US mainland this is a contributing factor. In New York, sales of condo units vary depending on the prestige of the property. In Florida, a sales director for the recently converted resort, The Cheeca Lodge and Spa in the Florida Keys, suspects that a number of buyers enjoy ownership as part of a social badge, "it's an ego thing," he explained in a January 2005 *New York Times* article.<sup>56</sup> The flag or management 'brand' of the hotel is a valuable component to condo hotel marketing. As one developer intimated "the brand is important because people are buying into a lifestyle, and the brand is an extension of that lifestyle."<sup>57</sup>

Yet, prestige aside, condo hotels offer a different type of second home for most buyers. Single family second homes or even condominiums do not offer the ease-of-use and level of management that condo hotels provide. For comparison purposes neither the higher priced

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<sup>55</sup> Passy, Charles. "A Keys Resort Sells a Piece of the Nest." *The New York Times*. Section F, Column 4, Escapes; Journeys; Pg 1. January 28, 2005.

<sup>56</sup> Passy, Charles. "A Keys Resort Sells a Piece of the Nest." *The New York Times*. Section F, Column 4, Escapes; Journeys; Pg 1. January 28, 2005.

<sup>57</sup> Parets, Robyn Taylor. "Why Condo Hotels are a Hot Concept." *National Real Estate Investor*. May 1 2005. p. 89

residential condominium nor the single family home could provide full marketing and leasing services for the property. Similarly, only condo hotels incorporate hotel-style amenities such as concierge, pool, gym, spa, maid service, and laundry service. While condos and homes offer more storage space many condo hotels still have the benefit of owners' storage lockers. More importantly, in condo hotels there is none of the traditional upkeep and maintenance that might be required with a beachside bungalow or mountain cabin - when owners arrive only a whole array of guest services are there to greet them.

From the operations perspective, management is more than happy to run a condo hotel with a 50-50 revenue split, guaranteed monthly fees, and have no equity at risk in the property. Yet management must add value to the property less renewal of contract be called into question. Proper management is a difficult process and with some many individuals viewing their units as investment vehicles there is the risk that management will be subject to scape-goating and lawsuits with poor performance. With regard to the governance and operations structure of a condo hotel the CEO of an management company lamented that "not only do you have to get the splits right - revenue and allocations etc. - but there is also a customer relations function that is completely different than operating a hotel." In essence, the manager's role is to please both the guest and the investor. In some cases a new position of residence manager (not unlike a combination of property manager and concierge) has been created to address owner's needs.<sup>58</sup>

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<sup>58</sup> Staff. "Going Condo?" *Hotels*. (Reed Elsevier Inc.) January 1, 2005. Global Update, pg. 12.

## 5.6: Advantages Over Competitor Products

It has been noted that stand-alone second homes and conventional residential condominiums start at a higher price point in Hawaii than condo hotels and are thereby less attractive and attainable. Also discussed were the added-value to the consumer from the hotel operations and services that are provided. Yet if the option for owner use, full resort services, and price point are key selling points for buyers what gives condo hotels an advantage over other affordable forms of second homes such as fractional ('time-share') ownership? Like condo hotels, timeshares in Hawaii and other locales offer many different levels and types of product which are essentially turnkey. Many timeshares are no longer tied to specific units or properties and location swapping is common. Some timeshares, such as the Hilton Grand Vacations club which is based on a point system allows for flexible use and of dates, locations, level of room. Hilton' Vacation clubs are part of its hotel developments such that in Waikiki's Hilton Hawaiian Village separate high rise towers denote the fractional rooms.

For a potential buyer the lower entry price can make sense if the intention is to use the product instead of hotel stays for one's own enjoyment and the locations are conducive to annual travel. For example, for a buyer 8400 'points' is priced at \$53,900 and afford annually a full seven day Christmas week stay in an ocean-view two bedroom suite in Waikiki or two or more full weeks during a less popular season or at another resort in the same program.<sup>59</sup> If one is really only to use the property for a brief period annually and would like the flexibility to vacation in different locations this may afford greater liquidity to the buyer than real estate investment through condo

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<sup>59</sup> <http://www.hiltongrandvacations.com/ownership/offer.html>



hotels. Still, there is no control over annual membership fee or maintenance fees (if present), tax deductions are limited, and timeshares may not appreciate – which in today’s real estate expectations is tantamount to losing value. Developers incrementally raise prices until the sellout which cannot be construed as appreciation but the rise in prices portrays growth in value. Instead, the resale/market value of the timeshare can be 30-50% less on the secondary market than when purchased from the developer or hotel management company. Upon resale the transfer of deed will have the same bundle of rights and same use as the current owner. In other words, timeshare buyers might best consider a secondary market deed purchase for the best value. According to one Hawaii-based reseller, one might expect that ownership purchased on the secondary market (already 30-50% less than face value) should resell at roughly the same price as when purchased, “though resale value will depend on the property, asking price, and number of listings on the market in the same property.”<sup>60</sup> Furthermore – timeshares are not easily financed and, when possible, rate and terms are not competitive with typical mortgage rates but more closely mirror credit card debt.<sup>61</sup> Possibly the most convincing evidence that time shares are less attractive to many buyers are number that indicate the percentage of hotels converted to timeshares is small compared to the percentage that become condo hotels.<sup>62</sup>

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<sup>60</sup> Telephone conversation with Hawaii-based timeshare reseller July 2005.

<sup>61</sup> For instance, Hilton is currently offering in house 14.4% financing on it product.

<sup>62</sup> Toy, Joseph. *Impact Analysis of Hotel Conversion to Resort and Condominium and Timeshare Use*. American Resort Development Association. (ARDA). April 6, 2005. Pg. 6.

## 5.7: Financing

Because condo hotels can be financed one can leverage the purchase; for instance, what one might have paid to purchase two platinum weeks in a timeshare could be used as a down payment for full (though not debt-free) ownership in a condo hotel. Given today's low interest rates there may be some investment credibility to this perspective; however, just like any real estate product condo hotels can lose value. Loss of value can be catastrophic when leverage is involved, especially if the individual is forced to sell for whatever reason. Because many condo hotel owners depend on guest stay income and the properties are operated essentially as hotels most banks lend to individual buyers with similar terms to those of a hotel owner or developer. Loan-to-values (LTV) of 60-65% are not uncommon as banks seek to limit exposure to cyclic nature of the hotel market. In the eyes of the bank these properties are still hotels to a great extent and are therefore considered a risky product based on daily or weekly lease structure.

