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PUBLIC SUBSIDIES FOR HEADQUARTERS HOTEL DEVELOPMENT

By Charles Johnson and Robin Hunden

Throughout the country in the last ten years, cities large and small have been building and expanding convention centers at a rapid pace. While consistent with demand, this influx of space comes with a need to also offer a package of large, high-quality hotel room blocks, usually found only in larger convention hotels. As these properties are difficult to finance in any market, the public sector has jumped into the mix to help facilitate their development.

Since 1995, one of the most notable trends in public finance has been the use of municipal bonds and other public funding to enable the development of convention headquarter hotels. By a conservative count, the public sector has provided nearly half of the total \$3 billion spent to finance 20 major convention hotel developments since 1995. The accompanying table shows a summary of recent public-private hotel developments. This participation made possible the creation of 15,000 hotel rooms that now serve as the hospitality centerpiece of convention center developments.

This article addresses the following questions:

- Why would communities need or want to subsidize a hotel?
- If subsidies are necessary, what different strategies have been used to provide them?
- Should your community use financial incentives to induce the development of a convention hotel?

Proactive Reasons for Public Involvement

The business of establishing a successful urban core was once the secret to success of a few pioneering cities. In recent years, however, the expectation has spread to most cities, regardless of size or historical development patterns. Competition for free-spending tourists, conventioners and businesses has become fierce, as has creating a positive environment for visitors and residents. This has led to a building boom not only of convention centers, but sports venues, retail, housing, hotels and cultural attractions in most urban centers in the United States. Early analysis indi-

cates that cities that are not proactive and fail to spur urban core development will be at a competitive disadvantage in the future when venues, traffic flow and pedestrian access are not convenient or well-planned for visitors, residents, and business users.

Cities today are increasingly aware that planning hotels adjacent to convention centers, with additional access to other urban amenities, is necessary to help both properties succeed. Meeting planners demand easy access between venues, especially convention centers and hotels. Cities that fail to respond have been unable to attract meetings and conventions. Because of event growth, meeting planners demand larger and larger room blocks and try to house their entire membership in a small cluster of hotels. Cities that wish to remain competitive in the tourist and convention market must be visionary, proactive and creative in the sizing, placement and connectivity of major hotels with their convention center(s) and other attractions.

Reactive Reasons for Public Involvement

Cities have become involved in the financing of hotels due to the economic reality that convention hotels are key to the success of their tourism package. At the same time, such hotels are large financial undertakings that often do not provide enough of a return on investment for the private development community to tackle. Developing the appropriate project with the optimal level of meeting and support space results in a comparatively expensive project.

The sheer size of these projects, including extensive meeting and parking infrastructure, places financial pressure on the hotel during its early ramp-up years. The issue is not necessarily the long-term operating characteristics of the hotel. Most large hotels, as they stabilize after three to five years, perform well. The issue pertains to early year deficits and efforts to minimize risks, such as late convention center openings, longer than expected ramp up periods, or cost overruns. Once these poor early year

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ARE THEY NECESSARY?

Cities around the country have taken an increasingly active role in the development of convention center headquarter hotels in the last several years. While cities in the past have focused primarily on convention center development, it has become clear that a successful center is highly dependent upon a high-quality convention hotel located adjacent to or very close to the center. This article explores the importance of these hotels in economic development and the reasons for public involvement. It provides examples of how these collaborations have played out in four cities around the country.

