STRUCTURING A HOTEL INVESTMENT

The components of a hotel investment, complete with an example of how such transactions are being conducted, are examined.

by Stephen Rushmore

Whether a proposed hotel is being developed or an existing hotel is being acquired, the different components or parties to the transaction must work out and agree to a basic financial structure that determines how the various benefits and risks of the investment are to be divided and allocated. This article will identify and define the major players in a hotel investment; then, a typical hotel deal structure will be illustrated.

Owner

A hotel owner is the individual or entity that controls the equity portion of the investment. In many instances, hotel ownership takes the form of a limited partnership with control assumed by the general partner in combination with a group of limited partners who risk their invested capital. A developer is generally an owner, but a hotel owner is not necessarily a developer.

Benefits of Ownership. The economic benefits of hotel ownership consist of periodic cash flow during the term of ownership along with value appreciation realized upon the sale of the asset (residual value). The periodic cash flow refers to the net income remaining after payment of all operating expenses, fixed expenses, and debt service. This equity return is generally distributed (if available) to the owner on a monthly basis. The residual value is the cash remaining after the property is ultimately sold. It consists of the sales price less any outstanding mortgage balance less the cost of the transaction, such as brokerage and legal fees. The benefit of the residual value assumes that the property appreciates during the term of ownership. If the value of the hotel actually declines, the residual benefits may be negative. The benefit of value appreciation can also be realized during the term of the investment when the hotel is refinanced based on an increased value of the security.

In today's market, hotel equity investors are looking for the following returns on invested equity:

☐ *Cash-on-cash return of 10 percent to 14 percent.* A cash-on-cash return is a short-term calculation showing the return on equity during the initial years of the investment, which is calculated by dividing the annual cash flow to equity by the amount of the invested equity. This cash-on-cash return assumes a typical stabilized hotel investment with normal mortgage leverage equating to approximately 65 percent to 80 percent of value.

STEPHEN RUSHMORE, CRE, MAI, SREA, is President of Hospitality Valuation Services, Inc., a national consulting and appraisal firm specializing in hotels and motels with offices in Mineola, New York, and San Francisco. This article is excerpted from the author's forthcoming book, to be published this fall by Warren, Gorham & Lamont, Inc., on hotel investing for owners, lenders, and operators.

☐ *Equity yield of 18 percent to 24 percent.* The equity yield is a long-term calculation showing the annual return on equity over an extended period of time—traditionally, ten years. It is calculated through an iterative process that determines the discount rate that will discount the annual cash flows to equity plus the equity reversion to equal the value of the initial equity investment. This equity yield is based on the following investment factors:

Projection term	10 years
Annual inflation rate	4% to 6%
Terminal capitalization rate	9% to 12%
Mortgage leverage	65% to 80% of value
Mortgage interest rate	9% to 12%
Mortgage amortization	20 to 30 years

As shown, the equity yield specifically takes into consideration many more investment factors than the cash-on-cash return. The cash-on-cash return takes these investment factors into account in an intuitive manner rather than a specific manner.

☐ *Unleveraged yield of 12 percent to 15 percent.* Some hotel investors, such as pension funds and insurance companies, purchase hotels on an unleveraged (all-equity) basis. This calculation is similar to the previous equity yield except there is no mortgage leverage, debt service, or residual mortgage balance to consider.

Tax Benefits. In addition to the economic benefits cited, hotel investments offer equity owners certain tax benefits. In recent years, Congress has severely limited the tax shelter aspects of real estate investments, but hotel owners are still able to benefit from depreciation expense offsetting income generated by the hotel, thereby deferring income taxes over the term of ownership. Hotels offer somewhat better tax benefits than other forms of real estate because the items of furniture and equipment, which can comprise 10 percent to 25 percent of a hotel's assets, can be depreciated over seven years rather than the thirty-one and one-half years allowed for building improvements.

Ownership Forms. The entity owning a hotel can be an individual, a partnership, or a corporation. Normally, hotels are owned by groups of individuals who form a partnership. Typically, the partnership consists of one or more general partners who manage the affairs of the partnership and are at risk for all liabilities incurred. The partnership may also include a group of limited partners who are passive when it comes to the day-to-day management of the partnership and who have liability limited to their invested capital.

In most instances, the limited partners contribute most of the initial equity capital while the general partners contribute their time and expertise to find the property, structure the transaction, and put together the partnership. In addition, the general partners may or may not be responsible for any capital required beyond what was committed to by the limited partners.

In exchange for providing the equity cash, the limited partners generally receive a preferred equity return, ranging from 6 percent to 12 percent on their invested capital. In years where the cash flow is insufficient to provide this minimum return, the unpaid amount will often accrue until funds are available to make payment. The cash flow remaining after the preferred equity return is paid to the limited partners is split between the limited and general partners in ratios most often ranging from 60:40 to 85:15. The ultimate overall split of cash flow between the limited and general partners is a function of many factors, such as the perceived risk, guarantees made by the general partners, the split of refinancing and/or residual benefits, and so forth.

Upon the sale or refinancing, the cash remaining after all transaction expenses (including repayment of debt) have been paid is first allocated to the limited partners in an amount equal to their capital investment. The remaining cash is then divided between the limited and general partners in a ratio most often ranging from 60:40 to 85:15. The taxable income or loss is also allocated between the limited and general partners, usually at a ratio of 99:1.