Added to the historical cyclic nature of the lodging industry new and unpredictable threats such as global terrorism have impacted both room demand and the desire for banks to finance or refinance hotels. According to one 2003 article, when a number of hotels in Waikiki were changing hands, the hotel industry has "yet to post consistent revenue gains since the Sept 11, 2001, terrorist attacks." At this time, the total revenue per available room (RevPAR) nationwide dropped from \$41,335 in 2000 to \$35,753 in 2002, a 13% decline. Hawaii suffered an 8% decline with RevPAR dropping from \$38,675 in 2000 to \$35,678 in 2002.<sup>63</sup> At the same

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<sup>63</sup> According to the Hotel Research Group, a division of San Francisco Based PKF Consulting and DEBDT. See Webb, Steve. "Condos Help Seal Hotel Financing Deals." *National Real Estate Investor*. October 1, 2003.

moment, by converting the hotel from single ownership to many individual owners the bank, the developer, and the management company are actually disseminating market risk among many owners while raising new capital to improve existing hotels and creating value.

In the case of mixed use condominium hotels pre-sales of the units significantly diminish the risk of financing a stand alone hotel. The presence of the hotel in turn helps to brand and provide amenities to move condo units in sales. In existing hotel conversions collective financing through individual sales facilitates renovations and transfer of ownership by offering a premium to the owners in a transaction that might not have otherwise have taken place. One Honolulu-based industry CEO notes that sales of existing hotels to condo hotel developers can achieve a sales price 25% or greater than what the same property would sell for to a conventional hotel operator.<sup>64</sup> Existing hotel conversion to condo hotels avoids risks from zoning and permitting, time-to-market (including ground-up construction delays and defects), and provide a tangible property real estate asset to assist in pre-sales. Overall, the process of hotel conversion or sales of new construction condos out sources much of the project and operations risk into the portfolios of individuals. In effect, the condo hotel structure aptly addresses the realities of risk averse financing from the bank and owner perspective.

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<sup>64</sup> This individual also noted that this premium is ‘coming down’ with the decrease in hotel inventory and rise in ADRs Waikiki has been experiencing of late.

## 5.8: International Buyers

Condo hotels are located in destinations of choice for many travelers. Waikiki generates strong numbers from Asia, South Florida benefits from many Latin American and European travelers, New York City hosts tourists and business people from nearly every country in the world. As a result of a favorable exchange rate, capital seeking safe and stable havens, and economic growth abroad (especially in Asia), condo hotels can supply a hassle-free investment in American real estate and a place to stay while traveling. Depending on the cultural sensitivities of the country of origin these buyers may or may not place their units into the rental pool. Condo hotel operators relate that wealthy individuals and native Asian buyers tend not place their units into rental pools.

## Chapter 6

### Consequences of Conversion

Although Waikiki is a unique resort experience, the dynamics of condo hotels in the area may aid in the understanding of national trends and vice versa. Conversion of hotels in Waikiki and elsewhere has become a more prominent fixture of the real estate industry in the last few years. Most articles describe conversions that have taken place over the last four years although, as discussed, the process of hotel conversion to condominium ownership is not new.

A study of the potential consequences of condo conversion in Hawaii must necessarily focus on Waikiki. A 2000 Census review of the businesses in Waikiki evidences that 980 of 1607 establishments are in some way linked to the tourist and hospitality trade (**Table 3**). Thus not only is there the primary impact of revenues from these industries but the added value of local expenditures by the owners and employees of these industries.

<b>Table 3. Establishments in Waikiki, 2000</b>			
<b>Industry</b>	<b>Total Establishments</b>	<b>Industry</b>	<b>Total Establishments</b>
<b>ALL ESTABLISHMENTS</b>	<b>1,607</b>	Professional, scientific & technical services	49
Construction	18	Management of companies & enterprises	20
Manufacturing	11	Admin, support, waste mgt, remediation serv.	138
Wholesale trade	50	Educational services	13
<b>Retail trade</b>	<b>522</b>	Health care and social assistance	27
Transportation & warehousing	22	<b>Arts, entertainment &amp; recreation</b>	<b>30</b>
Information	11	<b>Accommodation &amp; food services</b>	<b>342</b>
Finance & insurance	25	Other services (except public administration)	197
<b>Real estate, rental &amp; leasing</b>	<b>117</b>	Other and unclassified	15

Source: U.S. Census Bureau, ZIP Code Business Patterns (ZIP Code 96815).

Moreover, about 45% of all tourists visit Waikiki and about the same percentage of all visitor expenditures in Hawaii take place in Waikiki (**Table 4**). Given this large share of the State's tourism the consequences of conversion as they effect Waikiki may be a strong indicator as to how the conversion trend might affect the Neighbor Islands, the State of Hawaii, and other Mainland US communities grappling with the same issues.

**Table 4. Waikiki's Share of Tourism**

Measure of Tourism	Statewide Visitor Industry	Waikiki	
		Number	Percent of Statewide Tourism
Visitors	6,389,018	3,718,768 <sup>1</sup>	NA <sup>2</sup>
Ave. daily visitor census	164,634	71,756 <sup>1</sup>	<b>43.6%</b>
Visitor units	70,783	31,717	<b>44.8%</b>
Occupied units (average)	49,053	22,297	<b>45.5%</b>
Total visitor expenditures <sup>3</sup> (\$millions)	\$11,023.9	\$5,015.9	<b>45.5%</b>

NA: Not applicable.

<sup>1</sup> Estimated as a proportion of Oahu.

<sup>2</sup> Because many visitors tour more than one island, percent is not applicable.

<sup>3</sup> Includes a portion of the overseas airfare supporting Hawaii-based airline services.

**Source: DBEDT.**

Lastly, Waikiki is important since the island of Oahu has seen the highest numbers of units converted to condominiums of all the Islands. Of the 2,687 units converted statewide in 2004, 2,211 were in Oahu.<sup>65</sup> Nearly all of these units were in Waikiki and the density of hotel units in one locale in Oahu permits a concentrated study of conversion. The ramifications of conversions in Waikiki and beyond have not been fully evaluated; however, several broad categories of focus arise.

### 6.1: Legal Liabilities

Although the legal structure of condominiums and even of condominium hotels is not new the growth in numbers of condo hotels nationally has tested the legal framework by which this form

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<sup>65</sup> Toy, Joseph. *American Resort Development Association (ARDA) Hawaii: Impact Analysis of Hotel Conversions to Resort Condominium and Timeshare Use*. Prepared by Hospitality Advisors LLC, Honolulu, HI. April 6, 2005.

of ownership exists. As more individuals own and use condo hotels there is now a wealth of new concerns and experiences related to the product. Thus, legal issues have emerged in parallel with the level of growth of the product. As a consequence of local laws, legal issues vary by state and county, but some topics such as securities legislation, concern federal laws.<sup>66</sup> With greater numbers of people interested in the product it is inevitable that some will perceive their purchase solely as an investment that, should expected returns not be met, could be the subject of litigation.

