CHAPTER 14

Investment Strategies

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¶ 14.01 REASONS FOR INVESTING

The following is a list of reasons to invest in hotel real estate:

1. Hotel real estate is typically countercyclical to stocks and bonds and provides portfolio diversification.
2. Hotels are an inflation hedge because hotel rates can be adjusted daily, within the constraints of market conditions.
3. Hotel real estate provides a refinancing opportunity that can generate tax-free return of capital from appreciating assets. Mortgage amortization also creates equity.
4. Hotel investing can be tax efficient because of associated depreciation and amortization write-offs.

5. Hotel real estate provides a competitive total return, and includes a current income component.
6. Hotel real estate is less volatile than equities.
7. Real estate is the single largest asset class available for investment.
8. Travel and tourism is the world's largest employer and industry. According to the Wharton Economic Forecasting Associates Group (WEFA), travel and tourism accounts for 10.2 percent of global gross domestic product, or $2.6 trillion; 183 million employees or one in every ten workers; 11.2 percent of capital investment (US $613 billion) and 11.0 percent of consumer spending worldwide. Travel and tourism is expected to increase over the next ten years.

¶ 14.02 HISTORICAL PERSPECTIVE

Rarely can an investor or company succeed through imitation or cost cutting. Creativity is necessary. However, creativity usually does not mean a truly new or revolutionary idea. What is generally needed is a new combination of ideas, an extrapolation of what is already known. This chapter reviews the recent history of the hotel industry from the perspective of hotel investment, describes the investment objectives that hotel real estate is most suited to achieve, and, finally, develops a series of investment guidelines.

The various participants in a typical hotel investment do not usually have the same goals or interests. Most participants, with the exception of the owner, are geared toward up-front fees, short-term benefits, and maximizing annual fees based on total revenue rather than toward profitability of the asset. The following sections consider the goals of some of the participants in the traditional hotel investment.

[1] Hotel Chains and Management Companies

In the early 1960s, companies such as Hilton and Sheraton created management contracts as a means of expanding into overseas markets. Once the viability of management contracts as an expansion vehicle was demonstrated, most US hotel groups emulated this strategy during the 1970s and the 1980s to capitalize on the advantages of third-party ownership. These management contracts featured up-front pre-opening fees and annual base management fees, generally ranging from 3 percent to 4 percent of total revenue. While many of these contracts included provisions for an incentive management fee, some management companies had no expectations of ever realizing them. The 3 percent to 4 percent base management fee, in many cases, was sufficient to allow management companies to realize a 50 percent net operating income after all operating and fixed charges.

The revenue-based (as opposed to profit-based) fees led to a continual upgrading of a chain's amenities and services, which increased revenue (and the fees) but not necessarily profits for the owner. Most of these management contracts lasted for long periods of time (more than twenty years) and did not provide any performance clauses or mechanisms for replacing inappropriate or incompetent operators.

As the real estate industry expanded in the 1980s, both foreign and US hotel groups were pursued by investors and owners in what was generally regarded as a "sellers' market" for management companies. Today, however, there is much competition between and among hotel groups and other management companies, and the market has turned in favor of the buyer of management services.

[2] Developers, Syndicators, and Architects

The short-term goal of developers during the 1960s and 1970s was to earn an up-front development fee or profit. Limited partners, brought into a deal by a fee-taking syndicator, were motivated primarily by tax write-offs. Their short-term goal was to shelter personal income with accelerated depreciation write-offs. Architects, frequently unburdened by such tedious concerns as economic budgets, designed properties that satisfied the egos of developers and provided syndicators with a salable image. Property amenities, room sizes, and construction quality increased (only partly as a result of a more competitive environment), whereas consumers' willingness to pay for these improvements did not rise at the same rate.

[3] Lenders

The desire of savings and loans to compete with commercial banks, their new authority to lend money to nonresidential borrowers, and their desire to increase volume and achieve higher levels of fee income resulted in excessive financing during the 1980s. Many savings and loans made a profit with up-front points and fees, in addition to high interest rates on near 100 percent loan-to-value financing. Other underwriting deficiencies included the failure to obtain accurate independent and timely appraisals, and lenders operating with incomplete or nonexistent "in-substance" foreclosure rules. In-substance foreclosure occurs when the debtor has little or no equity remaining and loan repayment is doubtful but the mortgagee has not taken possession of the asset.

[4] Highs and Lows

During the past nineteen years, occupancies peaked in 1979 at 72 percent and declined to 61 percent in 1987 and 1991. The average occupancy for the nineteen-year period from 1976 to 1994 was 65.7 percent. The average occupancy in 1995 was 65.5 percent. With the exception of the five-year period from 1988 to 1992, room rate growth has exceeded inflation for the twenty-year period from 1976 to 1995, demonstrating that hotel investments, unlike stocks and bonds, are a good inflation hedge (countercyclical), and a good investment for inflationary economies. In 1970, only 35 percent of US hotels were chain affiliated. By 1995, roughly 75 percent of US hotels were chain affiliated.