Recent Public-Private Hotel Developments									
City	Brand	Status	Rooms	Total Cost	Cost/Room	Public Participation	Public Participation as a % of Total Cost	Private Investment	Private Conventional Investment as a % of Total Cost
Atlantic City	Sheraton	Opened 1997	502	\$ 81,200,000	\$ 161,753	\$ 38,200,000	47.0%	\$ 43,000,000	53.0%
Austin	Hilton	Opening 2004	800	\$ 178,000,000	\$ 222,500	\$ 178,000,000	100.0%	\$ -	0.0%
Baltimore	Marriott	Opened 2001	750	\$ 133,000,000	\$ 177,333	\$ 10,000,000	7.5%	\$ 123,000,000	92.5%
Boston	Sheraton	Moving ahead w/out solid financing	1,120	\$ 270,000,000	\$ 241,071	\$ 24,750,000	9.2%	\$ 245,250,000	90.8%
Charlotte ³	Westin	Under Construction; Opening 2003	700	\$ 143,000,000	\$ 204,286	\$ 16,000,000	11.2%	\$ 127,000,000	88.8%
Chesapeake ¹	Hyatt	Opening March 2002	400	\$ 155,000,000	\$ 387,500	\$ 152,000,000	98.1%	\$ 3,000,000	1.9%
Chicago ¹	Hyatt	Opened 1998	800	\$ 108,000,000	\$ 135,000	\$ 108,000,000	100.0%	\$ -	0.0%
Denver	Hyatt	Pre-Development	1,100	\$ 220,000,000	\$ 200,000	\$ 55,400,000	25.2%	\$ 164,600,000	74.8%
Denver (renovation/expansion)	Adam's Mark	Opened 1998	1,230	\$ 135,000,000	\$ 109,756	\$ 25,000,000	18.5%	\$ 110,000,000	81.5%
Houston ¹	Hilton	Opening 2004	1,200	\$ 275,000,000	\$ 229,167	\$ 275,000,000	100.0%	\$ -	0.0%
Indianapolis	Marriott	Opened 2001	615	\$ 100,000,000	\$ 162,602	\$ 23,000,000	23.0%	\$ 77,000,000	77.0%
Madison	Hilton	Opened 2000	222	\$ 29,000,000	\$ 130,631	\$ 10,000,000	34.5%	\$ 19,000,000	65.5%
Miami Beach	Loews, 650 rooms; St. Moritz, 150 rooms	Opened 1998	800	\$ 110,000,000	\$ 137,500	\$ 29,000,000	26.4%	\$ 81,000,000	73.6%
Minneapolis ²	Hilton	Opened 1992	816	\$ 144,800,000	\$ 177,451	\$ 89,200,000	61.6%	\$ 55,600,000	38.4%
Overland Park ¹	Sheraton	Under Construction; Opening 2002	412	\$ 88,000,000	\$ 213,592	\$ 88,000,000	100.0%	\$ -	0.0%
Philadelphia	Loews	Opened 1998	350	\$ 54,000,000	\$ 154,286	\$ 18,000,000	33.3%	\$ 36,000,000	66.7%
Philadelphia	Marriott	Opened 1995	1,408	\$ 236,500,000	\$ 167,969	\$ 36,500,000	15.4%	\$ 200,000,000	84.6%
Sacramento	Sheraton	Opened 2001	503	\$ 95,000,000	\$ 188,867	\$ 95,000,000	100.0%	\$ -	0.0%
Saint Louis	Renaissance, 916 Rooms; Ren. Suites, 165 Rooms	Opening 2003	1,081	\$ 276,600,000	\$ 255,874	\$ 80,000,000	28.9%	\$ 196,600,000	71.1%
Tampa	Marriott	Opened 1998	716	\$ 93,500,000	\$ 130,587	\$ 16,500,000	17.6%	\$ 77,000,000	82.4%
Wichita	Hyatt	Opened 1998	303	\$ 42,385,000	\$ 139,884	\$ 20,069,000	47.3%	\$ 22,316,000	52.7%
Average (if applicable)			754	\$ 141,332,619	\$ 187,029	\$ 66,077,095	46.8%	\$ 75,255,524	53.2%
Total (if applicable)			15,828	\$ 2,967,985,000		\$ 1,387,619,000		\$ 1,580,366,000	

¹Owned by public sector through the sale of tax-exempt revenue bonds to private investors, which usually include hotel management

²City recently sold its interest in the hotel and is using proceeds for other economic development initiatives

³Charlotte also contributed a \$25 million credit enhancement

Source: C.H. Johnson Consulting, Inc.

economics are folded into the long-term financial picture, overall returns fall below alternative investment vehicles. As a result, there is reluctance among banks and other lending institutions to lend to larger hotels, unless there is an equity ratio of up to 50 percent.

The financial realities of convention hotels belie the notion that large groups will constantly fill the hotel, keeping it profitable. Large conventions are the exception, not the rule, in most cities. Several large city-wide conventions that a hotel-convention center package attracts each year do nothing to fill the large supply of rooms during the rest of the year. So although a city may want to build a 1,000-room property to host the largest conventions, reality dictates a more humble project.