Unlike the most real estate transactions outside of Real Estate Investment Trust (REIT) shares or sales of Commercial Mortgage Backed Securities (CMBS) most transfers of real estate assets are not regulated by the Securities and Exchange Commission (SEC). However, because condo hotel sales incorporate an operations company that also aids in leasing these services could be construed as investment management. According to Jim Butler and Guy Maisnik of the California-based Global Hospitality Group of Jeffer, Mangels, Butler & Marmaro LLP, “a security will be involved in once a condominium sale includes almost any of discussion of rental management services.”<sup>67</sup> The SEC has established a four-part assessment of whether an investment constitutes a security under the “Howey Test.” All four of the following components must be met for a purchase to be deemed a security and part of an ‘investment contract.’ First,

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<sup>66</sup> Review of materials including SEC concerns can be found in Augustine & Donovan’s *Resort Condominiums* which also contains legal documents pertaining to many types of actual resort condominium conversions, new construction, and federal regulation of condominium development. See Augustine, Don and Donovan, James. *Resort Condominiums*. Real Estate Law and Practice Course Handbook Series No. 68. Practising Law Institute, NY NY. 1973.

<sup>67</sup> Butler, Jim and Maisnik, Guy. Condo Hotels: Marking Them Work Involves Challenges and Rewards.” *Urban Land*. Urban Land Institute (ULI). February 2005 pp. 34..



the 'scheme' must involve an investment of money; second, the investment must be in a common enterprise; third, the enterprise must have the expectation of profits; fourth, these profits must come solely from the efforts of others.<sup>68</sup> Under these parameters it is not surprising that developers can find themselves in a legal conundrum if expectation of profits is provided before the purchase of the condo hotel unit. Similarly, the marketing of 'full-service' management of the condo hotel units could suggest that any profits resulting from the condo hotel unit are the result of the actions and efforts of others.

Therefore, during the sales process real estate brokers must be careful how they present the condo hotel unit and its potential to generate revenue. "Information provided in connection with a condominium sale cannot emphasize the economic or tax benefits of the rental arrangements, despite the investment motive of many condominium purchasers," and most brokers only relate that "ownership may include the opportunity to place your condominium in a rental arrangement."<sup>69</sup> Additional inquiries must be referred to the management company which must have physically separate offices and staff members. Unfortunately, the emphasis on only providing basic information on the property and marketing a lifestyle to potential buyers deprives consumers of key revenue and growth data crucial to making a prudent investment decision. Butler and Maisnik also suggest that restrictions prompt sales people to furnish the rental information illegally – a practice which could bring securities fraud and litigation against the sales staff and developers.

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<sup>68</sup> United States Security and Exchange Commission. *SEC vs. Edwards*, 124 S Ct. 892 (2004) par 2.

<sup>69</sup> Butler, Jim and Maisnik, Guy. "Condo Hotels: Making Them Work Involves Challenges and Rewards." *Urban Land*. Urban Land Institute (ULI). February 2005 pp. 34..

Why then shouldn't condo hotel units be sold as a security? This would necessitate a different legal structure and dictate that all income and expenses would be pooled and mandatory participation in the rental program would be required. In exchange buyers would have all financial information and sales/rental expectations at their disposal which could diminish the likelihood of misrepresentation or fraud litigation. But converting the condo hotel into a security would remove some of the tax incentives of depreciation and interest deductions that can a consideration on purchase. David Disick, a securities and tax attorney and Malcolm Noden a specialist in condominium management have suggested a means of structuring the condo hotel so that some tax advantages are preserved. By considering these products as securities, that is, separating the 'real estate asset from the hotel component of the investment to derive a specific Hotel Condominium Investment Structure (HCIS) and a separate Operating Limited Partnership (OLP).'<sup>70</sup> The authors believe that the public and developers accept the reality that condo hotels are in fact securities in order to make the product a more widely available and commonplace investment. Additionally, were this format adopted today given the current environment, it would place more emphasis on the operations profits and allow a conventional analysis of value in real estate, instead of anticipated appreciation gains which depend on a rising market.

One problem is that when condo hotels are sold as a security the emotional component of the purchase is eroded. Current condo hotel marketing and subsequent sales are as much the result of the selling of a lifestyle as a prudent real estate choice for personal use or the option of

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<sup>70</sup> A detailed discussion of the Hotel Condominium Investment Structure (HCIS) and Operating Limited Partnership (OLP) format is described in Disick, David and Noden, Malcolm. "Hotel Condominiums: After Tax Reform." *Cornell Hotel and Restaurant Administration Quarterly*; February 1989; 29, 4. pp. 20 -29 and related article by the same authors "Analyzing Condominium Returns." *Cornell Hotel and Restaurant Administration Quarterly*; November 1989, 30, 3. pp. 36-39

income. The mystique of the second home in Waikiki or any other location is diminished when the property is sold as a share – there is a certain palpable sense of ownership in holding a deed.

Furthermore, developers complain that securities compliance is costly and sales staff might require different training and licensing.<sup>71</sup> More likely, securities law and compliance is really not a developer's area of expertise and any mishandling might have serious SEC ramifications. The combination of real estate's traditional one-on-one sales environment and a buyer's heightened investment expectations could be a contentious combination down the road if those expectations are not fulfilled. Lastly, when all books are open, as they would under SEC regulations, not all condo hotels would cash flow to a standard that might be acceptable to the majority of investors and many deals would never be done.

Aside from SEC concerns that can plague the condo hotel developer, allegations of product misrepresentation can also lead to other legal disputes. For example, the buyers of a unit in an ongoing condominium and hotel project located in Singer Island, Florida on the site of a former Days Inn hotel were not explicitly informed that they were buying what was legally designated as a hotel unit. The marketing allegedly failed to mention that 100 of the 242 condo units are hotel suites, "only after [the buyer] received his legal documents did the Palm Beach Gardens lawyer find out he was buying an \$850,000 hotel suite...[which was further] classified as "restricted," forbidding him from applying for a homestead exemption to make the property a primary residence." The buyer eventually determined that his unit must be furnished, have maid

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<sup>71</sup> Butler, Jim and Maisnik, Guy. "Condo Hotels: Making Them Work Involves Challenges and Rewards." *Urban Land*. Urban Land Institute (ULI). February 2005 pp. 35.

service, and be connected to a main telephone switchboard.... It was never once represented to my real estate agent that this unit is zoned resort hotel...It's one of the disclosures that should be blaring."<sup>72</sup>

In Waikiki, the potential for the appearance of misrepresentation is complicated by the fact much of Waikiki sits on leasehold land and the terms of every land lease are unique and must be understood by the buyers as part of the due diligence necessary for informed ownership. However, many buyers do not take the steps necessary to have a lawyer review all the documents before entering into contracts. Furthermore the zoning and use restrictions in Waikiki are complicated and non-uniform. According to interviews with industry specialists some condo hotel properties and prospective condo hotel properties may sit on land developed under Special Use Permits that must be renewed according to the strict permits terms. Failure to comply with the permit requirements results in automatic revocation of use.

