

CONVERTING OFFICES TO HOTELS CAN MAXIMISE ASSET VALUES



The world economy, in general, seems to have overcome the recession of the past two years. In this context the German economy started to recover and GDP is expected to grow between 1% and 2% in 2010 and 2011. German business confidence, as measured by the Ifo index, (Institut für Wirtschaftsforschung - Institute for Economic Research) rose to 98.1 in March, its highest reading since 2008.

Unemployment in Germany did not climb as badly as expected and is to remain stable in the next two years at around 8.3% despite the phasing out of short time work sponsored by the state. However, the upturn is not considered to be stable at the moment as the economic stimulus packages will run out and the granting of credit is still difficult, which has a corresponding effect on investments.

So how is the hotel market performing in this general economic environment?

Hotel Market

As in other sectors the last two years have been challenging for the hotel sector. The economic crisis, increasing unemployment and concerns about swine flu all had a negative effect on the travel behaviour of private and business customers. In addition to the fall in demand, the situation was exacerbated by an increased supply of hotel rooms in many German cities.

“In Germany the predominant hotel category for conversions are budget hotels, as they are a better fit with the typical floor plan of an office building. Budget hotels have come through the crisis better than hotels of other categories and locations close to the main train stations are of especial interest as the demand for office space in these areas has fallen.”

Despite that, the outlook is positive and Germany showed a significant increase in both occupancy and average daily rates in February 2010 when compared to a year ago, albeit from a low baseline. Compared to Europe as a whole, this is a relatively strong increase following the early recovery of the economy in Germany.

According to a survey by HRS (Hotel Reservation Service) German hoteliers are satisfied with occupancy rates in 2009 and expect a growth in occupancy as well as an unchanged level of prices in 2010.

One positive fact for hotel business is the cut in VAT for hotel accommodation from 19% to 7%. This gives hotels the opportunity not only for price reductions but also for investment, improvement of service quality and additional services.

All this leads to the question of how international developers and investors can exploit opportunities that arise in a recovering market?

Conversion of Offices to Hotels

With the decline in demand for commercial office space in Germany during the recession, many developers are considering a change of use to maximise the value of their existing assets. With occupancy and Revenue per Available Room (RevPAR) in key cities such as Berlin and Munich comparing favourably with the rest of the Eurozone, hotels appear to be a favourable option for developers.

“The conversion of offices to hotels represents an excellent opportunity for investors and developers, although various issues have to be taken into account when considering the remodelling of office space”

Performance year-on-year - February 2010

	Germany		Europe	
	Rate	% change	Rate	% change
Occupancy rate	57,2%	4,3%	56,7%	4,5%
Average daily rate (ADR)	91,93 €	8,2%	93,21 €	-0,2%
Revenue per available room (RevPAR)	52,61 €	12,8%	52,88 €	4,2%

But what are the key issues that any developer should take into account when considering conversion of all or part of an existing office to hotel use?

1. Deal structure

In the current market, international operators will usually require either a management agreement or franchise. Developers who are more familiar with institutional office leases may be uncomfortable with entering into such agreements, particularly as the extent to which the developer is able to guarantee income is minimal.

In addition, where a franchise is proposed, the developer will need to enter into a separate agreement with a separate company to operate the hotel under the franchise brand, assuming that the developer does not have the capability or desire to undertake this role themselves.

2. Planning issues

Planning advice should be sought at an early stage to establish whether a change of use will be supported by the local authorities, and whether there will be any significant planning issues associated with the scheme.

3. Market demand analysis

When considering the ability to fit a hotel layout into an office building, the form and floorplate of the existing building will often naturally lend itself to a particular type of hotel offering (budget, mid-market or luxury).

Care should be taken to ensure that there is consistency between the most appropriate layout for the building and the market issues which will drive demand, and therefore revenue.

A full Market Feasibility Report should be undertaken at an early stage to inform the decision process around the hotel offering, prior to undertaking an operator search and selection exercise. Where there is a conflict between market demand for a particular offering and the ability to deliver that offering within the existing building, the overall business case should be re-appraised to ensure that the cost:value equation will still deliver a positive business outcome.