Based on the distribution of the economic benefits previously described, the pretax equity yield to the limited partners most often ranges from 14 percent to 20 percent on a before-tax basis and 12 percent to 18 percent on an after-tax basis. These equity yields are lower than those cited previously for the entire partnership because the limited partners are sharing a portion of the economic benefits with the general partners.

Lender

The lender is one of the most important components of a hotel transaction. By supplying the bulk of the capital needed to either develop or

purchase a hotel, the lender usually looks for security in the form of a mortgage on the property and sometimes guarantees from the general partners. This security is intended to provide the funds necessary to repay the loan in the event the borrowers default on their obligations. First-mortgage lenders have priority on the income generated by the hotel. Often, this priority even comes before a management company's incentive management fee.

The primary risk faced by the lender is that the hotel will not be financially successful enough to pay debt service. If a default occurs, the lender has the option to foreclose and assume ownership of the property. Although this course of action is available, the resulting publicity of a foreclosure (and maybe a bankruptcy) can have devastating impact on a hotel's business, particularly the meeting and banquet segments.

According to the American Life Insurance Association, recent foreclosure rates on hotel loans have been approximately 3.6 percent. Based on historic experience, lenders have fared pretty well after taking hotels back pursuant to a foreclosure. Generally, with a change in management and possibly repositioning the property with a new franchise, lenders are able to restructure their investments, create cash flow, and eventually work themselves out of a bad loan.

Seller

The seller is the person or entity who transfers all or part of an ownership interest to a buyer. Depending on the structure of the transaction, the seller may either terminate all future involvement with the property or maintain some form of continued interest. Examples of continued involvement include:

☐ *Selling only a partial share of ownership and remaining as a joint venture general partner, a limited partner, or owner of the land subject to a ground lease.* Sellers utilize this form of continued involvement to minimize adverse tax consequences brought about by a sale and/or to obtain a higher selling price by making various types of financial guarantees.

☐ *Selling the entire ownership interest and taking back financing in the form of a purchase money mortgage.* This form of continued involvement often produces a higher selling price and a quick sale since the buyer does not have to search out and obtain third-party financing.

☐ *Selling the entire ownership interest and maintaining a management contract.* If the seller is a management company, particularly a first-tier operator, it can be advantageous to retain a management contract after the sale. Should a seller/management company be willing to make financial guarantees, a higher selling price can often be realized.

By remaining involved with the hotel after the sale, the seller faces the same risks as an owner, lender, or management company. Under these circumstances, the seller should thoroughly investigate the contemplated buyer to ensure that the financial relationship will be satisfying to all parties involved.

Hotel Management Company

The hotel management company provides the management expertise to operate the hotel. If the management company is a first-tier operator, the property benefits from a chain affiliation. For new hotels, the owner must generally locate a management company and negotiate a management contract. For existing hotels, the management is often in place, and the new owner buys subject to the terms and conditions in the existing agreement.

In situations where the hotel management company is also an owner, the management fee structure may sometimes be modified downward, reflecting a form of imputed equity. Occasionally, management companies with equity ownership may also make debt service guarantees.

Other Players. There are numerous other individuals and entities that have smaller but no less essential roles in a hotel transaction. Among them are:

☐ *The hotel franchiser,* which provides the hotel with an identity, mode of operation, and reservation of referral system.

☐ *The real estate broker,* who works as an agent for the owner to locate a buyer and to assist in the negotiations. Compensation generally takes the form of a commission that is paid upon closing; depending on the size of the transaction, commissions for hotel sales range from 1 percent to 4 percent.

☐ *The mortgage broker,* who works for the buyer and assists in obtaining mortgage financing. Compensation is generally a commission paid at closing. Depending on the size and type

of mortgage financing obtained, this will range from 0.5 percent to 3 percent of the deal.

☐ *The equity broker/dealer,* who raises limited partner equity capital. These registered security dealer firms assist in structuring the syndication and sell partnership interests to their customers. Because the broker/dealer has a vested interest in selling successful deals, it will often perform an extensive amount of due diligence and project analysis before offering a partnership to their customers. Equity syndicators are generally paid a commission, ranging from 5 percent to 15 percent of the equity raised, as partnership units are sold.

Other parties to a hotel transaction include:

- Accountants;
- Appraisers;
- Attorneys;
- Title companies;
- Engineers; and
- Property tax consultants.

Hotel Investment Structures

The relationship of each party or component of a hotel investment can be best illustrated through examples. The first example involves a new hotel that is ready to open. Although few hotel investments can be classified as typical, this example is representative of some of the structures currently being utilized by hotel investors.

New Hotel Ready to Open. The facts and investment structure include:

☐ The developer of a 300-room hotel decides to sell the equity in the property upon its opening. The developer's objective is to recoup his existing invested equity and maximize the selling price by maintaining an interest in the hotel after the sale and providing certain cash flow guarantees.

