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Conversion of Offices to Hotels

Hotel to Office Conversion in Kuala Lumpur

Is there a gap in the Market?

An Introduction

The conversion of office buildings to hotels is an easy way to maximise asset values in certain markets and is resulting in a large change in the way property developers go about creating new hotels. A good example of positive profit being made, can be seen in Germany. With a large amount of office to hotel conversion being used for Budget Hotels, new franchises located around Berlin near busy transport lines are seeing large gains in room occupancy and revenue per available room (RevPar). Hotel Indigo Berlin Hardenbergstrasse is an 81 room office conversion. Opened in Spring 2012, tourists are attracted to the hotel by its cheap prices and prime location. The hotel sits close to the famous Ku'damm Avenue, known for its designer shops, restaurants and bars.

Furthermore, with a drop in VAT accommodation rate from 16% to 7%, it has allowed not only reductions in Room rates 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? And is it possible for Kuala Lumpur to capitalize on the success of others in this industry, and in turn increase the net profit and yield of vacant offices in the region.

The Indigo Berlin Hardenbergstrasse

What is the Purpose of conversion?

Exploiting the Current Market

In the 1Q 2013, NAPIC (National Property Information Centre) stated in its Commercial Stock Report that there is a total of 104 million sq ft office space in Klang Valley. The overall vacancy rate in the market is reported at 23 per cent, slightly lower than the 25 per cent vacancy rate recorded in the previous quarter. The vacancy rate reflects not only empty office a place where business is not taking place, it also means the loss of hundreds, if not thousands of RM a day in rent, as well as the knock-on effect to other businesses.

Contrasting this to the UK where nationally around 12 per cent of offices have stood empty in recent years, with some areas including Birmingham reporting 18 per cent of commercial property standing empty, we can see Malaysia is in more need of filling commercial office space. In order to combat this in the UK, the government believes that thousands of sites could be converted into homes (rather than Hotels) while still meeting future demand for offices when the economy picks up. It is thought a vacancy rate of just five per cent would be sufficient to cope with the 'churn' of offices as business start-up, grow and in some cases fail.

This is interesting to note as Malaysia's current vacancy rate is nearly double the Britains which means there is more of a gap in the market for Office to Hotel investments, in order to take advantage of empty commercial spaces. Furthermore, in Malaysia, which sees an ever increasing tourism rate, with arrivals in 2012 reaching an all time high of 25.03 million, Vacant office buildings in the city, which often have prime locations nearby popular holiday destinations are perfect buildings to convert into Hotels. With the buildings being tenanted by nothing more than dust and with the rise in tourism sector at a steady rate, the conversion of vacant office buildings to hotels, seems to go hand in hand with the growth of tourism in Malaysia.

Rising Tourism Arrivals in Malaysia

TOURIST ARRIVALS & RECEIPTS TO MALAYSIA

YEAR	ARRIVALS	RECEIPTS (RM)
2012	25.03 Million	60.6 Billion
2011	24.71 Million	58.3 Billion
2010	24.58 Million	56.5 Billion
2009	23.65 Million	53.4 Billion
2008	22.05 Million	49.6 Billion
2007	20.97 Million	46.1 Billion
2006	17.55 Million	36.3 Billion
2005	16.43 Million	32.0 Billion
2004	15.70 Million	29.7 Billion
2003	10.58 Million	21.3 Billion
2002	13.29 Million	25.8 Billion
2001	12.78 Million	24.2 Billion
2000	10.22 Million	17.3 Billion
1999	7.93 Million	12.3 Billion
1998	5.56 Million	8.6 Billion

Rank	Country	UNWTO Region	International tourist arrivals (2011)[2]	International tourist arrivals (2010)[2]	Change (2010 to 2011)
1	France	Europe	79.5 million	77.1 million	+3.0%
2	United States	North America	62.3 million	59.8 million	+4.2%
3	China	Asia	57.6 million	55.7 million	+3.4%
4	Spain	Europe	56.7 million	52.7 million	+7.6%
5	Italy	Europe	46.1 million	43.6 million	+5.7%
6	Turkey	Europe[note 1]	29.3 million	27.0 million	+8.7%
7	United Kingdom	Europe	29.2 million	28.3 million	+3.2%
8	Germany	Europe	28.4 million	26.9 million	+5.5%
9	Malaysia	Asia	24.7 million	24.6 million	+0.6%
10	Mexico	North America	23.4 million	23.3 million	+0.5%

Malaysia Ranked 9th in the World for International Arrivals in 2011 and tourism continues to grow

Current Investments in Malaysia

Examples inside Malaysia

In terms of office to hotel conversions in Kuala Lumpur, Tan Sri Tony Fernandes stated in an article from Endemic Guides that there are substantial number of property owners wanting to convert their office buildings into hotels to get higher yield.

In fact, a few Malaysian entrepreneurs have validated Tan Sri Tony Fernandes' statement and already started to convert office buildings to hotels, take Mak Hoong Weng for example, for the past ten years, the ardent property investor has racked up a respectable collection of buildings, that stretch from Kuala Lumpur, to Malacca and Kuantan.