## 6.2: Management and Governance

It is usually the operator's responsibility, on behalf of the condominium association, to insure that such compliance occurs. In conjunction with daily operations and leasing this places tremendous liability on the management company for the property. The management company is charged with meeting the expectations of all the individual investors which implies concurrently fulfilling the needs of all the guests of the hotel on a daily basis. To insure

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<sup>72</sup> Clough, Alexandra. "Condo Buyers Get Hotel Suite Instead." *Palm Beach Post*. Business, Pg 1F. February 20, 2005.

seamless operations, which ultimately are the measure of success of this type of product, seasoned local developers stress the importance establishing a balanced and appropriate governance structure upfront.<sup>73</sup> If the operating documents and implementation are not executed correctly the result is malcontent, owner revolt, or litigation. Documents must not only be legally correct, but also insure that all interests are aligned between developer, buyers, management, and eventually guests. Fair allocation of property expenses with use must be achieved between the different components of the hotel especially if large retail spaces, popular restaurants, or other real estate product types with heavier use exist under one roof.<sup>74</sup> Condo documents and management agreements that are poorly conceived can result in the need to achieve consensus between all owners in order to rewrite the master agreement. For a condo hotel developer to continue to obtain deals and maintain a strong public reputation selecting an experienced and involved management company to guide properties post-conversion is

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<sup>73</sup> Reference materials for governance structure and agreements may be found in Augustine, Don and Donovan, James. *Resort Condominiums*. Real Estate Law and Practice Course Handbook Series No. 68. Practising Law Institute, NY NY. 1973 as well as Romney. Keith and Romney, Brad. *Condominium Development Guide*. Warren, Gorham & Lamont: Boston. (1983)

<sup>74</sup> The following is an excerpt regarding just such a problem that developed in a Florida mixed-use condominium hotel from Weil, Dan. "Key Biscayne Condo Residents Sue for Control." *Broward Daily Business Review*. Vol 46, No 29, Pg 1. January 20, 2005. Although the issue pertains to a condominium and hotel mixed product it is illustrative of the types of disputes that can arise between condo owners and hotel management. "The resident associations of the Ritz-Carlton condominiums in Key Biscayne have filed a lawsuit against the condo-hotel's owner and developer, alleging it overcharged unit owners for maintenance and illegally withheld financial information. Residents in the towers just north of the hotel claim they are paying for maintenance that should be charged to the hotel and have been stonewalled on their requests for budget and other financial information. "Once a certain amount of units are sold, the developer turns over control to the condo association," said Daniel Small, a partner in the Miami office of Duane Morris, who represents the plaintiffs. "That was supposed to happen here about five years ago. They have refused to turn over control. They also have used their improper control to pay excessive expenses and assess fees disproportionately - all to the benefit of the hotel." The lawsuit also contends that "the hotel owner has overcharged or improperly assessed the master association for certain common Area expenses, including those related to access control services and related security expenses, water irrigation, holiday lighting, bad-debt write-off, exterior sealing and coating of access roads, etc." As evidence of unfair allocations, the complaint says that while the hotel accounts for 57.7 percent of the units in the community, it pays only 30 percent of the master association operating costs, and while the plaintiffs account for less than 31 percent of the community's units, they pay 38 percent of the operating budget. "Many condo residents are seasonal, but the hotel's use of the common areas is intense," the complaint says.

paramount. "The appreciation in price of the condo units is largely attributable to the standard of excellence of the administration, amenities and common areas."<sup>75</sup>

Management must also insure that the hotels are run at a high standard, but within the confines of association budgets. Management and condo associations need to be realistic as to the capital accounts necessary to keep the overall property running profitably. These accounts support maintenance of the aesthetic appeal and mechanical operations of the property while ensuring hotel services are not lagging. The realistic allocation of deposits for capital improvements and upkeep is usually underestimated by inexperienced home buyers. Individuals might not want to buy into a property with high mandatory capital account deposits and instead opt for those with lower allocations. To compete in the marketplace, there is pressure on the developer and the management company to establish minimal monthly fees. Lower allocation properties may not adequately account for future costs – although the perspective of many is that they will no longer be owners by the time large-scale capital improvements are necessary. This is clearly a shortsighted and one can imagine under this approach that 10 - 15 years from today Waikiki condo hotels could exhibit the same deferred maintenance problems that drive older hotel conversion today.

Although the management oversees the well-being of the entire property, in the long run individual owners must take some role in their investment. Failure to upkeep one's unit will relegate that unit over time to lower price points for rentals and although at first this might effect

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<sup>75</sup> Weil, Dan. "Key Biscayne Condo Residents Sue for Control." *Broward Daily Business Review*. Vol 46, No 29, Pg 1. January 20, 2005.

only the owners unit, collective disregard to the appearance and features of hotel units could hurt the entire operation. In response some condo associations do maintain standards of unit conditions but there is always a subjective element. Besides physical appearance – what happens if a unit is not fiscally cared for? What if owners don't pay their fees? Or when bad economic times lead to the neighbors unit being foreclosed upon? Perhaps nothing if the bank assumes ownership and the property continues to run as a hotel, but over time with individualized ownership the property means different things to different people. The property can be any combination of an investment, a second home, or even a retirement option. For instance, how will the character of the building change if a retiring owner population make these units their semi-primary residence? For the retiring owners a building with full hotel services in a resort setting would be a perfect place to reside but this effect could turn properties into unintended retirement communities of the future and for today's younger buyers this effect may not be a part of the investment bargain. Yet these challenges exist in any condominium or cooperatively owned property today and disputes do erupt. Over time buildings do change character. The only difference is that with single ownership or strong management guidance, a building (especially one that is an investment vehicle) can reinvent itself more readily.

### 6.3: Unbundling of Property

On a grander scale the unbundling of property that results when Waikiki hotels, or any building, are converted to individual ownership can effect future development of the property. Today's wave of condominium conversion of hotels in Waikiki is fueling the renovation and reinvention

of lodging supply in the area. This is inline with city, state, and private efforts to improve the area for tourism. Private efforts to revitalize the area include Outrigger's \$800 million Beach Walk development. The massive project includes the demolition of several older hotel buildings and a substantial assemblage of land. According to executive at Outrigger, "completion of the project will turn an aging and congested portion of central Waikiki into a combination of new and refurbished upscale time-share and hotel accommodations." The coordinated upgrade is anticipated to attract higher-spending visitors and increase hotel room rates.<sup>76</sup> But the further fragmentation of ownership in Waikiki could mean that large scale projects that depend on assemblage of land and coordinated re-development might not happen. Instead, these projects could move to other locales such as nearby Kaka'ako or worse, to other resort areas.<sup>77</sup>

Conversion of existing hotels presents another problem – not only might it hamper regeneration years from now – it solidifies the zoning abuses of the past. City GIS Specialist Mark Lierman has explained that the building boom of the 1960's and early 1970's in Waikiki "led to extensive high rise development with floor plates extending to property lines, with limited open space, pedestrian environment or visual linkages to the surrounding in favor of maximizing the use of the developable lot."<sup>78</sup> Condo conversion of hotels capitalizes on this legacy of haphazard zoning to extract the greatest value from the property yet by placing ownership into the hands of many these properties are unlikely to be ever eliminated from the building stock in Waikiki.