☐ When the hotel opens for business in 1990, the total project cost is estimated to be as follows:

Hard costs		
Land	$ 2,600,000	
Improvements	13,500,000	
Furniture, fixtures, and equipment	4,500,000	
Contingency	550,000	
Subtotal	$21,150,000	
Soft costs		
Appraisals	$ 30,000	
Architecture and engineering	600,000	
Financing fees	316,000	
Interest during construction	1,291,000	
Legal	30,000	
Miscellaneous	91,000	
Operating reserve	1,200,000	
Preopening	600,000	
Property taxes	50,000	
Surveys	15,000	
Fees and permits	100,000	
Working capital	200,000	
Development fee	587,000	
Franchise fees	90,000	
Subtotal	$ 5,200,000	
Total cost		$26,350,000

☐ Although the appraised value of the hotel is estimated to be $31 million upon opening, it is doubtful whether the developer could actually realize this amount if he or she insisted on an all-cash transaction with no continued involvement. The primary reason has to do with the fact that most lenders are reluctant to finance new hotels with nonrecourse mortgages exceeding 80 percent of the total project cost until a property establishes a track record of earnings. For the subject hotel, this equates to $21 million, which is below the $23.23 million financing assumption contained in the appraisal. The lower leverage and resulting need for additional equity makes it difficult to justify an all-cash purchase price of $31 million. By staying in the transaction and making some financial guarantees, however, the developer should ultimately realize the hotel's full opening value. This produces a developer's profit equal to 17.6 percent of the total project cost, 22 percent of hard costs (excluding development fee), and 25 percent of hard costs (including deelopment fee).

Transaction: Developer and Partnership

To accomplish the objectives of realizing the full $31 million value and obtaining a developer's profit in excess of 17 percent, the developer enters into a transaction with a hotel syndicating firm. The structure of this venture is summarized as follows: A limited partnership will purchase the subject hotel upon opening from the developer for a price of $26.35 million, to be obtained from

a $21.08 million nonrecourse first mortgage and $5.27 million in cash generated by an equity syndication. To obtain the necessary $5.27 million, the syndication had to raise a total of $6.501 million. The costs associated with performing the syndication along with the sources and usage of funds are:

Syndication costs	
Commissions paid to broker/ dealers	$ 520,000
Broker/dealer expenses	65,000
Printing and promotion	100,000
Legal	45,000
Accounting	30,000
Acquisition fee	325,000
Funds for operation	146,000
Total syndication costs	$1,231,000
Acquisition price	5,270,000
Total to be raised	$6,501,000

Sources of funds	
Limited partners	$6,500,000
General partners	1,000
Total funds raised	$6,501,000

The first mortgage, representing a loan-to-cost ratio of 80 percent and a loan-to-value ratio of 68 percent, will have a fixed interest rate of 10.5 percent, a thirty-year amortization schedule, and a ten-year term. The resulting mortgage constant is 0.10977 with an annual debt service of $2.314 million. Because of the low loan-to-value ratio, the lender does not require a personal guarantee from the general partner.

Before-Tax Analysis. The developer will have a nonownership, supervisory interest in the property, receiving 45 percent of the cash flow remaining after a 10.5 percent cumulative priority return on the $6.501 million raised by the syndication is paid to the partnership. This annual priority return equates to $683,000. The developer guarantees to fund all operating losses above the $1.2 million in operating reserves subject to a time limit of three years and a $3 million maximum. In addition, the developer keeps any unused operating reserve.

Table 1 shows the annual allocation of cash flow between the partnership and the developer based on the ten-year projection of income and expense for the subject hotel. In 1990, the cash flow after debt service and audit fee is projected to be −$934,000, which can be covered from the $1.2 million operating reserve fund. The $683,000 preferred distribution of cash flow is not made, but it does accumulate. In 1991, the cash flow after debt service and audit fee is projected to be $244,000. This amount flows to the partnership as a preferred distribution and the $1.122 million of unpaid preferred distribution ($1.366 million − $244,000) is deferred until the next year.

In 1992, the cash flow after debt service and audit fee is projected to be $1.334 million, which flows to the partnership as a preferred distribution, and the $470,000 of unpaid preferred distribution ($1.804 million − $1.344 million) is deferred until the next year. In 1993, the cash flow after debt service and audit fee is projected to be $1.516 million, which is sufficient to pay the current $683,000 preferred distribution plus the $470,000 accrued preferred distribution from the previous year. The balance remaining to be split between the partnership and the developer is $363,000, which goes 55 percent ($190,000) to the partnership and 45 percent ($163,000) to the developer. The total cash flow to the partnership is the $1.152 million preferred distribution plus the $199,000 share of the cash flow, which totals $1.352 million. The developer receives a total of $163,000.

From 1994 and beyond, the cash flow is projected to be sufficient to pay the preferred distribution plus the full 55:45 split.

When the hotel is sold or refinanced, the net proceeds are first allocated to the partnership until their $6.501 million capital has been repaid. The remaining proceeds are then divided 50 percent to the developer and 50 percent to the partnership.

