

# Hotel Development: Inception to Operation

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Images of an elegant and luxurious hotel, glimmering in the sun on a white sandy beach, surrounded by palm trees gently swaying in the warm breeze evokes in most, if not all of us, dreamy thoughts of glamour, relaxation, pampering and absolute delight. Those in the industry know very well that whilst this is the experience the hotel staff strive hard to provide for their guests, achieving this requires extreme hard work and dedication. But this hard work doesn't start and end there – this is the public face of the hotel.

The 'private' life of the hotel starts long before the first guest checks in. In many respects, the development process (which commences with identification of a development opportunity and ends with completion of the finished product), is equally as difficult and demanding.

The hotel industry, whether you are an owner, developer or operator, is certainly not for the faint-hearted. This article seeks to outline the private life of the hotel – from inception through to its unveiling. This journey is in fact far from simple, and the development process will take many twists and turns before it is completed.

Whilst both an operator and an owner will each go through a similar process, this article focuses on the development process from an owner's perspective. This is because not all owners will have the same level of knowledge and experience of development or the hotel industry. This article therefore seeks to show, simplistically, just how complex the development process is and how important it is to get it right. Hotel development is too expensive a business to get wrong!

The process will differ slightly from country to country throughout the Middle East, but on the whole is very similar throughout the region and so is designed to be a guide and a starting place.

## **The Beginning: An Opportunity**

An opportunity presents itself. Whether this is by way of a development site, an existing building under construction (or already constructed), or an operational hotel, the process starts.

Included in this article is a diagram outlining, in basic form, the various stages of an hotel development, together with identification of what's involved at each stage. This diagram cannot capture all the issues that may need to be dealt with, but hopefully provides an informative overview.

# Identification of opportunity



The structure commented on also assumes a stand-alone hotel. In the event the hotel is part of a larger mixed-use development, or forms part of a building which also includes residential and/or commercial components (which will not form part of the hotel and will not be managed by the hotel operator), the structure necessarily becomes more complex. Additional issues and considerations will be involved in these circumstances.

## **Due Diligence**

The next step is to undertake a thorough due diligence exercise.

This will require the involvement of various professionals, including hospitality consultants, lawyers, surveyors, architects, accountants, insurers, government liaison representatives and potentially hotel operators.

The due diligence process forms the foundation upon which the project will evolve and the hotel will be built. It is a vital part of the process and it should be afforded sufficient time, resources and effort.

The due diligence process can be broken down into separate components, comprising the following:

- market research covering the geographical location of the project, competition of the proposed hotel, demographic information, potential customer analysis, the political and economic environment of the region, financial analysis of existing hotels in the vicinity of the proposed project, and trading and employment framework etc.;
- land and ownership investigation, to discover whether there are any potential problems with the land (survey and environmental issues), restrictions on the title or 3rd party interests etc., which may affect the development;
- development issues such as planning, access, utilities and licensing requirements – to understand what will be required, hurdles to be overcome and whether it will be possible to build the hotel as required;
- corporate structuring considerations: how does the acquisition impact the owner's corporate structure, is the project located in a different country, is a local company required, do property ownership restrictions apply to the owner, what corporate governance requirements need to be complied with internally?
- financial due diligence and planning: what is the tax regime in the location of the project, how does this impact the owner's existing operations and corporate structure, can profits be repatriated, does a foreign investment regime apply to the owner's investment, what duties will be payable where goods/materials/services are imported, what are the estimated development and construction costs, can workers and materials be procured locally or do they need to be imported, what borrowing requirements does the owner have, what security will a lender require, and general consideration of lending arrangements to be agreed;
- business plan, forecast and risk analysis (summarising all aspects of the due diligence); and
- (for non-operational assets), hotel operator expressions of interest: it is always beneficial to involve the hotel operator at the earliest stage possible, to obtain their feedback and opinion of the proposed project and the location, together with confirmation of their interest to manage the hotel (subject to agreement of terms).