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<sup>76</sup> Shaefers, Allison. "Waikiki Resort Project Pushing Out Little Guys." *Desert Morning News* (Salt Lake City) and *Honolulu Star Bulletin*. February 20, 2005.

<sup>77</sup> Clifford, Janine Shinoki and Kreiger, Alex. *Planning in Paradise: Urban Redevelopment Honolulu Hawai'i*. The President and Fellows of Harvard College (Cambridge, MA) 2003.

<sup>78</sup> Lierman, Mark; Schmidt, Ken; Pierson, *Waikiki Zoning: The Waikiki Special District (WSD) - Polishing Hawaii's Jewel*. City and Country of Honolulu Department of Land Utilization Honolulu, HI.1998.



Nicholas Trkla in a recent Urban Land Institute study entitled *Five Visions for Waikiki*, laments that “uncoordinated piece meal development has left its mark on the resort district, and proposals for major projects – private and public – continue to surface without the benefit of an overall plan or development strategy for the area.”<sup>79</sup> From a city planning standpoint conversion can improve neighborhoods and businesses but cannot elevate them beyond what their physical structure dictates.

#### 6.4: Taxation

The unbundling of property and resultant ongoing renovation and improvement of hotels through condo conversion has added value to Waikiki, the City of Honolulu, and the State of Hawaii. Conversion of bulk property and subsequent higher value individual parcel sales generates both property transfer taxes and a substantial boost in the valuation of property for taxes under the City and County of Honolulu. Researchers have noted that the tax value of residential property typically increases immediately after conversion to condominiums.<sup>80</sup> In the case of condo hotel in Waikiki post-conversion piecemeal valuation increases the property’s total value and has the added benefit not interrupting the taxable income from room-stays. In Hawaii, Transient Accommodation Tax goes to the State, and Property Tax goes to the City and County. Given that most condo hotel professionals cite about 90% of rooms participate in the rental pool, vacancy rates do not change from before conversion, and RevPAR increases after renovation –

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<sup>79</sup> Trkla, Nicholas V. “Five Visions for Waikiki.” *Urban Land Institute* (ULI)

<sup>80</sup> Sternlieb, George and Hughes, James. “Condominium Conversion Profiles: Governmental Policy.” *American Real Estate and Urban Economics Association (AREUEA) Journal* Volume 3, Issue 3, 1975.

the City and State stand to fiscally benefit from conversions. In fact, one could argue that with an upgraded product city revenues may also be higher as a result of a greater occupancy. Additionally, by taxing condominiums and room rentals the city mitigates the risk of a temporary downturn in tourism since the city will still be entitled to condo property taxes even if room occupancy and revenues drop. City services should not be stressed any more than current use unless in the long run, more individuals make their Waikiki condo hotel unit a choice for longer-term or even permanent stays. If condo hotels do evolve into semi-retirement communities Honolulu could see greater reliance on city medical or other public services. To avoid permanent use places such as Treasure Island, Florida, prohibit allowing condo hotels from being classified as primary residences.<sup>81</sup>

## 6.5: Hotel Inventory

Whereas debate around condo conversion in the 1970s revolved around displacement of individuals, one might be concerned about the potential displacement of guests in Waikiki with today's conversions. In effect, while conversion may be increasing the value of property in Waikiki it has the potential to decrease the number of active hotel rooms in the area. Fewer accommodation options could make it difficult to attract larger conventions or even meet tourist demand.<sup>82</sup> Since many condo hotels and prospective conversions are set back from the beach they are actually closer by foot to the Honolulu's new \$350 million convention center.

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<sup>81</sup> Swider, Paul. "Legal Review Sought on Condo-Hotel Rules." *St. Petersburg Times: Neighborhood Times*. March 27, 2005. pg.7.

<sup>82</sup> Schaefer, Allison. "No Rooms at the Inn." *Honolulu Star Bulletin*. March 13, 2005.

Ultimately, a depletion of hotel keys could theoretically undermine the basis of the local economy.

Erosion of hotel units is not solely the result of conversion. The hotel industry itself has opted to reduce the number of rooms on the market in favor of condominiums. For example, Outrigger Hotels and Resorts has lost 29% of its 8,300 rooms to conversions. The company that once managed the Ohana Hobron, the Ala Wai Tower, and the Ohana Surf – all budget hotels that have been converted into condo hotels – has also removed hotel rooms from its new construction projects.<sup>83</sup> Outrigger’s Beach Walk project originally included a \$200 million 890-room hotel tower though current plans call for 400 luxury condo units to be designated for a mix of residential use, condo hotel operation, and hotel rooms. Two aging hotels with a total of 210 rooms have been demolished to make way for the new tower. The President of Outrigger laments that the destination would be “better served by a high-rise hotel,” but that “financial realities” of strong condo demand and a dearth of supply pointed otherwise.<sup>84</sup> Reorienting the property as residential made the project less risky to finance and recent legislative failure to extend and increase a hotel redevelopment tax credit sealed the decision.

Although there is no consensus number in the industry, conversion to conventional residential condominiums has permanently eliminated between 200 and 700 hotel rooms in recent years from properties that have been converted to conventional condominiums without any hotel operation. Properties that remain in operation as a hotel see 2-10% of their rooms excluded from

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<sup>83</sup> Schaefer, Allison. “No Rooms at the Inn.” *Honolulu Star Bulletin*. March 13, 2005.

<sup>84</sup> Staff. “Outrigger Opts for Luxury Condos Over Hotel Rooms.” *Associated Press*. May 5, 2005.

rental pools.<sup>85</sup> The small size of Waikiki units is a contributing factor as to why most individuals view their condo hotel units an investment or seasonal second home rather than a primary residence. Some believe that the trade-off of a very small percentage of lost inventory in Waikiki is “a positive investment” in the context of the value conversions and renovations bring to the city, “this will not go on forever as other exit strategies [for hotel owners] are already surfacing due to renewed vigor in Waikiki tourism” one individual explained. Similarly, the removal of inventory strengthens the pricing power of the remaining hotels and at some point there will be little stock of older hotels to convert.