Sale Presumption. The projection in this example assumes a sale at the end of year 10 (the year 2000). Assuming the eleventh year's net income is expected to be $5.436 million and the terminal (going-out) capitalization rate is 11 percent, the resulting sales price would be $49.414 million. From these sales proceeds, selling costs (broker and legal—3 percent) and the final mortgage balance must be deducted; the initial working capital is then added back. This is calculated as follows:

Sales price		$ 49,414,000
Less:	Selling costs	− 1,482,000
	Mortgage balance	−19,314,000
Plus:	Working capital	+ 200,000
Cash to distribute		$ 28,818,000

TABLE 1. STATEMENT OF CASH FLOW

(+$000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Income before debt service	$1,380	$2,588	$3,679	$3,863	$4,056	$4,259	$4,472	$4,695	$4,930	$5,177
Less: Debt service	2,314	2,314	2,314	2,314	2,314	2,314	2,314	2,314	2,314	2,314
Less: Audit fees	-0-	30	32	33	35	36	38	40	42	44
Balance	$ (934)	$ 244	$1,333	$1,516	$1,707	$1,909	$2,120	$2,341	$2,574	$2,819
Reserve Funds	934	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Balance	$ -0-	$ 244	$1,333	$1,516	$1,707	$1,909	$2,120	$2,341	$2,574	$2,819
Preferred—current	$ 683	$ 683	$ 683	$ 683	$ 683	$ 683	$ 683	$ 683	$ 683	$ 683
Preferred—cumulative	683	1,366	1,804	1,153	683	683	683	683	683	683
Preferred—paid partnership	-0-	244	1,333	1,153	683	683	683	683	683	683
Balance	$ -0-	$ -0-	$ -0-	$ 363	$1,024	$1,226	$1,437	$1,658	$1,891	$2,136
Partnership (55%)	$ -0-	$ -0-	$ -0-	$ 199	$ 564	$ 674	$ 790	$ 912	$1,040	$1,175
Developer (45%)	-0-	-0-	-0-	163	461	552	647	746	851	961
Totals										
Cash flow—partnership	$ -0-	$ 244	$1,334	$1,353	$1,246	$1,357	$1,473	$1,595	$1,723	$1,857
Cash flow—developer	-0-	-0-	-0-	163	461	552	647	746	851	961

The distribution of the sales proceeds to the developer and partnership is:

	Developer	*Partnership*	*Total*
Return of capital		$ 6,501,000	$ 6,501,000
Distribution of balance	$11,159,000	11,159,000	22,317,000
Total distribution	$11,159,000	$17,660,000	$28,818,000

The total cash proceeds to the developer and partnership over the ten-year life of this investment is projected as follows:

Year	*Developer*	*Partnership*
1990	$ -0-	$ -0-
1991	-0-	244,000
1992	-0-	1,334,000
1993	163,000	1,353,000
1994	461,000	1,246,000
1995	552,000	1,357,000
1996	647,000	1,473,000
1997	746,000	1,595,000
1998	851,000	1,723,000
1999	961,000	1,857,000
Cash flow	$ 4,381,000	$12,182,000
Sales proceeds	11,159,000	17,659,000
Total cash flow and sales proceeds	$15,540,000	$29,841,000

The net present value to the developer of the total cash flow and sales proceeds assuming various discount rates is:

Discount Rate	Net Present Value of Project Developer's Cash Flows and Sales Proceeds
5.0%	$9,861,000
10.0	6,423,000
15.0	4,285,000
20.0	2,925,000
13.9	4,650,000

The 13.9 percent discount rate shows the rate of return that produces a net present value of $4.65 million, which is the profit to the developer if he could have sold the hotel upon opening for $31 million. The discount rate would be 14.8 percent if the $266,000 remaining in the developer's reserve fund ($1,200,000 – $934,000) is included. The internal rate of return (IRR) to the partnership, assuming an initial investment of $6.501 million and that the preceding cash flows and sales proceeds are realized, would be 20.8 percent.

Partnership: General and Limited Partners

The preceding section described the financial structure between the two joint venture parties, the developer and the partnership. Separate and apart from that structure is the financial relationship of partnership that is comprised of general and limited partners. The distribution of cash flow and sales proceeds within the partnership can utilize different formulas from those described for the joint venture.

The partnership was organized by the general partner who received a fee of $325,000 for finding this hotel investment opportunity, performing the necessary due diligence, negotiating the joint venture structure with the developer, structuring the partnership, and monitoring the sale of partnership units. The partnership is capitalized with $6.501 million, which was obtained from the sale of limited partner units ($6.5 million) along with $1,000 from the general partner.

During the life of the partnership, the general partner will provide asset management services to oversee the operation of the hotel and ensure