Where the asset proposed for acquisition is an operational hotel, the due diligence process as outlined above will be required to a large extent. Additionally, detailed analysis of the existing hotel operation and management itself is required as follows:

- review of existing hotel management agreements and consideration of whether sale of the asset will require operator consent or trigger termination, or whether the agreement (and thereby the operator) may be assigned to the owner, does the operator have a first right of refusal to purchase the hotel?
- consideration of the commercial terms of the operator's appointment, including fees, exclusivity arrangements, the existence of a performance test, freedom to dispose of or grant security over the hotel etc.;

- review of the existing hotel management team and performance of the hotel to date;
- review of financial records and audited accounts to establish the trading history of the hotel, income and expense levels and resulting profitability for the owner;
- inspection and survey of the hotel itself: what is the condition of the rooms and public areas, is a refurbishment required?
- is the back of house in good order?
- what is the quality of the FF&E and operating equipment: is there a need for large scale replacement?
- what is the age and quality of the infrastructure and M&E plant - have these been maintained properly, what are the likely costs where replacement and/or repair are required, what warranties over the plant and equipment will be transferred to the owner?
- HR and employees: does a trade union exist, how does the employment legislation regime of the country in which the hotel is located impact operation, what are the likely owner's costs associated with employment of the hotel staff (i.e. pension and insurance contributions etc.), are there any pending legal actions or tribunals against the hotel/existing owner?
- review of all leases, supplier and service agreements entered into by the hotel: what are the obligations and liabilities?
- review of the hotel's insurances and claim history; and
- a detailed analysis of whether the hotel or existing owner is (or is likely to be) a defendant in any legal action, what are the existing and potential legal liabilities of the hotel?

On the assumption that all due diligence investigations, surveys, business plan, financial forecasting and risk analysis are acceptable, then acquisition of the asset can take place and the process will then move into a more detailed development stage.

## **Development Stage**

The development stage brings in further specialisms and professionals. During this part of the process, involvement will be required from hotel operators, architect and design consultants, a project manager and cost consultant, contractor and potentially other consultants as may be required subject to how the development team is to be structured.

The development stage will also depend on the type of asset that has been purchased.

### ***a. Development site***

If acquisition of bare land for development has occurred, the development stage will necessarily involve:

- appointment of the hotel operator, which ideally should be undertaken pursuant to a detailed RFP and selection process;
- obtaining the various development licences and planning permissions, and non-objections from local tourism authorities;
- commencement of concept design of the hotel, with involvement of the appointed operator to ensure that the hotel will, in all respects, comply with the operator's brand standards;
- preliminary development cost projections; and
- preliminary design and construction programme.

### ***b. Existing building (whether partially or fully completed)***

The development stage, where the asset acquired is an existing building, will follow the requirements of a development site for the most part, particularly with regard to hotel operator appointment and the design process (where the building is partially complete, or only completed to a shell and core finish).

In both cases (acquisition of a development site or an existing building), it is important that selection and appointment of the hotel operator occurs as early as possible. Such an early appointment will facilitate the design programme of the hotel, with the owner being able to obtain input, guidance and approvals from

the operator in line with the development programme. It will also ensure that the hotel is designed and built in accordance with the operator's brand standards, and allows the owner to draw on the experience of the operator with regard to market positioning and optimising the marketability of the hotel.

Late appointment of an operator may cause additional pressure and stress to the design and construction programme, and is likely to push up development costs, particularly if design needs to be re-worked to accommodate the operator's requirements.

### ***c. Operational hotel***

The development stage may or may not apply where the acquisition is of an operational hotel. This will depend upon whether the existing hotel management agreement is transferred to the owner and operation remains unaffected, whether renovation/refurbishment is required, or whether the hotel management agreement is terminated and a new operator needs to be appointed, with a major renovation.

In the event that the development stage does apply, then it will follow a similar path as per (a) or (b) above. Additional complexity will arise in the event of partial renovation or refurbishment of the hotel, which is to be undertaken without closing the hotel. This will need to be carefully considered, with the operator's views and approval obtained, before the renovation budget and programme can be finalised. It may also be a requirement of the operator that the hotel is 'de-flagged' during the renovation period until it is brand standard compliant.