Another motivation for cities' involvement in the support of downtown convention hotels is to reign in suburban sprawl and focus economic energy in their downtowns. Suburban growth, in many instances, has come at the expense of downtowns and their centralized resources. Often when hotels are subsidized, there is criticism from various groups. However, these direct subsidies pale in comparison to the indirect and unmeasured cost of spreading cities' infrastructure to outlying areas. The efforts of economic development officials have not been to just keep other cities from luring businesses

and their spending to other states, but to keep urban businesses from moving to their own suburbs.

Downtown boosters have been fighting for workers, visitors and residents since the suburban boom began. When given a choice, private hotel developers will often build limited service hotels in suburban locations, due to lower risk and lower overall costs for land and buildings. As hotel offerings and other services expand in the suburbs, businesses find it easier to move from the central business district to suburban locations. A lack of quality Central Business District hotels contributes to the push of local businesses out of downtowns, as full service hotels are a key amenity to corporate location. But limited service hotels clustered around suburban interstates do nothing to lure conventions, meetings or tourists and undermine the economics of center city full-service hotels.

Cities have responded to the new reality of the convention hotel business in numerous ways, depending upon various state and local laws and financing mechanisms. Assistance ranges from favorable land leases at one end of the spectrum, to regulating development of limited service hotels in the middle range of intervention, to complete public ownership of hotels at the farthest end of the spectrum.

The following examples illustrate how cities have recently participated in convention hotel development in a cross section of markets.

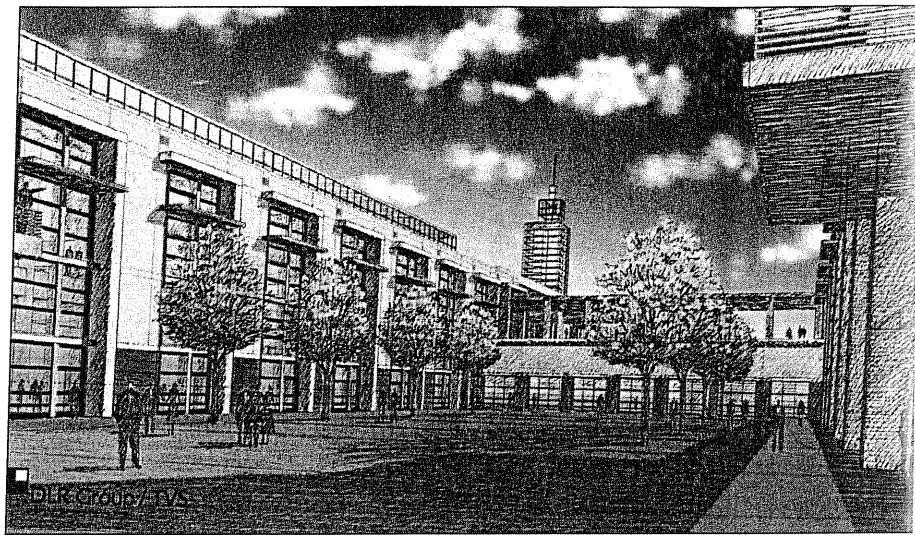
Overland Park, Kansas

The city of Overland Park, Kansas, adopted a strategy in the early 1990s to capitalize on its status as a successful edge city with a large corporate presence. Located on the outskirts of Kansas City, Overland Park determined that to create a total corporate visitor package, a convention center complex with adjacent hotel was appropriate. With only a small exhibit hall and a large wave of limited service hotels, the market challenge was apparent. The public sector funded development of the \$60 million Overland Park Convention Center but still needed a hotel to complete the package, resulting in a recent public/private partnership.

Project: The 412-room Sheraton is an upscale hotel with 30,000 square feet of function space. The total project costs (excluding financing) are budgeted at approximately \$70 million for hard costs. Total costs, including soft costs and some shared infrastructure costs for both the hotel and convention center are \$88 million. The \$70 million investment is slightly higher than the cost of the convention center. The hotel is directly connected to the Overland Park Convention Center, which is being designed and constructed simultaneously, but as a separate project with separate financing. The hotel is designed by TVS and DLR and constructed by Turner Construction. Turner has provided a guaranteed maximum price for approximately \$54 million of the hotel's construction costs. The hotel will be owned by the city, and will require a subsidy for debt service. Use of tax exempt financing, described next, reduced the hotel's subsidy.