TABLE 2. DISTRIBUTION OF PARTNERSHIP CASH FLOW

(+$000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Cash flow—partnership	$ -0-	$ 244	$1,334	$1,353	$1,246	$1,357	$1,473	$1,595	$1,723	$1,857
Reserve funds	146	104	146	146	146	146	146	146	146	146
Interest—reserve funds	8	6	8	8	8	8	8	8	8	8
Less: Asset management fee	40	42	44	46	49	51	54	56	59	62
Partnership expenses	10	11	11	12	12	13	13	14	15	16
Cash reserve	$ 104	$ 301	$1,433	$1,449	$1,339	$1,447	$1,560	$1,679	$1,803	$1,933
Cash available for distribution	$ -0-	$ 155	$1,286	$1,303	$1,193	$1,301	$1,414	$1,533	$1,657	$1,933
Preferred—current	$ 715	$ 715	$ 715	$ 715	$ 715	$ 715	$ 715	$ 715	$ 715	$ 715
Preferred—cumulative	715	1,430	1,991	1,433	858	715	715	715	715	715
Preferred—paid	$ -0-	$ 155	$1,286	$1,303	$ 866	$ 722	$ 722	$ 722	$ 722	$ 722
Preferred—limited (99%)	$ -0-	$ 154	$1,274	$1,290	$ 858	$ 715	$ 715	$ 715	$ 715	$ 715
Preferred—general (1%)	$ -0-	2	13	13	9	7	7	7	7	7
Remaining cash	$ -0-	$ -0-	$ -0-	$ -0-	$ 327	$ 579	$ 692	$ 810	$ 935	$1,212
Second distribution—limited (75%)	$ -0-	$ -0-	$ -0-	$ -0-	$ 245	$ 434	$ 519	$ 608	$ 701	$ 909
Second distribution—general (25%)	-0-	-0-	-0-	-0-	82	145	173	203	234	303
Totals										
Cash flow—limited	$ -0-	$ 154	$1,274	$1,290	$1,103	$1,149	$1,234	$1,323	$1,416	$1,624
Cash flow—general	-0-	2	13	13	90	152	180	210	241	310

that its management is operating the property in a profitable and efficient manner. For these asset management services, the general partner will receive an asset management fee of $40,000 in 1990, which increases 5 percent per year thereafter. In addition to the asset management fee, the partnership pays annual expenses estimated to be $10,000 in 1990 and to be increased 5 percent per year thereafter.

When the partnership was organized, $146,000 was set aside in a reserve account to pay partnership expenses in the event that cash flow was insufficient. Unused reserve is invested and accumulates interest at an assumed rate of 5.5 percent. The $146,000 reserve balance is maintained throughout the life of the partnership.

Tracking the Cash Flow. The cash flow to the partnership remaining after the partnership expenses have been paid is allocated to the limited and general partners in the following manner:

- ☐ A noncompounded cumulative preferred distribution is allocated 99 percent to the limited partners and one percent to the general partner so that the limited partners will receive an average annual distribution over the life of the investment of 11 percent of the $6.5 million raised, or $715,000. If the cash flow in any one year is insufficient to make this distribution, the unpaid amount accumulates without interest until sufficient cash flow is available.
- ☐ Any cash flow remaining after this initial preferred distribution is allocated 75 percent to limited partners and 25 percent to the general partners.

Table 2 illustrates the distribution of the partnership cash flow. In 1990, there was no cash flow to the partnership. The asset management fee and partnership expenses were charged against the reserve fund, reducing it to $96,000; however, interest on the reserve funds brought the ending reserve balance to $104,000. The $715,000 preferred distribution to the limited partners was not paid and was deferred until the following year.

In 1991, the cash flow to the partnership was $244,000. Adding to this amount the $104,000 in the reserve fund plus $6,000 in interest on these reserve funds and deducting $42,000 in asset management fees along with $11,000 in partnership expenses produce a cash reserve of $301,000. From this amount, the $146,000 reserve must be replenished, leaving $155,000 cash available for distribution. At the end of the year the total cumulative preferred distribution amounted to $1.43 million, which was comprised of the $715,000 cumulative preferred for 1990 and the $715,000 for 1991. The $155,000 cash flow is paid 99 percent or $154,000 to the limited partners and one percent or $2,000 to the general partners. There was no money available for the second distribution.

In 1992, the cash available for distribution was $1.286 million. The cumulative preferred balance

at the end of 1992 was $1.991 million, which resulted from taking the $1.43 million balance in 1991, deducting the $155,000 preferred paid in that year, and adding the $715,000 preferred from 1992. Since the cash available for distribution ($1.286 million) was less than the preferred cumulative ($1.991 million), the entire amount is allocated 99 percent to the limited partners ($1.274 million) and one percent to the general partners ($13,000). There was no cash flow available for the second distribution. In 1993, the method of distribution is the same as in 1992.

In 1994, the cash available for distribution ($1.193 million) is greater than the preferred cumulative of $858,000, which means that by the end of the year the limited partners would receive their 11 percent preferred return since the opening of the hotel. The preferred paid is calculated by dividing the preferred cumulative by 99 percent and allocating this amount ($866,000) 99 percent to the limited partners ($858,000) and one percent to the general partners ($9,000). After making the initial distribution, the remaining cash of $327,000 is split in the second distribution: 75 percent to the limited partners ($245,000) and 25 percent to the general partners ($82,000). Totaling the preferred and second distribution, the limited partners will receive $1.103 million in 1994 and the general partners will receive $90,000.

From 1995 to 1999, the distribution is calculated the same as in 1994. The preferred cumulative for prior years has been paid off, leaving only the $715,000 for each current year.

