Leisure Law Insider - Vol. 1 (October 2023)

The Changing Climate: Factoring Sustainability in Hotel Due Diligence

October 2023

Key Take: *Climate change risks should be factored into the underwriting of hotel projects.*

Changes in our climate have created drastic increases in flooding, fires, heat waves, and droughts. It seems that so-called “hundred year storms” are being experienced on a yearly basis. Coastal areas have experienced severe damage from flooding and high winds, and extreme heat and drought conditions have devastated California as well as interior states. Unfortunately, current projections suggest that these conditions are bound not only to continue but also to worsen in the coming years.

Hotel owners, developers, and acquirers need to be cognizant of the risks posed by climate events as well as local statutory and regulatory “sustainability” requirements that may apply to real estate development and operations. Quite simply, climate change risks should be factored into the underwriting for hotel projects.

Analysis of sustainability requires due diligence beyond that which has traditionally been the norm. A "Phase I" environmental assessment and property condition report—"traditional" areas of property-level due diligence—do not include analyses of the potential for flooding and sea level changes that could affect a real property asset and its operations. Depending on the location of the property, a report that analyzes current and future flooding potentials and suggests solutions for mitigating their effects should be included among the information collected as part of due diligence.

Traditional due diligence reports also typically do not analyze or explain existing and pending regulatory requirements, some of which could have significant financial impacts. For example, as a result of Superstorm Sandy, which in 2012 caused extensive and catastrophic flooding in Manhattan and low lying portions of New York's outer boroughs, New York City adopted new zoning and building requirements to raise the levels of entrances, mechanical equipment, and the like to conform with new floodplain maps that were created by FEMA. Other cities and states, notably many in Florida and California, have adopted similar requirements.

In addition to flooding and sea level concerns, agencies are requiring information and analysis of greenhouse gas emissions, which many believe are a significant factor in changes to the climate. Some cities have required retrofitting existing buildings to reduce emissions from HVAC systems. For example, Local Law 97 in New York City requires building owners to substantially reduce greenhouse gases by 2024, with further reductions required by 2030 and 2050. Compliance with this type of legislation is a lengthy and costly process and may, in some instances, require changing HVAC systems from burning fossil fuels to electric power or renewable forms of energy.

Hotel owners, developers, and acquirers should also factor in the premiums for property insurance, which are uncontrollable and often hugely significant costs. In recent years, many owners have faced sharp increases in premiums along with higher deductibles, due to both weather-related risks and inflation.

The lesson to be learned from these and other requirements is that due diligence and underwriting for hotel projects must include an analysis of the need to protect against potential impacts of climate change and the costs of mitigating or protecting property from the sequelae of flooding, increased global temperatures, and compliance with regulatory requirements. Hotels, like other real estate asset classes, are not immune from climate risks, and owners, developers, and acquirers should as much as possible be cognizant of the associated costs.