Project Financing: The project is being financed through the issuance of tax-exempt municipal bonds under IRS rule 63-20, which allows the formation of a not-for-profit corporation by the public sector in order to qualify for tax-exempt funding status. Overland Park established such a single purpose nonprofit corporation that issued approximately \$88 million in non-recourse debt to be repaid from revenues of the hotel.

Approximately \$60 million in Series A bonds are rated as investment grade and consequently carry an interest rate below 7 percent. This rating is made possible by high coverage ratios and a debt service guarantee from the city. The city agreed to provide debt service support by dedicating approximately \$5.0 million of its annual Transient Guest Tax Collections to pay debt service in the event that the hotel's revenues are insufficient to pay debt. This debt service support agreement will stay in place until the hotel achieves stabilization. Approximately \$20 million in Series B bonds will be subordinated to Series A bonds but will also be supported by the city debt service support agreement. These bonds were purchased by qualified institutional investors. The interest rate on these bonds was slightly above 8 percent.



The 412-room Overland Park Sheraton Hotel is an example of tax-exempt financing being used to fund an edge-city convention center and hotel.

Approximately \$8 million in Series C bonds served as quasi-equity in the deal because they are to be paid only after all other operating subsidies, debt service reserve funds and management fees are paid. These bonds were acquired by Sheraton, the operator, the developer, and a small investor group. These bonds were important to the deal as they provide incentive to the operator and the developer to make the project succeed. The interest rate on these bonds approximated 11 percent due to the fact that the Series C bondholders are exposed to the greatest risk. The operator is also provided an \$800,000 working capital loan.

In addition to its debt service support agreement, the city contributed approximately \$3.9 million in land that will be leased to the public corporation on favorable terms. The city is also contributing approximately \$1.0 million in road and infrastructure improvements and \$1.0 million in shared costs of the convention center and the hotel (e.g. the convention center and the hotel share a common power plant which is to be paid for by the convention center project).

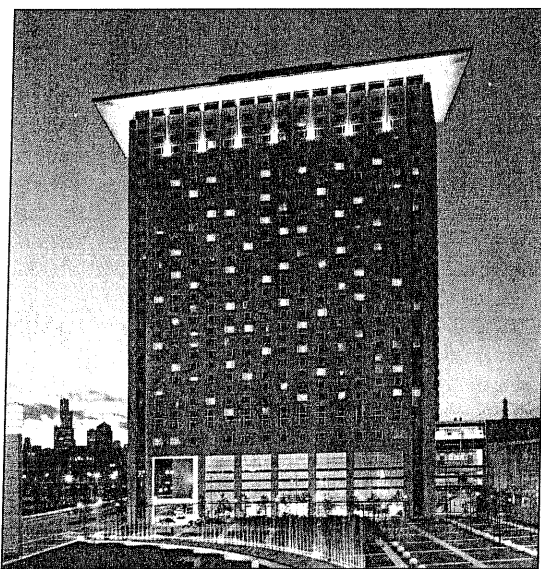
The most positive aspects of this deal were sharing of costs with the convention center and an enlightened City Council that invested time to understand the convention and hotel industry and who were willing to "own" the hotel to take advantage of tax-exempt financing savings. It was also fortuitous that Sprint's headquarters were announced next to the site.

Indianapolis, Indiana

Indianapolis has taken a proactive approach in planning its downtown over the last 20 years with the goal of creating a synergistic collection of convention, visitor, sport, retail and other venues laid out in a compact area. Meeting planners appreciate this compactness. However, by 1995 the city



The 615-room Indianapolis Marriott (above) was developed as a traditional public-private venture, with the city paying for public spaces and infrastructure. The hotel connects directly to the recently expanded Indiana Convention Center. Chicago was the first city to finance a convention hotel with tax-exempt bonds to be repaid with hotel revenues. The 800-room Hyatt McCormick Place (right) has helped the city retain shows that required a room block onsite.



was losing conventions as events began to outgrow the facility's 1992 expansion as well as the adjacent hotels, the largest of which was the 573-room Westin.