Hotels are retail–oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. The hotel industry is cyclical, event sensitive, and volatile. Hotels can be high-risk investments, especially if the management company, developer, syndicator, architect, and lender do not have congruent interests and goals. As a result of divergent interests among these participants, many hotels have been built in markets that did not need additional hotel capacity, and at escalated costs resulting from up-front fees, which meant that while many hotels were not profitable, many of the participants in hotel deals made money, at the expense of the hotel owner.

The US lodging industry during the 1980s was characterized by a massive building boom (product segmentation), favorable tax laws (syndication), strong economy, a rising stock market, extremely strong capital markets with declining interest rates, significant increase in hotel debt levels, and foreign participation (globalization), which drove up purchase prices. Net interest payments increased from less than 7 percent of total revenue during the late 1970s and early 1980s to more than 14 percent by 1991.

From mid-1990 to late-1993, the US lodging industry suffered through a worldwide recession and was further hurt by the junk-bond market collapse in late 1990, the Persian Gulf war in early 1991, illiquidity in the capital markets, and overbuilding. Overseas lenders and investors substantially reduced their activity in the US, and the Financial Institution, Recovery, Reform and Enforcement Act of 1989 (FIRREA) required more stringent capital standards for thrift institutions.

In addition to the changes in lending policies mandated by FIRREA, many newly conservative institutions reduced new real estate funding levels as a response to large increases in their nonperforming real estate loans. Because banks and savings and loan associations had historically been the source for roughly half the financing for commercial properties, a material reduction in loan activity significantly affected real estate markets. The shortage of debt financing occurred at a time when many 1980s bullet loans and mini-perms were approaching maturity. According to a national accounting firm, more than $2 billion in hotel loans was delinquent or in the process of foreclosure as of September 1990. More than 40 percent of the mini-perms and construction loans held by US banks were scheduled to mature by the end of 1992.

Hotel values eroded considerably during the recession, and capable buyers typically dictated price and terms of a hotel sale. Sales of foreclosed hotel assets by the Resolution Trust Corporation and the Federal Deposit Insurance Corporation during the early 1990s, regardless of the poor condition of the capital markets, resulted in liquidation pricing. In short, the market favored hotel buyers.

The industry returned to profitability in 1993 through a reduction in interest (lender write-offs), payroll (downsizing), property taxes (lower values), and food and beverage expenses and reductions in management fees. In 1993, for the first time in five years, average rate increased at a rate greater than inflation. By late 1993, a flurry of activity in the market began as investors slowly realized that hotel values had hit the bottom of the cycle. It appears that in 1996 the greatest inflow of capital into the hotel industry in more than a decade will have occurred. From 1994 to today, a rising US stock market, favorable interest rates, an expanding economy, and a lack of new hotel supply (particularly in the full–service segment) have helped the hotel industry.

[5] Current Environment

New full-service hotel construction in the US is currently inhibited because (1) development costs exceed value; (2) there is limited capital availability for new full-service construction, and (3) many projects require multi–year development lead times. Most industry sources do not expect significant new, full–service hotel construction in the US between now and 1999. Nationally, room starts have already increased 250 percent from 1993 (excluding Las Vegas casino starts—see Chapter 23) to 1995. Currently there is a shortage of decent hotels available for sale. At the same time, large pools of qualified potential buyers are seeking new acquisitions.

¶ 14.03 VALUE DRIVERS: INDUSTRY FUNDAMENTALS VS. CAPITAL MARKETS

Capital availability is a prime determinant of values in the hospitality industry. Liquidity facilitates transactions and provides for price discovery. Without liquidity, small capital flows can move pricing.

While occupancy figures receive a lot of publicity, other factors, such as changes

in average rate, investor psychology, financial liquidity, and profitability ratios are also very important. Capital availability and cost affect returns more than industry fundamentals such as occupancy and average rate. Capital availability drives capitalization rates and new construction feasibility and therefore new supply. Supply changes have a higher correlation with capital availability than with demand. Unfortunately, supply growth does not necessarily correlate with demand growth. In the early 1980s, room starts nearly doubled, while occupancy was steadily declining from its 1979 high. The early 1990s crash was a result of a capital crash more than it was a result of a demand crash or overbuilding.

Real estate assets typically exhibit lower volatility (and consequently lower returns) than stocks or bond investments; however, in the short-term, a hotel's performance may vary more than other types of real estate with long-term leases. This variability dictates either longer potential holding periods to smooth out industry cycles or a market cycle timing approach, with the end result of potentially greater equity returns for hotel investments as compared to other real estate.