#### 6.6: Economy and Employment

Higher priced hotel stock and fewer hotel rooms can help Waikiki achieve its goal of attracting a higher value customer, yet too much displacement of guests could lead to fundamental economic shift in Waikiki. Other tourist dependent regions which have experienced growing numbers of hotel conversions have begun to address the issue through studies and sometimes legislation. The concern is that direct loss of revenue from hotel stays and hotel employment will be coupled with indirect loss of revenue from tourist spending in other businesses such as shops, restaurants, and leisure activities while in town. Will, for example, condo hotel residents and guests spend less in Waikiki than traditional hotel guests? State of Hawaii economists do not believe that the typical hotel condo guest spends markedly differently than the average conventional hotel

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<sup>85</sup> Conversations with developers, management companies, and state researchers confirm over 90% of condo hotel units are placed back into circulation.

guest.<sup>86</sup> A state researcher and analyst explains “we find that although lodging and food expenditures decrease, spending for shopping and other activities does not change dramatically between condo visitors and hotel visitors.”

But Florida towns are particularly concerned about the tourist industry’s ‘trickle-down’ revenue effect and some such as Pinellas County, a resort community, commissioned a study to evaluate the impact of lost hotel inventory. The study assumed 75% of hotel keys would be lost in ten years. Not surprisingly the research determined that the tourism industry, currently 30% of the county’s revenue, would decline as condos replaced hotel units; but lost revenue tourism revenue would eventually be replaced with “other types of industry.” According to the consultants that prepared the work “beach communities are going to be hit hardest...as a community you need to decide what you want this community to look like.”<sup>87</sup> Tax revenues, though lower from the loss of accommodations tax and tourist purchase, was expected to increase overall due to the higher value condominiums. It is important to note that in Pinellas many of the converted hotels are located on the waterfront, whereas in Waikiki most condo hotels are in less desirable locations. Also conversion in Waikiki also does not typically result in full residential condos but a hotel operated product which continues to serve tourists. In some sense Waikiki gets a ‘win-win’ with higher value condos and the retention of accommodations revenue.

Despite some studies that indicate minimal impact of condominium development and conversion Florida cities and towns are looking to stem the process of change. From the perspective of

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<sup>86</sup> Discussion via email July 2005.

<sup>87</sup> Shoichet, Catherine E. “Study: Condos to Hurt Tourism” *St. Petersburg Times: Largo Times* (Florida) February 9, 2005. Pg.1

lawmakers and city officials the real estate of the last few years should not have the opportunity to disrupt what some perceive to be the economic foundations of communities. Like Waikiki's legacy of haphazard zoning, hotels in Pinellas County/Clearwater Florida exceed current code allowances. The city has seized upon zoning as an opportunity to legally restrict conversion. Currently if a developer seeks to replace hotel units with condominiums either through demolition and new construction or in an existing hotel building, they are permitted to convert the existing rooms into residential units at a ratio of 4 to 3. The Mayor contends that this ratio is "an unintended incentive" for conversion and has proposed allowing only the number of units that current code dictates. For example, a 217 unit hotel can become 162 condos today, but legislative changes would commit the same property to a maximum of 57 units under code.<sup>88</sup> Elsewhere in the state Key West has instituted a 180 day moratorium on conversions so that its City Planning department will have the opportunity to better evaluate the effect on tourism.<sup>89</sup> With fewer hotel rooms the County Commissioner expects that tourists will "still come, but they'll come for the day and stop in Tampa to eat and stay the night...all we will get is the opportunity to clean up their trash from the beach."<sup>90</sup> Despite this, the valuation of each converted condo is expected to be 3.4 times as much as the hotel unit it replaces and the tax revenues will be more than made up from the loss in tourism yet the neighborhood "would be forever changed."<sup>91</sup>

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<sup>88</sup> Sharockman, Aaron. "Clearwater May Make Conversion Tougher." *Largo Times*. April 27, 2005. Pg1.

<sup>89</sup> Phillips, Christie. Key West, Fla., Condo Conversions Not New phenomena." *Florida Keys Keynoter*. November 24, 2004.

<sup>90</sup> Behnken, Shannon. "Condo Conversions to Change Pinellas." *Tampa Tribune*. February 9, 2005.

<sup>91</sup> Behnken, Shannon. "Condo Conversions to Change Pinellas." *Tampa Tribune*. February 9, 2005.

In New York, tourism is not the primary component of the economy but there are still vocal cries for regulation. Like Waikiki, New York hotel properties generate top dollar from developers because they occupy some of the most valuable real estate in the city and have no tenants to evict. Unlike New York, In Waikiki most of the converted hotel rooms will remain in the available inventory. The New York debate as it relates to Waikiki is important to illustrate what a sensitivities a community as diverse as New York might harbor regarding the loss of hotel rooms. Only some of the hotels in New York have been converted to condo hotels and many have made the transition to conventional condominium buildings. But the discourse in NY is as much over employment as it is over the potential impact of lost tourist dollars and tax revenue. Controversy stems from the direct hit hotel employees will take as rooms are converted to condos or mixed product. News articles cite that in the last few years approximately 3,000 hotel rooms of an estimated 65,000 hotel rooms citywide have been lost.<sup>92</sup> Furthermore, 6 of 7 hotels sold in Manhattan in 2004 involve plans to convert some or all of the building to residential use.<sup>93</sup>

The New York Hotel Trades Council, a hotel workers union, is planning to fight the trend on which they blame a loss of 1,076 hotel jobs in the past year not including the 900 jobs expected

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<sup>92</sup> Price Waterhouse Coopers cites 64,900 hotel rooms in 2005. Staff. "NYC Hoteliers Seduced By Condominium Conversions." *Business Travel News* March 21, 2005 Gilligan, Eugene. "Will Protests Slow Hotel Condo Conversions in NYC?" *New York Real Estate Online*. April 01, 2005. See also James Barron. "Mayor Intervenes in Plans for Condo Conversion of the Plaza." *New York Times*. Section B, Column 2, Metropolitan Desk. Pg3. February 17, 2005.

<sup>93</sup> Yee, Amy. "Property Boom Shuts Doors of the Plaza: The Fabled New York Hotel's Conversion Into Apartments Reflects a Global Trend of Disposals in a Red Hot Real Estate Market." *Financial Times*, April 20, 2005. p. 30

to be lost in the Plaza conversion plan.<sup>94</sup> The union is enlisting celebrities and a \$1 million public relations campaign to stop the conversion. Additionally, the union is pressing the Landmarks Preservation Commission to keep historic properties from being reinvented. Mayor Bloomberg has been recruited to broker a compromise between the developers and the union and there is a tentative agreement to keep 348 instead of just 150 hotel rooms in a move that would save several hundred jobs.<sup>95</sup> As in Pinellas County in Florida, New York's City Council has come under pressure to consider legislation limited hotel conversion. Currently there is a proposal aimed at preventing hotels from converting more than 20 percent of their space to condos.<sup>96</sup> But hotel operators and developers respond that the powerful unions have driven hotel margins to bare minimums giving few options but sale for owners of marginal hotels in the City.<sup>97</sup> Luckily Waikiki has escaped a contentious union versus management debate; however, because tourism and convention revenues are a much more important sector of the economy in Hawaii small voices of concern could evolve into larger routs.