In 1996, Indianapolis committed to expand its convention center by 100,000 square feet of exhibit space and knew it needed a headquarters hotel to accommodate the type of business the city wanted to attract. "We needed a hotel to complement the expansion. It was a chicken and egg issue," says Rick Hughes of the Indianapolis Convention and Visitors Association. The city also was keenly aware that high-profile events that it sought, like NCAA Final Fours and higher-rated conventions, demanded large, high-quality hotels connected to the Indiana Convention Center and RCA Dome complex.

The city set about to find the least-expensive way to satisfy the convention and meetings market. After analyzing several scenarios, including an expansion of the Courtyard Marriott complex into a full-service campus and an expansion of the Westin hotel, Indianapolis chose to participate in the development of a new 615-room Marriott hotel connected to the convention center and adjacent to the Westin.

Project: The hotel, designed by HOK and developed by a partnership of White Lodging, REI Investments, and The Kite Companies, includes 615 guest rooms, a concierge floor, 40,000 square feet of meeting and ballroom space, including a 20,000-square-foot ballroom, suites, a lounge and two restaurants. A 300-space parking garage was built underneath the hotel and above-grade connectors were built to an adjacent garage (shared with the state office building complex) as well as the Indiana Convention Center. The hotel is the second-largest Marriott franchise property in the chain.

Financing: The city issued an RFP stipulating that it wished to participate in a 600+ - room hotel and would make available up to \$23 million to construct public areas, plus a long-term favorable land lease and funds for the two connectors. To avoid conflict with laws banning public funds for private development, Indianapolis used its funds to construct the parking garage, the connectors (approximately \$1.5 million), public spaces and infrastructure for the project. The remaining project costs, approximately \$75 million, were paid for by the private sector. The city financed its portion by extending the TIF bonds originally used for construction of Circle Centre Mall, located just two blocks away. The hotel opened in the spring of 2001 and has been a major success for the convention center and the city.

Chicago, Illinois

Chicago faced an interesting dilemma when completing its last expansion of McCormick Place. Although Chicago reigns as the leader of the convention industry, its position has been threatened as warm-weather cities such as Las Vegas, Orlando, and Atlanta have enticed business away with ever-larger facilities, large convention hotels, lower labor costs and sunnier climates. In an all-out effort to retain convention business, the city took a proactive stance on all fronts, including insuring that its hotel supply question was answered. Although Chicago had approximately 25,000 hotel rooms downtown, there were no hotels within walking distance of McCormick Place, a fact that clearly irritated convention planners. While there was a hotel onsite before convention center expansion, the hotel lay in the path of the Center's expansion and was condemned.

With little else around McCormick Place to generate demand, the Metropolitan Pier and Exposition Authority (the MPEA, a joint body of state and city appointees) determined it would have a difficult time enticing a private developer to build a hotel in a place where demand could be 100 percent one day and

substantially less the next. The financial reality was too unstable for any developer or lender to accept. "We ultimately concluded we were better off financing and owning it ourselves," says James Reilly, CEO of the Authority during the project. "We could borrow money cheaper than anybody else." So the MPEA took on the project itself, in one of the first projects of its kind. The initial response of the municipal bond community was caution, however, Reilly notes "We were kind of a first in the bond market. We had to do a road show...to convince them that the hotel revenues would cover the debt service. We were successful in doing that because McCormick has such a full calendar." The hotel's cash flow plus the Authority's robust funding source supported the project.

The results have been successful for hotel performance and McCormick Place. The hotel has covered its bond obligations and the city has retained the vast majority of its largest shows, which continue to expand. Others have been attracted to the market. As a result, the Authority will soon expand McCormick Place by another 660,000 square feet of exhibition space.

Project: The Hyatt McCormick Place is a 32-story, 800-room full-service convention hotel attached to the latest expansion of McCormick Place and includes all of the amenities of a full-service hotel. The original intent was to have a reduced amount of in-house meeting space, with the assumption that when McCormick Place wasn't full, sufficient meeting space could be used in the interconnected McCormick Place. As such, a limited amount of space was provided.