Renovation of an hotel whilst it remains operational, is one of the most sensitive and difficult scenarios for owner and operator alike. Both parties will try to balance the need for a facelift to the hotel (to hopefully improve revenue) against the requirement for minimal impact on available room inventory, common areas, provision of services, and the guest experience generally. Time is of the essence, and the works programme needs to take these issues into account, which adds further management issues. This is a difficult balancing act to achieve.

## **Construction and Beyond**

The nature of the project will dictate what is required in terms of construction. The process will differ depending on what is required, i.e. construction of a new hotel, completion of construction of a partially built hotel, refurbishment/renovation of an operational hotel or conversion of a residential building into an hotel.

Renovation/refurbishment of an operational hotel will bring additional complications and considerations. In many ways, this situation raises the greatest risk to owner and operator alike and will require the most management by all parties to ensure that it is successfully executed with minimal impact on the operator, guest experience and revenue.

Once a schematic design is completed (incorporating the operator's input to ensure compliance with its brand standards and requirements), the owner can finalise the pricing and programme. The owner can then also commence the tender process for appointment of its contractor.

The owner's professional consultants should advise on the type of procurement method best suited to the project. This advice will structure the construction process, the team and the type of construction contracts to be entered into. The owner's consultants will assist in putting together the tender package and will identify suitably qualified, experienced and licensed contractors that should be invited to tender for the construction works.

In the event that the project is the completion of a partially built hotel, it may be that the best advice for the owner is to re-engage the original contractor for completion of the works. This would be appropriate where the quality of the work is acceptable and will avoid the need to find another contractor that is willing to take responsibility (and liability) for the existing works – something which is often difficult to achieve

and will come at a cost to the owner in any event.

Once the contractor has been appointed and the project costs and programme set, detailed design of the hotel can be finalised and fed to the engineer and contractor, and physical construction may commence (subject to obtaining all necessary approvals).

Throughout the construction process, the operator and the owner should continue to work together, to ensure that the operator remains fully involved in the design process, so that each stage of design and construction can be signed off by all parties. It is inevitable that issues, problems and delays will arise at some point, and this is where a cohesive and communicative relationship between owner, operator, professional team and contractor will prove to be beneficial. The construction process very rarely runs smoothly, and it will save time and money in the long term to deal with any issues quickly and proactively.

Completion of the detailed design will also enable the owner to fix specifications of all furniture, fixtures and fittings, thereby allowing these items to be procured. It is important to get the timing of this right and to work backwards from the estimated project completion date, ensuring that items with the longest lead times for order and delivery can be procured as a priority. In doing so, this should avoid any need to make late changes to the specifications (which will already have been approved by the operator and incorporated into the construction costs), as well as avoid delaying the construction programme and the anticipated hotel opening date.

## **Mock-up and Benchmark Rooms**

Completion of the detailed design will also allow the creation of a 'mock-up room' for each room type, for inspection and acceptance by the operator. Sign-off of the mock-up room establishes and fixes the design, layout and specification of the rooms and no further changes should be necessary.

Also, during the construction and fit-out process for the rooms, a 'benchmark room' should be established for each room type. Whilst the mock-up rooms fix design, layout and specification, the benchmark room fixes quality, actual construction processes and finished detail of the rooms. This serves as a marker for all those engaged in the construction, (from the plasterers to the electricians, the plumbers to the carpenters), and the benchmark room should not be deviated from, either in process or finishing quality.

## **Completion**

Upon completion of the construction works in accordance with the construction contract, the owner's engineer will issue a certificate of practice completion. This is issued subject to a defects' liability period (usually of 12 - 24 months), during which period any snagging or minor defects will be remedied. The authorities will also be required to issue a completion certificate, a permanent utilities connection, and ensure that the building is approved and insured for occupation following inspection of the works.