When the hotel is sold at the end of 1999, the limited partners first receive their $6.5 million investment back from the proceeds of the sale. The general partner then receives its original $1,000 investment back. The remaining proceeds allocated to the partnership are allocated 75 percent to the limited partners and 25 percent to the general partners. The calculation is illustrated as follows:

Partnership Distribution of Sales Proceeds

	Limited Partners	*General Partners*	*Total*
Return of capital	$ 6,500,000	$ 1,000	$ 6,501,000
Distribution of balance	8,369,000	2,789,000	11,158,000
Total	$14,869,000	$ 2,790,000	$17,659,000

The total cash proceeds to the limited and general partners over the ten-year life of this investment are projected as follows:

Year	*Limited Partners*	*General Partners*
1990	$ -0-	$ -0-
1991	154,000	2,000
1992	1,274,000	13,000
1993	1,290,000	13,000
1994	1,103,000	90,000
1995	1,149,000	152,000
1996	1,234,000	180,000
1997	1,323,000	210,000
1998	1,416,000	241,000
1999	1,624,000	310,000
Cash flow	10,567,000	1,211,000
Sales proceeds	$14,869,000	$2,790,000
Total cash flow and sales proceeds	$25,436,000	$4,001,000

The net present value to the general partner of the annual cash flows and sales proceeds assuming various discount rates is illustrated as:

Discount Rate	**Net Present Value of Projected General Partner's Cash Flows and Sales Proceeds**
5%	$2,536,000
10	1,650,000
15	1,099,000
20	749,000

The IRR to the limited partners, assuming an initial investment of $6.5 million and the preceding cash flows and sales proceeds are realized, would be 18.4 percent.

After-Tax Benefits

Although the tax benefits of a hotel investment have been greatly reduced in recent years, they still provide some shelter, thereby deferring some of the ordinary income generated by the hotel. The calculated tax benefits are based on the tax law as of 1988.

Assuming a purchase price of $26.35 million, the tax basis for the subject property based on development costs is calculated as follows:

Land acquisition price	$ 2,600,000
Improvements (real property)	13,500,000
Furniture, fixtures, and equipment	4,500,000
Contingency	550,000
Soft costs	5,000,000
Working capital	200,000
Total cost	$26,350,000

The $200,000 in working capital is not part of the depreciable basis. The contingency and soft costs totaling $5.55 million must, however, be

TABLE 3. DEPRECIATION EXPENSES

(+$000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Real property	$ 561	$ 561	$ 561	$ 561	$ 561	$ 561	$ 561	$ 561	$ 561	$ 561	
Original FF&E	841	1,442	1,030	735	526	526	526	263	-0-	-0-	
Reserves 1990	51	87	62	45	32	32	32	16	-0-	-0-	
1991		61	104	74	53	38	38	38	19	-0-	
1992			70	119	85	61	44	44	44	22	
1993				73	125	90	64	46	46	46	
1994					77	132	94	67	48	48	
1995						81	138	99	71	50	
1996							85	145	104	74	
1997								89	152	109	
1998									93	160	
1999										98	
Total depreciation	$1,453	$2,151	$1,827	$1,607	$1,459	$1,521	$1,582	$1,368	$1,138	$1,168	$15,274

TABLE 4. ALLOCATION OF DEBT SERVICE

(+$000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Beginning balance	$21,080	$20,974	$20,875	$20,727	$20,583	$20,423	$20,245	$20,047	$19,828	$19,584
Payment	2,314	2,314	2,314	2,314	2,314	2,314	2,314	2,314	2,314	2,314
Interest	2,208	2,197	2,184	2,170	2,154	2,136	2,116	2,095	2,070	2,044
Principal	106	117	130	144	160	178	198	219	243	270

allocated among the improvements, furniture, fixtures, and equipment (FF&E). This will be accomplished based on the ratio of improvements and FF&E to total value.

		Ratio	*Allocation*	*Depreciable Basis*
Improvements (real property)	$13,500,000	75%	$4,163,000	$17,663,000
FF&E	4,500,000	25	1,387,000	5,887,000
Total	$18,000,000	100%	$5,550,000	$23,550,000

The real property improvements can be depreciated on a straight-line basis over a thirty-one-and-one-half-year term, which equates to an annual depreciation expense deduction of $561,000.

The original FF&E plus the annual replacements, which are assumed to be the projected reserve for replacement, can be depreciated in accordance with the following schedule:

Years in Service	*Depreciation Percentage for Year*	*Accumulated Depreciation*
1	14.28%	14.28%
2	24.49	38.77
3	17.49	56.26
4	12.49	68.75
5	8.93	77.68
6	8.93	86.61
7	8.93	95.54
8	4.46	100.00

Table 3 shows the annual depreciation expense for the proposed hotel. In addition to the depreciation of the building and FF&E, the $325,000 acquisition fee can be expensed on a straight-line basis over five years, which equates to an annual deduction of $65,000.

The annual first mortgage debt service is $2.314 million. Of this amount, a portion represents interest, which is a deductible expense, and a portion represents repayment of principal, which cannot be deducted as an expense. Table 4 shows the annual allocation of debt service between interest and principal.

The annual income to the partnership is calculated by taking the projected income before debt service and adding back the reserve for replacement since this amount will be depreciated rather than expensed. In addition, the interest generated from the invested reserve funds is taken in as income. Additional deductible expenses would include the mortgage interest, audit fee, depreciation, acquisition fee, asset management expenses, and partnership expenses. The income of the partnership is shown in Table 5.