4. Layout and brand compliance

Once the most appropriate hotel offering has been selected, initial layouts should be developed in liaison with the proposed operator to maximise the efficiency of the scheme. In areas where existing building constraints mean that specific brand standards are unachievable, waivers should be sought and formally approved.

Benchmarking and efficiency analysis of the proposed scheme should be undertaken, that any inherent inefficiencies can be identified, corrective action or consequences can be taken into account in the developer's business plan.

5. Design Considerations

When designing a hotel within a building form intended for office use, the following key issues should be considered:

- a. Does the existing structural design support the proposed change of use? In particular, are there any specific issues with loadings, forming of risers for en-suite bathrooms, providing column-free space for key public areas?
- b. Is the existing lift (elevator) provision appropriate for the new use? Are additional lift cores required in order to meet the operator's brand standards, and can they be incorporated into the structure? If only part of the building is to be converted, what impact will this have on lift use and how will the different areas be kept segregated from the different visitors?
- c. Are the existing Mechanical and Electrical (M&E) and Fire Life Safety systems able to be modified to suit the new use? Does the deal structure require separation of

systems, or if new systems need to be added to meet capacity, where can they be located? Does a floor/zone need to be allocated as service transfer space for soil and waste pipes, water, distribution, etc?

- d. If significant elements of the existing building need replacing to suit the new use, are they already near the end of their useful life, and if not, does this impact on the overall viability of the scheme?

6. Life cycle costing

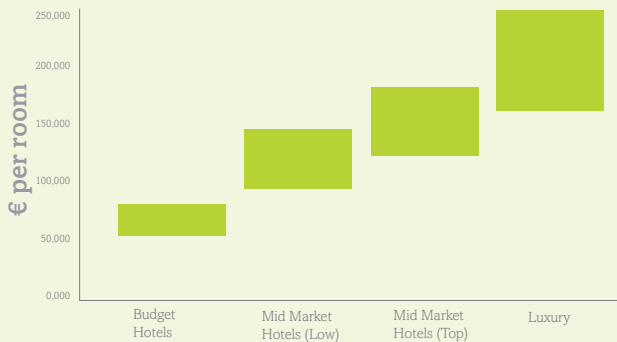
When considering the capital costs for conversion to hotel use, Life Cycle Costing techniques should be used to ensure that whole life costs are minimised. A clear understanding of the deal structure is required to ensure that the incremental cost of any life cycle cost is borne by the party who will benefit financially.



Development in Germany

In Germany the predominant hotel category for conversions are budget hotels, as they fit better with the typical floor plan of an office building and in Berlin a few conversions have already been completed. This development is encouraged by the fact that budget hotels have come through the crisis better than hotels of other categories. Locations in the vicinity of the main train stations are of especial interest as the demand for office space in these areas has fallen.

New Hotel costs in Germany (costs per room - 1st quarter 2010)



Note:

The costs shown above are based on the Study of International Building Costs which EC Harris carries out, with figures based on the 1st quarter of 2010 price levels. The comparative figures exclude VAT, land costs, professional and legal fees, etc. VAT on construction work in Germany is currently 19% (although the rate of VAT on hotel accommodation was reduced to 7% on the 1st January 2010).

Conclusion

The conversion of offices to hotels represents an excellent opportunity for investors and developers, although, as noted above, various issues have to be taken into account when considering the remodelling of office space. One risk is the lack of experience in the hotel business for developers who have previously invested in office space. Considerations about design need to be answered and research should be carried out to test the demand for a hotel in the specific category which fits into the floor plan of the building to be converted. The costs for the project also need to be assessed beforehand and compared to the cost of a new build hotel since the cost differential might be lower than expected.

All in all one must conclude that a decision needs to be considered carefully to avoid false investment, taking into account the key issues as outlined above. Appropriate advice should be sought at an early stage of a project taking into consideration technical and economical aspects.

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