Completion of the works pursuant to the construction contract is a major milestone - upon this date, the hotel is physically handed over by the contractor to the owner and the risk of and responsibility for the property then passes to the owner. The owner will, in turn, pass the responsibility for management of the hotel to the operator, pursuant to the terms of the hotel management agreement (and ancillary agreements, as appropriate).

## **Pre-Opening**

Approximately 12 months prior to the estimated completion date, the operator must hire executive personnel for the hotel. These are the people who will work with the owner to take the hotel through the pre-opening stages to actual opening and full operation. Generally, the hotel general manager, the sales and marketing director and the financial controller are among the first employees usually hired. The owner should be entitled to interview candidates proposed by the operator for these roles and approve or reject

any proposed candidates.

The 12 months leading up to the opening date are busy for the operator – it is during this time that the sales and marketing strategy plan for the hotel must be put together, the pre-opening budget compiled for agreement by the owner, the first annual operating budget and performance forecast is compiled, cashflow forecasts and working capital requirements are prepared, and the rank and file hotel staff employed and trained. It is also an expensive time for the owner, as they will now start to provide the working capital that the operator requires to implement such points.

At the same time, the FF&E is being installed at the hotel and the construction phase is coming to a close. The operator will remain involved with completion of the hotel fit-out and decoration, protecting its brand throughout and ensuring compliance with the brand standards.

All the various operational licences must be applied for and obtained, including the liquor licence (if applicable) and local police/security department clearance in terms of surveillance and security systems at the hotel. Most of the operational licences will necessarily be applied for in the name of the owner, with the operator's assistance. To facilitate this and the management of the hotel generally, it is usual for the owner to provide the hotel general manager with a power of attorney.

Where an hotel is operated under a management agreement (which remains the most common form of agreement throughout the Middle East), usually the owner will be the legal employer and sponsor of the hotel staff. Therefore, whilst the operator will manage the staff on a day-to-day basis, and the staff remuneration and benefits packages will reflect those implemented by the operator (either on a regional or international basis), the owner remains legally responsible for the employees, and this includes payment of salaries and any end-of-service benefits as an operational expense.

In terms of marketing and advertising of the hotel, this period sees a gradual rise in activity, as the hotel will officially be included in the operator's portfolio and customer loyalty programmes, and centrally marketed through its international sales networks for bookings to commence. Closer to the opening date, the hotel will also be marketed on a local and regional basis and events will be planned for the opening date. Sometimes, where the operator is comfortable to do so, an hotel may open on a 'soft opening' basis. This is a period prior to the official opening date where the hotel may be partially occupied and therefore not very busy with guests, which allows the staff a period of time to implement their training on a 'live' basis and to de-bug any problems that may arise.

## **The Opening Date**

At some point during the pre-opening period, the owner and the operator will agree and fix the official opening date of the hotel. Ideally, this might be timed to coincide with a particularly busy period for the tourism industry specific to the location of the hotel, or with any major conferences, exhibitions or sporting/leisure events taking place within the vicinity of the hotel. Wherever possible, the intention should be to maximise the impact of the launch of the hotel and to capitalise on these events by attracting as many guests as possible. This should allow the hotel to firmly establish itself and commence development of its reputation and customer loyalty.

Completion of the hotel under the construction contract will be subject to snagging and rectification of any minor defects, and the operator will play an important part in logging all the various items with the owner, which will require such remedy by the owner's contractor over the next 12 – 24 months. The operator will want these items to be remedied as swiftly as possible with as little inconvenience to the hotel operation as possible. Retention of a percentage of the construction costs from the owner until all the defects have been remedied also provides the contractor with an incentive to remedy as soon as possible.

## **The Start of a Beautiful Relationship...?**

On the opening date, the development process (save for snagging) draws to a close and the operator assumes control of the operation of the hotel and hopefully, a return of profit to the owner.

The official launch of the hotel is an exciting time for all involved. It is the culmination of the hard work and endeavours by many individuals involved during the time leading up to this event. It may have been a very stressful or relatively painless process but however the hotel comes into being, the road ahead should hopefully be the start of a long, fruitful and mutually beneficial relationship between owner, operator and of course, the guest.

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