Mak, the director of Art Form Enterprise Sdn Bhd that manufactures footwear, has plans to convert 10 of his buildings into hotels by the end of 2013 offering over 1,000 rooms. At the Junction of Jalan Raja Chulan is Star Luxury hotel, a development by Mak which saw the conversion of two office towers into a upmarket boutique hotel that charges between RM280 and RM1,500 a night. An interesting note, the main tower has appreciated beyond what Mak has paid even before the hotel was opened as someone offered him nearly three times of his cost price to part with building.

Mak has also acquired many other buildings in the vicinity, with the most notable being a multi-storey heritage building at Jalan Tun Perak. Presently, the ground floor of the building has been leased to food and beverage operators and the rest of the building is rented to a budget hotel operator.

Sticking in the Kuala Lumpur area, the Wisma Peladang office building underwent a complete retrofit in 2006 in order to create the current Piccolo Hotel. The 13 storey office building with a prime location along Jalan Bukit Bintang was transformed into a modern hotel and Berjaya Land immediately struck interest in the hotel, buying 51% ownership. Piccolo hotel boasts 4 star quality and as of September 2013 the hotel recorded an average room rate of RM246 and occupancy of 80%.

In addition, the Plaza Atrium building, located along Lorong P Ramlee is currently under reconstruction by Pinehigh Development Sdn Bhd (a wholly-owned subsidiary of the Far East Organization) to convert the former corporate office tower into 109 service apartment units stretched over 34 floors in an annexed wing. The original Plaza Atrium, was a corporate office tower designed by renowned architect Kenneth Yeang which was completed in 1984. The building received an application in 2005 for it to be redeveloped and extended.

The above are not the only instances of transformation of office spaces into hotels in Malaysia. In Kuching, Sarawak two office buildings have been converted into Hotels to capture the increase in tourist arrivals. The former KKB building was redeveloped to 80-rooms Abell Hotel while the former Kuching Tower Building was converted to 50-rooms Lime Tree Hotel.

These two redevelopments are part of a RM28.55 Billion investment deal in order to build 14 mega projects in the Sarawak Corridor, accounting to RM334 Billion in investments from 2011-2030. The mega projects are expected to accelerate the state governments' industrialisation plans, thus creating job opportunities and boosting the state economy.

On the whole, the current trend of investments in office building redevelopments in Kuala Lumpur, seem to be taking place in older office buildings. This is due to the growing number of new Grade A office buildings with prime locations and better facilities compared to the much older office buildings, causing tenants to opt to move out to new and more stylish offices even if it means higher rental rates, thus leaving these older office buildings tenant free.

Furthermore, old office buildings makes a much preferred choice to be transformed into hotels due to the lower rental rate it charges compared to the newer buildings which translates into a much lower yearly income. Hence, redevelopment of old office buildings that are located at strategic locations and close to tourist attractions into hotels would maximize yields and boost income dramatically as the gain margin is far higher.

Artists Impression of Plaza Atrium

The redeveloped Piccolo Hotel

Successful Investments Abroad

Examples outside Malaysia

Malaysia is not the only one that has seen large success in the new development strategy. Although Tan Sri Tony Fernandes is yet to develop the concept in Kuala Lumpur, he has developed office buildings into hotels before in London, England. The Malaysian entrepreneur and his Tune group of hotels has recently expanded their locations to London. The new hotels are situated in prime areas across London such as Kings Cross and Paddington.

In September 2011, Tan Sri Tony Fernandes acquired a substantial vacant office building at 324 Grays Inn Road, Kings Cross, formerly the head quarters of Unite union. The Tune Hotels Kings Cross, which opened in 2012 a few weeks before the Olympics saw them meet their first month occupancy rate target of 95% and has been awarded with an average Expedia guest rating of 4 out of 5, which is needed to qualify for the Certificate of Excellence award, in which two of the London based Tune Hotels have already won. In addition, 95% of people recommended the hotel on tripadvisor.com, showing the immediate success of the investment.

Tune Hotel, Kings Cross

It is not only in London where office space is being transformed. The Trump Organization is planning a US$200 million redevelopment of the iconic Old Post Office Building in Washington, D.C., into a luxury hotel. Donald Trump's company said it finalised a deal with the US General Services Administration to redevelop the national landmark on Pennsylvania Avenue now that a Congressional review has been completed.


Post Office building on Pennsylvania Avenue in Washington, D.C.

Fulfilling the demands of the Market

Why Transform Office space to Hotels?

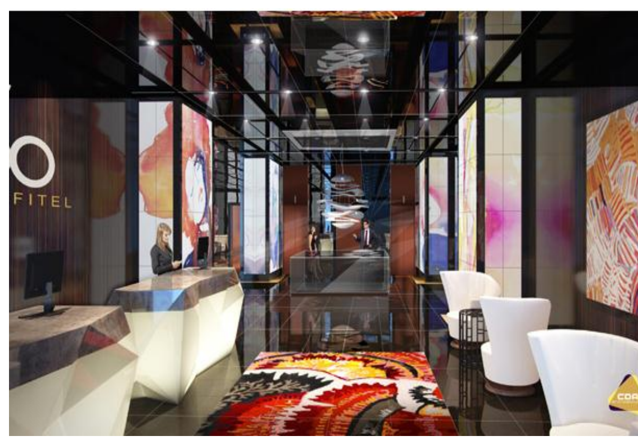
One of the main reasons is because it allows the owners to maximise returns on their property. A vacant building will be losing thousands of any currency a week on rent and depending on how long the office remains vacant it could cost a property owner Millions. Converting the office space to hotel, allows yield to be maximised and an income to be constant (even in low season). Furthermore with the current vacancy rate of office space in Malaysia at 23% coupled with substantial amount of future supply of office space, there is large competition to secure tenants, meaning it could be months even years before a potential client fills vacant office space.

