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Pop-Up Hotels to the Rescue

Michael Goodwin, *Arnold & Porter*, Washington, DC

A significant cost of developing a new multifamily project is carrying the project from completion through stabilization. Pop-up hotels - one of the newer manifestations of the "sharing economy" - offer multifamily developers the opportunity to transform what is typically a period of negative cash flow into a money-making opportunity.

When construction of a new apartment building is completed, the building is typically fully assessed for real estate tax purposes. Operating expenses must be paid, many of which (like insurance) are relatively fixed and do not depend on the level of lease-up. And that pesky construction lender is still looking for payment of monthly interest on its loan.

The revenue side of the new building is typically slower to ramp up. Even in a strong market, a large apartment building may require well over a year for initial lease up. For example, a new 300-unit building may take 10 to 24 months to fully lease up and stabilize.

Enter the pop-up hotel. Just as the sharing economy has enabled homeowners and renters to generate extra income from their underutilized space, so pop-up hotels are creating revenue-generating options for multifamily developers with unleased units.

Consider a 300-unit apartment building that requires 24 months to lease up. If half of these units are set aside, fully furnished and operated as short-term rentals, the revenue potential could generate positive cash flow from the day the building opens. As lease up proceeds, short-term rental units can gradually revert to long-term residential use, and the hotel component wound down.

Not only does the pop-up hotel bridge the revenue gap between completion and stabilization; it can also help reduce the duration of that gap. Properly structured and managed, the pop-up hotel can serve as an amenity for long-term renters and actually accelerate the lease-up process. Prospective tenants - particularly if visiting from out of town - can stay at the pop-up hotel before signing on the dotted line of a lease. As a lease-up incentive, free or discounted hotel rooms can be offered to prospective tenants. The proximity of the hotel is an amenity when tenants host out-of-town guests, and the hotel may extend its services (e.g., cleaning and other al la carte hospitality services) to long-term tenants.

WhyHotel (whyhotel.com) has been the first to market in the pop-up hotel space. WhyHotel was initially created by Vornado Realty Trust for a new apartment building developed by Vornado in Arlington, Virginia. When the pop-up hotel proved a huge success, Vornado spun off WhyHotel as a separate, privately-owned company. WhyHotel currently has hotels up and running in Washington, DC and Baltimore, with a significant pipeline of additional hotels in the works. If you are in a major metropolitan area, look for a WhyHotel coming to you some time soon.

This is a legal publication so let's talk about legal documents. The WhyHotel template involves a management agreement between the building owner and WhyHotel, as manager. Under the management agreement, the owner engages WhyHotel to manage a pool of units within the building for short-term rental use only. WhyHotel agrees to furnish the units at its cost, and then manages the rental and operation of the units on a soup-to-nuts basis. It pays the cost of popping-up and then operating the hotel (including a management fee to itself), and remits the balance of the revenues to the owner as profit.

Given the relatively short-term nature of the pop-up hotel, the management agreement is simpler than you might expect (particularly if you who have grown accustomed to hotel management agreements with pages numbering in the hundreds). It contains many of the provisions that you would typically expect to see in any property management agreement, such as budget approvals, indemnities, insurance requirements and the like. It also includes provisions that are unique to the pop-up hotel:

- The term is geared to the anticipated lease-up period. The owner will have the right, within agreed-upon parameters, to recapture units earlier if lease-up is faster than anticipated.
- To accommodate residential lease-up, the owner may also have the right to swap units - i.e., provide to WhyHotel additional units for hotel use, while WhyHotel returns to the owner a like number of units for residential use.
- WhyHotel's operations will be restricted to short-term rentals so that it does not compete with the owner's lease-up of the building. By the same token, the owner will typically agree that WhyHotel will be the only purveyor of short-term rentals in the building.
- As discussed below, the regulatory regime for short-term rentals is rapidly evolving in jurisdictions around the country. The management agreement will need to address the risk that the pop-up hotel cannot open - or that a regulatory change requires the pop-up hotel to be shut down.
- When units are released from the short-term rental pool for residential lease-up - either at the end of the term or if recaptured earlier by the owner - the management agreement will provide that WhyHotel must return the unit in "rentable condition" (i.e., substantially the same condition as other units leased by the owner).
- Popping up a hotel in a portion of a building that is in the final phases of construction is a challenge. The management agreement needs to address, in ways that can be tailored to the needs of each property, the process for cooperation between WhyHotel and the owner in getting the pop-up hotel up and running.

Many of the largest national apartment developers are publicly-traded REITS, so WhyHotel's relationship with these owners must navigate the complex requirements of the REIT rules. To insure that the income from the WhyHotel units is "good" income for REIT purposes, WhyHotel and the REIT owner will enter into a lease of a pool of units in lieu of a management agreement. WhyHotel will pay rent under the lease based on a percentage of gross revenues, similar to the traditional retail participating lease format. In a lease structure, WhyHotel is taking more of the economic risk of the operations, so the rent to the REIT owner will be typically somewhat less than the net profit that is payable to the owner in a management agreement structure. Otherwise, many of the operational details of the lease are similar to those of the management agreement.

The news is awash with reports of jurisdictions that are struggling to find ways to appropriately regulate short-term rentals. Many of the regulatory regimes are aimed at single units, so do not affect the pop-up hotel concept. More fundamentally, the WhyHotel business model does not raise many of the concerns usually leveled at short-term rentals. WhyHotel does not take affordable housing units out of the market. To the contrary, WhyHotel subsidizes the addition of new units to the rental supply. A pop-up WhyHotel also does not represent a threat to its neighboring community. WhyHotel venues are located in dense urban environments and not single family neighborhoods. The long-term tenants in WhyHotel projects are informed about the pop-up hotel when they rent their units, and as mentioned above typically view the hotel as an amenity and not as a threat.

If, like me, you perennially register late for ACREL meetings and there’s no room at the inn, maybe a nearby WhyHotel will be the answer?