Overall, like many of Hawaii's defining attributes, Waikiki condo hotels are different than those found in most other places. More condo hotels will remain in the available inventory for guest stays; smaller size, operating agreements, and zoning prevents most from being taken as primary residences; and since most are set back from the choicest beachside locations their conversion is unlikely to dissuade tourists from the accessing the amenity that brings them to Waikiki. Joseph

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<sup>94</sup> Gilligan, Eugene. "Will Protests Slow Hotel Condo Conversions in NYC?" *New York Real Estate Online*. April 01, 2005. See also James Barron. "Mayor Intervenes in Plans for Condo Conversion of the Plaza." *New York Times*. Section B, Column 2, Metropolitan Desk. Pg3. February 17, 2005.

<sup>95</sup> Yee, Amy. "Property Boom Shuts Doors of the Plaza." *The Financial Times*. April 20, 2005. pg 30.

<sup>96</sup> Yee, Amy. "Property Boom Shuts Doors of the Plaza." *The Financial Times*. April 20, 2005. pg 30.

<sup>97</sup> Fickenscher, Lisa. "Hotel Battle Begins." *Crain's New York Business*. Feb 28, 2005. Pg. 1



Toy of Hospitality Advisors LLC believes that condo hotels are part of an industry diversification trend to “satisfy the divergent market interests of a more experienced travel market.”<sup>98</sup> Repeat tourists to Hawaii require differentiated lodging options. As guests of condo hotels they are finding a product that fits their price point and expectations. As owners, they have found that condo hotels fill a void for a low maintenance investment resort product and second home offering.

Waikiki’s condo hotels by virtue of their transformation through renovation play a key role in retaining tourists for Oahu. The challenge of encouraging new and repeat visitors to Waikiki has been exasperated by greater numbers of direct flights from the mainland to neighbor islands and more expensive inter-Island flights. Hawaii’s visitor industry has diversified geographically from Oahu to the Neighbor Islands, particularly Maui.<sup>99</sup> The hope is by attracting a broad array of tourists other than group tours, the conversion-funded reinvention of these lodging options reinforces the city and local business efforts to attract quality tourists back to Waikiki.<sup>100</sup>

On top of cyclic downturns that have historically affected the hotel industry, dramatic terrorist attacks can immediately stifle tourism and travel. Individualized ownership of Waikiki condo hotels can help temper the dynamic shifts of a tourism-based economy. In a 2000 article in the *Journal of Real Estate Research (JRES)*, Gallagher and Mansour examined groupings of hotels

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<sup>98</sup> Toy, Joseph. *Impact Analysis of Hotel Conversion to Resort Condominium and Timeshare Use*. American Resort Development Association (ARDA). Pg.4.

<sup>99</sup> Song, James. “More Hawaii Tourists Looking Beyond Waikiki.” Associated Press. June 8 2003. BC Cycle

<sup>100</sup> Dunford, Bruce. “Weinert’s First Assignment: Help Waikiki.” Associated Press. June 23, 2003, BC Cycle.

and their sensitivity to external market forces.<sup>101</sup> Waikiki is represented in the ‘Honolulu, Hawaii’ designation. In terms of volatility, Honolulu was grouped in ‘Cluster 4’ along with other locations having statistically similar historical RevPAR activity and measures of supply and demand volatility. Cluster 4 included the nation’s ‘top tourist destinations’ of New York City, Las Vegas, NV, Orlando FL, and Fort Lauderdale, FL. Interestingly, these locations are not far off from the areas which have seen condo hotel growth in the last few years. The study suggests that this Cluster suffers from the most volatility and therefore risk than other locations. The groupings are intended to aid portfolio managers in assembling geographically and market diversified investment products. Overall, the authors explain that hotels have “shorter functional lives than other property sectors, with styles and hotel formats changing constantly...the hotel market has usually been the first hit in view of a negative economic shock, suffering immediately.”<sup>102</sup> By spreading ownership and revenue risk among many owners the individualized ownership structure of Waikiki’s condo hotels may better weather abrupt but transient changes in demand. Within a single condo hotel association will be potentially hundreds of owners from many different states or even countries with differentiated risk profiles and diverse sources of income.

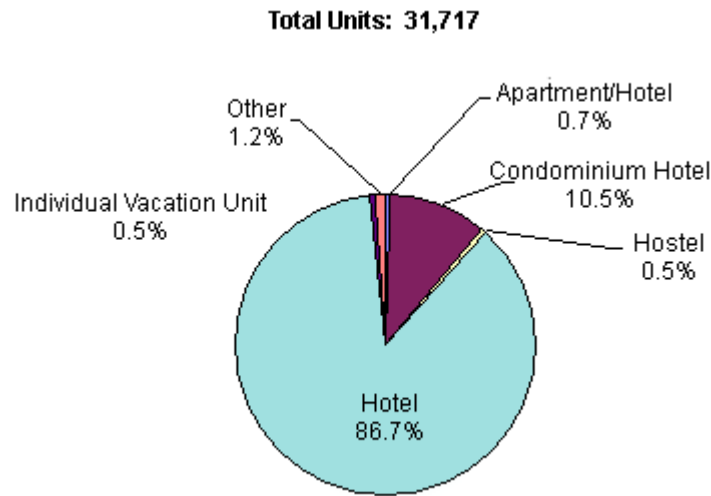
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<sup>101</sup> Gallagher, Mark, and Mansour, Asieh. “An Analysis of Hotel Real Estate Market Dynamics,” *Journal of Real Estate Research (JREER)*. Vol 19 No: 1 / 2, 2000. pp. 133-164

<sup>102</sup> Gallagher, Mark, and Mansour, Asieh. “An Analysis of Hotel Real Estate Market Dynamics,” *Journal of Real Estate Research (JREER)*. Vol 19 No: 1 / 2, 2000. Pg 136

Understanding the overall consequences of conversion in Waikiki, whether positive or negative, requires the perspective of the DEBDT's data for available Waikiki visitor units in 2002 (Figure 2). This data supplies an important clue as to the magnitude of the effect of condo conversion in the city.