A quick fix? A change of industry, swapping the building use from catering to corporate market to booming tourism and hospitality market would be an ideal solution as well as will generate higher returns. In 2012, the tourism sector in Malaysia attracted 25 million foreign tourists, generating a revenue of RM60.6bil. Malaysia's tourism market is forecasted to show a steady growth of 5%-7% per year and expected to receive a total of 32 million tourist arrivals in 2015. The booming tourism sector entails more hotel rooms to be built in order to cater the growing number of tourist arrivals.

Playing the market is very important when large sums of money are being used to redevelop property, in terms of when to develop, from previous examples, entrepreneurs seem to be investing in a recovering market.

A prime example of where people have catered for the market can be seen in London, England. Recently a 1960s eight storey office building on Red Lion Street in central London's Bloomsbury was granted permission to be converted to a 150-bedroom hotel as the continuing use of the building as office was not considered as an viable option. The conversion of the office building to hotel was also considered ideal as it was in accordance with the London Plan's strategic need for increased hotel provision.

The trend of converting office buildings to hotels is not just catching on in the West. There are quite a number of major office buildings in Auckland's CBD that are apt to be switched to hotels. International hotel operator Accor Hotels announced it would open a boutique operation in the Reserve Bank office building on Customs Street in downtown Auckland which is expected to be the start of a trend of converting office buildings to hotels, as there is a strong demand for hotels in Auckland due to acute shortage of existing hotel stock for sale, thus making more office conversions a real possibility.



Artists impression of the proposed hotel along Custom Street, Auckland

Transformation Tips: How to Develop

Guidelines to follow before redeveloping

There are many factors that ought to be considered whilst carrying out transformation of office building to hotel.

The following guidelines are based around a previous study which took place in Germany. The guidelines provides some insights to ensure a successful redevelopment venture of office building to Hotel.

❑ Deal structure

The owners of office buildings must make sure to select the right deal structure as it ascertains the amount of returns it would generate. In the present market, international operators will usually require either a management agreement or franchise.

Owners who are more familiar with institutional office leases may be uncomfortable with entering into such agreements as the agreement only offers a minimal guarantee on income to the owners.

Franchise, on the other hand, requires the owners to enter into a separate agreement with a different company in order to operate the hotel under a specific franchise brand, assuming that the owners does not have the capability and skills or desire to undertake this role themselves

❑ Planning issues

Conversion of office building to hotel will require planning permission to change the existing use. As such, planning advice must be sought at the very beginning to establish whether a change of use will be supported by the local authorities and to determine whether the building has the capacity to cater as a hotel

❑ Market demand analysis

A detailed market feasibility must be conducted to identify the market demand for specific type of hotel to ensure the viability of the conversion. Market demand analysis would reveal the supply and demand of hotels by type and location thus providing insights on the market gap.

The market demand analysis coupled with the suitability of a office building's layout to convert into a specific type of a hotel would facilitate in making the accurate decision, thus ensuring viability of the conversion.

❑ Design Considerations

Conversion of office building to hotel involves changing the existing design of the building which was intended for different use to suit the requirement of a hotel. As such the following issues should be considered :

i. Does the existing structural design support the proposed change of use?
ii. Is the existing lift appropriate for the new use?
iii. Are the existing Mechanical and Electrical (M&E) and Fire Life Safety systems able to be modified to suit the new use
iv. To evaluate whether a significant elements of the existing building requires replacing to suit the proposed new use and if yes are they already near the end of their useful life, and if not, does this impact on the overall viability of the scheme?

❑ Life cycle costing

Life Cycle Costing techniques should be used to ensure that whole life costs are minimised when the capital costs for conversion of office building to hotel use is being considered.

Conclusion

Investments for the future

The Conversion of office to hotels represents a brilliant opportunity for investors and developers alike. One major problem that may occur, is the lack of experience in the hotel sector some investors may have, who predominantly invest in office space.

A way to counter this is to carry out detailed research on the demand for a particular type of hotel in that area and whether it fits the layout of the existing office building, for example a 3 storey office building in Sri Kembangan may not be the prime location for a Luxury hotel.

Nonetheless, conversion of office buildings to hotels seems to suit Malaysia's scenario, which has an ever booming tourism industry, something that has to be catered for.

Furthermore with the increasing number of new grade A office buildings being built and a high vacancy rate of 23% it seems sensible to take advantage of the cheaper older office buildings that are currently vacant on the market to maximize the returns from the property.

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