Attributes include a 12,600-square-foot ballroom, a full-service restaurant, lounge, health club, indoor pool and game room. Due to IRS regulations, the initial term of the management contract was five years with renewal options. Within the development is a 600-space parking garage and a grand porte-cochere with dancing fountains. A conference center offering 31,000 square feet of meeting space and funded by the MPEA has subsequently been added, addressing the Hyatt's original lack of meeting space and adding a new dimension to the McCormick Place campus.

Financing: Project funding was made possible by the issuance of tax-exempt bonds in the amount of \$108 million by the MPEA. The bonds are being repaid by revenue streams generated from the hotel and garage as well as a \$23.2 million equity contribution by the Authority.

Houston, Texas

Houston is one of the largest cities in the country, yet it has a downtown with less than 1,800 hotel rooms. The need for more rooms has been an issue for almost two decades. Cities of comparable size have central business district room counts three to six times that amount. Considering Houston's convention center size, with 550,000 square feet of prime exhibit space (the fourth largest in the nation), as well as the city's interest

in developing a stronger and more compact central city, Houston was desperately lacking not only a headquarters hotel, but any amount of rooms for conventioners to stay in. When city leaders were faced with the need to expand the center to over 700,000 square feet of exhibit space because of interest in annual and national events, they quickly realized that a hotel component was not just warranted, it was essential for the survival of their market as a convention destination.

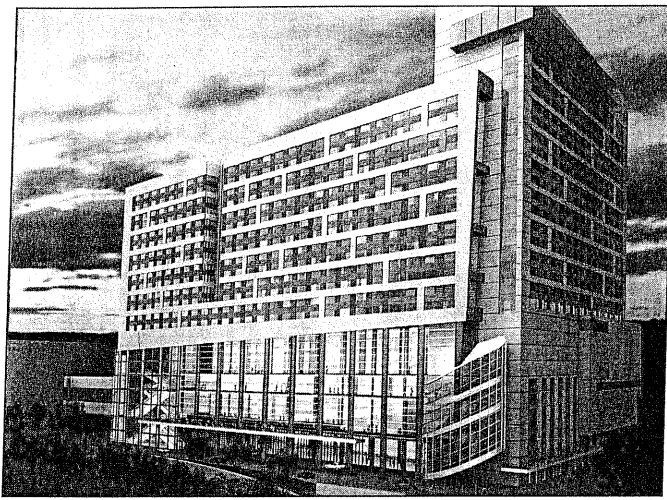
After 15 years of working to come up with a headquarters hotel plan that worked, the city of Houston recently announced it will spend \$630 million to expand its convention center and build a new convention hotel. The weak Houston downtown hotel market and generally weak downtown atmosphere proved too tough a burden for a privately-developed facility. Mayor Bob Lanier, who originally opposed the idea of public funding, changed his mind after learning of the economic impact of the hotel and the difficulty in securing private financing. "The numbers just didn't work." As a result, according to Lanier, the city has invested heavily in the hotel, which fortuitously follows many other downtown investments, including the convention center expansion, substantial housing and the new baseball stadium.

Project: The Hilton Americas 1,200-room headquarters hotel located adjacent to the convention center will be managed by Hilton Hotels for 15 years. The hotel is expected to be complete in October 2003, just prior to the Superbowl in January 2004. The Gensler & Associates design includes two large ballrooms, several restaurants, a parking garage and spa, as well as two skyways connecting it with the George R. Brown Convention Center. The development will increase the number of rooms downtown from 1,800 to 3,000. And with this development and other downtown efforts, several private hotel projects are in the works that will add hundreds of additional rooms.

Financing: Estimated costs for the total project are \$630 million (\$275 million of which is for the hotel), but the city of Houston will issue up to \$700 million in tax-exempt public bonds for the hotel, garage and convention center expansion if necessary. Under 1992 state legislation specific to Houston, a municipally-owned non-profit corporation that owns a 1000+room hotel is allowed to recapture all state taxes, including bed, sales, and beverage taxes, for ten years. The same law also permitted any local government body to rebate their applicable taxes. This tax rebate adds up to a \$100 million value for the project. "It allowed us to do what was not possible," said Jordy Tollett, director of the city's Convention and Entertainment Facilities Department.