**Figure 2. Waikiki Visitor Units, 2002**



Source: DBEDT

From a macro standpoint the data indicates that condo hotels constituted about 10% of all lodging in Waikiki in 2002 – today that number would be slightly higher. Within this 10%, industry insiders estimate about 10% of these rooms are permanently removed from the hotel inventory pool. Therefore from the total number of visitor units in Waikiki it figures that only about 1% of total guest lodging in Waikiki, or 10% of the condo hotel units would be removed from the current supply. In exchange for that overall 1% numerous hotels have been converted and upgraded; tax revenues for the city would have significantly increased based on value and higher room rates; and thousands of individuals have been able to participate in second home and investment ownership which might have otherwise been out of reach.

But accurately determining the true number of hotel rooms taken from active service is a difficult number to arrive at. Defining what constitutes ‘removal’ is also perilous since individual owners needn’t place their units in the rental pools to let their rooms. Use of rooms by family, friends, or colleagues would probably not be documented in any measurable way. Based on the percentage of owners who place their units in rental pools the state, developers, and hotel operators estimate a maximum of 10% of rooms are removed permanently. Yet a recent study by private consultants determined that of the 2687 units that have been converted in the past four years, 917 units were permanently removed from transient hotel use.<sup>103</sup> Table 5 is excerpted from this study. The table reviews the hotels converted in the last four years and tabulates the room inventory either gained or lost as a result of conversion. (See next page)

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<sup>103</sup> Hospitality Advisors LLC for American Resort Development Association (ARDA) Hawaii. “Impact Analysis of Hotel Conversions to Resort Condominium and Timeshare Use.” April 6 2005.

**Table 5: Conversion of Hotels to Condominium Status from 2000-2004**

Hotel Conversion to Condominium 2000-2004					
OAHU	# Units in 2000	Reduction/Addition due to Reconfiguration	Converted Rooms 2004	Permanent Removal From Hotel Pool	Estimated Units Available for Resident Use or Hotel Pool
Aqua Bamboo	91	-	91	-	91
Aqua Marina (former Chana Ala Wai Tower)	167	-31	136	43 <sup>(b)</sup>	93
Aston Beachside	79	-69	10	-	10
The Palms (former Aston Parkside)	250	13 <sup>(a)</sup>	263	-	263
The Luana (former Waikiki Terrace)	242	-45	217	-	217
The Chia (former Chana Surf)	251	-	251	251	0
The Windsor (former Chana Hobron)	612	-	612	612	0
Diamond Head Beach Hotel	62	-	62	-	62
Diamond Head View Hotel	11	-	11	11	0
Hawaiian Monarch	241	-	241	-	241
Kuhio Village	110	-	110	-	110
Royal Garden Waikiki	220	-13	207	-	207
Oahu Totals	2336	-158	2211	874	1294

(a) Addition due to conversion of administrative offices and meeting rooms to lodging units

(b) Condo by-laws prohibit 43 units to be used as transient accommodation units

Source: Joseph Toy, Hospitality Advisors LLC from State of Hawaii DBEDT information and various news articles part of study for the American Resort Development Association (ARDA) entitled

*Hawaii: Impact Analysis of Hotel Conversions to Resort Condominium and Timeshare Use*

If the numbers from this study represent a more accurate determination of units removed from the hotel inventory pool, greater than one third of the converted rooms have been removed from the current inventory. With one third of the units removed from available condo hotel inventory the impact of conversion on the overall lodging unit inventory would be more pronounced; yet still represent only 3% of the total number of lodging units in Waikiki. A fast moving primary and secondary sales market with thousands of different owners complicates tracking actual use. A current owner may choose to participate in the rental pool while the next owner may not.

Given this confusion it would be crucial to establish parameters of what constitutes permanent removal. In tandem, some form of standard questionnaire or filing would aid in researching the trend and gauging the number of rooms truly in circulation. Even a solid terminology and detailed questionnaire would at best apply to the current owners of the unit and thus represent a mere snapshot of the marketplace.

In coming years will today's buyers continue to own their units and if so as these owners age and their needs change will they opt to occupy the units themselves? Alternately are they more likely to rely on the income from hotel operations and therefore be less likely to pull their unit from the rental pool? It is possible that today's 'boomer' buyers will seek warmer climes and full-service living in the future thus it is reasonable to expect that greater numbers of condo hotel units will be used on a longer term basis. Yet, in the future, it is also likely that development in Waikiki and the Honolulu area would have in some way responded to the long term market supply needs through new projects or redevelopment.

## **Conclusion**

Nationally, conversion of hotels to condo hotels responds to market demand for second home ownership and an investment real estate product in desirable locales. Low interest rates, burgeoning demographics, and greater public interest in ownership of property have driven many to consider purchasing a diverse form of real estate products whether they be one's primary residence, an investment property, or even shares of Real Estate Investment Trust (REIT). In this marketplace the combination of lifestyle amenities, low maintenance ownership, and the possibility of income has proven condo hotels to be an attractive form ownership.

In Hawaii, condo hotels appeal to both local buyers pursuing an investment property and vacationers seeking a piece of Waikiki's resort paradise. The recent cyclic downturn in the hotel industry, coupled with an excess and aging room inventory supply the means by which innovative developers can create value. These developers acquire, improve, and reinvent these properties by providing individual ownership of a hotel product. The sale of individual hotel units, which continue to be operated as a hotel, serves as a creative, small-investor funded vehicle for transfer of ownership and renovation of larger projects. As more inexperienced developers enter the marketplace conversion of properties is at risk for misrepresentation and legal disputes as well as growing pains from poorly established operations and management. Furthermore, with greater numbers of condo hotels appearing in markets such as Waikiki and beyond, the consequences surrounding conversion of hotels has come under the scrutiny of the

public eye. In other markets, such as New York and Florida, concerns have been raised regarding the conversion trend's impact on local employment and tourist dollars. These potential impacts must be weighed with the benefits, such as much needed financing for renovations, increased tax revenues, and greater risk dispersal through multiple ownership, that are supplied by condo hotels.

Yet, unlike the mainland, most of the condominium hotels in Hawaii serve as investment properties and only small numbers are reserved for exclusive use as second homes. Most would agree that the renovation financing that condo hotels have afforded has aided in the collective efforts to revitalize and reinvent Waikiki. As part of an upcoming study, State officials are still examining the tax and economic consequences of conversion but preliminary evidence suggests that some of these as long as the majority of units remain in the rental pool there is little tax impact. However, there is still concern in local government that should conversion markedly increase eventually there might not be enough hotel rooms for the tourist and convention trades to drive growth in employment.

Other relevant but untested issues will dictate the future of condo hotel conversion and consequences in Waikiki. For instance, will conversions and sales continue in a down market? Will current owners be forced to liquidate the ownership in poor economic times? What if changes in buyer demographics, such as greater numbers of Asian buyers or older individuals, prevent rooms from being re-entered in the leasing pools? And there is always the question of are condo hotels the last manifestation of an overheated housing market or the beginning of



established form of ownership and investment. Either way, like the development cycles that have previously reshaped the area, condo hotels have the potential to alter the character of Waikiki.

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