The cash flow applied represents the cash shortfall guarantee of the developer, which is taken as income to the partnership in 1990. The income (loss) of the partnership is allocated to the limited and general partners in the following proportion: 99 percent to the limited and one percent to the general, as shown in Table 6.

The assumed sale at the end of 1999 creates a taxable event by producing a capital gain to the partnership. The calculation of this gain starts

TABLE 5. PARTNERSHIP INCOME

(+$000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Cash flow before debt service	$1,380	$2,588	$3,679	$3,863	$4,056	$4,259	$4,472	$4,695	$4,930	$5,177	$39,099
Plus: Reserve for replacement	356	426	488	512	538	565	593	623	654	686	5,440
Plus: Interest on reserves	8	6	8	8	8	8	8	8	8	8	78
Less: Interest	2,208	2,197	2,184	2,170	2,154	2,136	2,116	2,095	2,070	2,044	21,373
Less: Acquisition fee	65	65	65	65	65	-0-	-0-	-0-	-0-	-0-	325
Less: Asset management	40	42	44	46	49	51	54	56	59	62	503
Less: Audit fee	-0-	30	32	33	35	36	38	40	42	44	331
Less: Partnership expenses	10	11	11	12	12	13	13	14	15	16	126
Less: Depreciation	1,453	2,151	1,827	1,607	1,459	1,521	1,582	1,368	1,138	1,168	15,274
Cash flow applied	934	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	934
Income (loss)	($1,098)	($1,476)	$ (28)	$ 450	$ 828	$1,075	$1,270	$1,753	$2,268	$2,537	$ 7,579

TABLE 6. INCOME/LOSS ALLOCATION

(+$000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Total
Limited	($1,086)	($1,461)	$12	$446	$820	$1,065	$1,258	$1,737	$2,246	$2,513	$7,549
General	(11)	(15)	-0-	5	8	11	13	18	23	25	76

with the determination of the total basis of the partnership at the time of the sale. This is calculated as follows:

	Original Basis	Additions and Replacements	Total Basis as of Sale
Improvements	$17,663,000	$ -0-	$17,663,000
FF&E	5,887,000	5,440,000	11,327,000
Land	2,600,000	$ -0-	2,600,000
Total	$26,150,000	$5,440,000	$31,590,000

The additions and replacements represents the total annual reserve for replacement during the projection period. The book value, as determined below, is the total basis of the property less the total depreciation during the ten-year projection.

Total basis as of the sale	$31,590,000
Less: Total depreciation	15,267,000
Book value	$16,323,000

To the book value can be added certain partnership costs that were incurred when the partnership was formed but could not be expensed or capitalized and depreciated at that time. Instead, they could be deferred and used to offset any gain at sale. The effect of this adjustment is to increase the book value of the property, thereby decreasing the gain upon sale, as follows:

Book value	$16,322,000
Plus:	
Commissions paid to broker/dealers	520,000
Broker/dealer expenses	65,000
Printing and promotion	100,000
Legal	45,000
Accounting	30,000
Adjusted book value	$17,082,000

The gain upon sale is calculated by subtracting the adjusted book value from the net sales price (after selling costs) of the property:

Selling price	$49,414,000
Less: Selling costs	1,482,000
Net sales price	47,932,000
Less: Adjusted book value	17,082,000
Taxable gain upon sale	$30,850,000

An alternative method for calculating the gain upon sale is to calculate the basis of the partnership as of the date of sale. Partnership basis increases with capital invested by the partners along with taxable income generated by the partnership. The basis decreases with distribution of cash flow. The basis of the partnership immediately prior to the sale of the property would be calculated as follows:

Original capital	$ 6,501,000
Plus: Total taxable partnership income	7,626,000
Less: Cash flow distributions to developer	4,382,000
Cash flow distributions to limited partners	10,566,000
Cash flow distributions to general partners	1,211,000
Partnership basis prior to sale	$(2,032,000)

The cash distributed upon the sale further decreases the basis of the partnership. Any nega-

TABLE 7. ANNUAL TAX DUE

(+$000)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	Sale
Income (loss)	($1,086)	($1,461)	$ 12	$ 446	$ 820	$1,065	$1,258	$1,737	$2,246	$2,513	$11,385
Unusable losses	1,086	1,461	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-	-0-
Cumulative losses	1,086	2,547	2,535	2,089	1,269	203	-0-	-0-	-0-	-0-	-0-
Taxable income	-0-	-0-	-0-	-0-	-0-	-0-	1,054	1,737	2,246	2,513	11,385
Tax due (28%)	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ -0-	$ 295	$ 486	$ 629	$ 704	$ 3,188
Cash flow	-0-	154	1,274	1,290	1,103	1,149	1,234	1,323	1,416	1,624	14,869
After-tax cash flow	$ -0-	$ 154	$1,274	$1,290	$1,103	$1,149	$ 939	$ 836	$ 787	$ 920	$11,681

tive basis remaining after the sale is considered a taxable gain:

Partnership basis prior to sale	($2,032,000)
Less: Cash distributed upon sale	28,818,000
Taxable gain upon sale	$30,850,000

Both methods for calculating the gain upon sale produced identical results. The allocation of the gain upon sale among the developer, limited partners, and general partners is accomplished utilizing the second method:

	Developer	*Limited Partners*	*General Partners*	*Total*
Original capital	$ -0-	$ 6,500,000	$ 1,000	6,501,000
Plus: Taxable income	-0-	7,549,000	76,000	7,626,000
Less: Cash flow distributions	4,382,000	10,566,000	1,211,000	16,158,000
Basis prior to sale	$(4,382,000)	$ 3,484,000	$(1,134,000)	$ (2,031,000)
Less: Cash distributed upon sale	11,159,000	14,869,000	2,790,000	28,818,000
Taxable gain upon sale	$15,541,000	$11,385,000	$ 3,924,000	$30,849,000

Assuming a 28 percent tax rate, the annual tax due for the limited partners over the ten-year projection period will be illustrated. Under the current tax laws, limited partners are considered passive investors so any passive losses cannot be used to offset active income. This after-tax projection assumes that all limited partner losses will accumulate and be used to offset income in future years. Table 7 shows the calculation of the annual tax due.

In 1990 and 1991, the limited partners had cumulative losses totaling $2.547 million, which shelter the income completely until 1995 and partially in 1996. Between 1996 and 1999, the investors had to pay income tax on the income generated by the property. Deducting the annual tax due from the cash flow produces the after-tax cash flow to the limited partners. Using the after-tax cash flow to the limited partners and assuming an initial investment of $6.5 million, the after-tax internal rate of return (equity yield) to the limited partners is 15.5 percent. This compares to a before-tax internal rate of return (equity yield) to the limited partners of 18.4 percent.

Mortgage Lender

Even though the debt is assumed to be nonrecourse, the first mortgage lender in this transaction has a relatively secure position, lending 80 percent of the project cost and 68 percent of the appraised value. The $1.2 million shortfall reserve along with the guarantee of the developer to fund additional cash needs provides still more comfort.

Another measure of lender risk is the debt coverage ratio calculated by dividing the income before debt service by the debt service. Hotel loans that achieve a debt coverage of 1.30 by the stabilized year are considered conservative. The projected debt coverage ratios for this hotel are set forth as follows:

(+$000)

	1990	*1991*	*1992*	*1993*
Income before debt service	1,380	2,588	3,679	3,863
Debt service	2,314	2,314	2,314	2,314
Debt coverage ratio	0.60	1.12	1.59	1.67

By the stabilized year (1992, year 3), the subject property has achieved a debt coverage ratio of 1.59, indicating a highly safe loan. With a fixed interest rate of 10.5 percent, the first mortgage lender will yield 10.5 percent over the life of the loan.

Hotel Management Company and Hotel Franchiser

The hotel management company is assumed to be a second-tier operator receiving a management fee of 3 percent of total revenue. A franchise fee equal to 5 percent of rooms revenue is included

in the market expense category. The total fees projected to be paid to the management company and hotel franchiser over the ten-year period are as follows:

	Projected Fees Over Ten-Year Projection
Second-tier management fee	$ 5,440,000
Franchise fee	5,059,000*
Total revenue	181,329,000

* Includes an initial franchise fee of $90,000.

The total projected second-tier management fee plus the franchise fee expressed as a percentage of total revenue equates to 5.8 percent. This combined amount should be sufficient to retain a first-tier hotel management company, which would also provide the subject property with some operational expertise and a national identity.

Other Participants in the Transaction. If there was a real estate broker involved in bringing the buyer together with the developer/seller, the fee is normally an expense of the seller and has not been directly factored into the preceding calculations. A $316,000 financing fee was, however, included in the estimate of total project cost; this equates to 1.5 percent of the first mortgage amount of $21.08 million. This should be sufficient to pay a mortgage broker and associated financing fees.

The estimated syndication costs for selling $6.5 million in limited partnership interests amount to $520,000 in commissions paid to broker/dealers plus $65,000 in broker/dealer expenses. The estimated commissions paid plus broker/dealer expenses equate to 9 percent of the equity monies raised, which is a reasonable compensation for these services.

Additional professionals also received compensation for services performed with regard to this transaction, as outlined here:

Professional	Estimated Professional Fee
Accountants	$ 30,000*
Appraisers	30,000
Attorneys (acquisition only)	30,000
Attorneys	45,000*
Engineers and architects	600,000
Survey	15,000

* Syndication costs

Conclusion

This example illustrates one of numerous possible structures utilized by hotel purchasers, particularly those who employ limited partnership syndications. Some of the many permutations that could affect this structure would include:

- ☐ The developer may want an all-cash price and be out of the transaction when it is sold. This could reduce the purchase price paid by the buyer. In this situation, if the general partner had to assume the initial cash shortfall exposure, the split in cash flow between the limited and general partners may be more heavily weighted toward the general partner.
- ☐ The transaction could assume a refinancing at some point that would probably increase the yield to the limited partners somewhat. Likewise, if the project was sold prior to the assumed ten-year holding period, the partnership yield (the IRR) would probably be higher.

Today, with sophisticated computerized financial analysis programs, buyers and sellers of lodging facilities will spread out the proposed transaction as it evolves on a computer spreadsheet to quantify the effect of any modifications made during the negotiation process. The various tables and charts contained in this article illustrate the final output from these programs. ■