For hotel loans, commercial interest rates range from 10 to 14 percent, depending on risk, while the municipal bonds issued being used for the project have a rate of 4.9 percent. The savings on public versus private financing amounts to \$30 million per

“ Building large hotels is very difficult due to their sheer size and cost. However, large hotels are essential for successful convention center environments to work properly. Public entities have owned hotels for many decades, as evidenced by numerous land lease structures at airports and in downtown settings. However, more direct participation has been called for as the private sector has had difficulty obtaining hotel financing at reasonable equity and interest rate levels. ”



The city of Houston used tax-exempt financing to fund the 1,200-room Hilton Americas Convention Center Hotel, along with the expansion of the George R. Brown Convention Center and a 1,600-space parking structure.

year in interest costs for the project. In addition, because the project is owned by a not-for-profit corporation, there will be no property taxes payable, leaving more revenue for bond coverage.

Public Participation Options

Building large hotels is very difficult due to their sheer size and cost. However, large hotels are essential for successful convention center environments to work properly. Public entities have owned hotels for many decades, as evidenced by numerous land lease structures at airports and in downtown settings. However, more direct participation has been called for as the private sector has had difficulty obtaining hotel financing at reasonable equity and interest rate levels.

Public participation can help hedge the financial risk in the early ramp-up years of a large convention hotel property. Credit enhancements, tax turn backs and abatements, and capital investment that count towards equity are all tools that are used to get over the initial bubble period. The public sector has creatively dealt with participation in many ways, sometimes unique to state and local regulations.

The most direct form of public participation is public ownership of the asset, allowing the hotel to qualify for tax exempt financing and avoid property taxes. In this instance, the city is investing in the hotel as an insurance policy for its convention center and urban renewal efforts. This approach was used for Chicago's Hyatt McCormick Place, Houston's new 1,200-room Hilton, and in Overland Park, Kansas' new Sheraton hotel. Other public investment, in the form of inducements to bridge the financing gap, has taken the form of land assemblage, public payments for parking and infrastructure, and funding public components of the hotel, such as meeting and ballroom space. This approach was used in Norfolk for its Marriott, Portsmouth for the new Renaissance, Indianapolis for its Marriott, and in many other markets. Another strategy uses

grants, tax abatements, or creation of districts where taxes earned in the district are used to fund the public contribution. Often a combination of these sources is used to make a project happen, as has been demonstrated in numerous instances.

Land leases are also a common incentive for hotel developers. In some cases, a public entity may acquire the necessary land and lease it back to the developer for below market rates. The advantage to land leases is that they lower the development costs and allow the cost of the land to be amortized and subsequently paid for out of operating revenues.

The following is a list of incentives provided by public agencies to stimulate hotel development:

- Tax abatement
- Tax rebates
- Tax Increment Financing (TIF)
- Equity participation
- Construction of meeting space, parking structure, and/or other infrastructure
- Credit enhancement of financing
- Rebate of development fees for licensing, permitting and water and sewer hookup fees
- Free or nominal ground rent
- Section 108 loans
- Community Development Finance Authority (CDFA) grants or Community Development Block Grants (CDBG)
- Land assemblage

The options available to cities and developers continue to increase as both the public and private sector create new funding mechanisms unique to the legal, financial, and other political realities of the city, county or state.

Are convention hotels necessary? The reality in today's competitive convention market is this: the market has demanded and received top-quality hotel and convention center packages, usually connected to each other, in most major U.S. cities. Even small cities have stood behind the development of smaller hotel and conference center developments. For a community to be competitive in the industry, a convention center alone will not suffice. Clearly, the destination package must include a solid-quality convention hotel.

Should your community consider using the public sector to induce development of a convention or conference hotel? If the need exists to move forward on a convention or conference hotel, communities should explore their options and determine the level of public support, if any, that is needed for an appropriately sized hotel to be developed. Some communities have leveraged very small investments into large private commitments, while others, as shown, have completely funded the projects.

What has been proven is that where there is leadership, vision and energy by local boosters, be it politicians, the business community, the convention and visitors bureau, philanthropic institutions, or all of the above, convention hotels can become a reality through public-private partnerships.