Hotels, perhaps more than any other type of real estate, display cyclical occupancy trends over the long term. New hotels are built either because of an abundance of capital or because growth in demand causes an increase in area-wide occupancy levels and attracts the attention of developers, lenders, hotel chains, and management companies. When the rate of new property construction outpaces growth in demand, overall occupancy levels decline while demand "catches up" and/or the least competitive facilities drop out of the market.

¶ 14.04 INVESTMENT STRATEGIES

[1] Timing the Market

Unlike stock investing, the best strategy for investing in hotel real estate is market cycle timing, not dollar-cost-averaging or holding for long time periods. Hotel real estate market cycles take years to change, while equities can change in a day. The Tax Reform Act of 1986 removed many of the tax benefits associated with real estate ownership that had assumed greater importance than sound economic underwriting. That the industry remained relatively strong for three to four years after the Act was passed demonstrates how easy it is for an astute investor to time the hotel real estate market.

The hotel real estate cycle historically is eight to twelve years long. The building boom of the early 1920s came to an end with the depression of the early 1930s. The REIT-induced real estate slump of the early 1970s was forgotten by the time of the peak of 1979 and the early 1980s. That peak ended in the early 1990s. Many investors that purchased hotels at or near the bottom of the 1970s cycle and sold in the early and mid-1980s realized large returns. Those investors that purchased hotel property in the early 1990s will earn huge returns when as they sell in 1996 and beyond.

The most prudent time for hotel acquisition, as demonstrated by the 1970s and 1990s real estate cycle, is not when the market is achieving strong occupancies and many new properties are under development, but rather when new construction has peaked and occupancies and average rates are improving.

[2] Risk Avoidance

An approach that not only analyzes investment opportunities prospectively but also assesses potential risk complements this market cycle timing strategy. Controlling

downside risk maximizes portfolio yields, in the same way that the baseball batter that consistently hits doubles and triples will outperform the "home-run or strikeout" hitter. Risk is managed with adequate cash reserves, intelligent renovation plans, low property break-even levels, and an asset diversification strategy.

The selection of hotel properties may be the most important aspect of a combined market cycle timing/risk avoidance strategy. Recognizing current and future value, buying "right," enhancing value with effective asset management, negotiating well-structured property management and franchise agreements, and selling at or near the peak in the real estate cycle is a strategy that has proven successful.

[3] Appreciation Maximization

It is a good idea to focus on appreciation and seek to maximize total return and not just current yield, because yield can be more than offset by capital losses. Current income is not always a true indicator of underlying asset value. A high current dividend strategy favors premium-priced performing hotels in strong markets. These properties often have minimal upside, if they have any at all. Because at the time of acquisition these assets are maximally productive, they sometimes have only one direction in which they can move—downward—and are therefore higher-risk investments than they appear. The reliance of the pension fund community on this investment strategy is a significant reason for its poor performance in hotel investments. Strong hotels in strong markets sell at premium and may be at the peak of their life cycle. Appreciation maximization strategy seeks strong market positions with defensible niches. High penetration rates or profit margins are indicative of a dominant competitive position. However, when the market is very strong, it can attract competition.

Secondary markets are sometimes better markets in which to execute this strategy because they sometimes attract less notice, and therefore less new competition.

Performing hotels in recovering markets are hard to value, because market changes are beyond the hotel owner's control. The greater the percentage value attributable to future market behavior, the greater the likelihood that value will vary over time. However, market recovery bets can be very profitable—hotel investors that bought well-located, strong property in the oil-producing, depressed areas of Texas and parts of Colorado in the late 1980s have demonstrated this with huge earned appreciations since that time.

Some hotels are underperforming and are located in weak markets. Weak hotels in weak markets face two questions: will the asset improve and will the market improve? Such hotels are too risky.

[4] "Fixer Uppers"

The most consistent way to maximize returns and minimize risk is to find hotels that have a problem that can be fixed. The fixable requirement generally excludes locational problems. Buying underperforming hotels in sound markets is less risky because the investor is not dependent on factors out of his control. If the market is sound or even strong, he does not have to wait for the market to turn around—he needs only to turn the property around. Five basic strategies for purchasing hotels include:

1. Look for properties that are receiving their fair share of revenue but have high expenses that can be reduced with competent management. Increases in cash flow from expense reductions are generally less risky than forecasted

revenue increases. Historical statements should be recast to provide an example of potential cost savings and the effect on value. Roughly 40 percent of all the expenses at a hotel are labor. An expense reduction strategy should focus on the number of employees currently at the hotel, their wages and benefits, and labor productivity based on sales. Characteristics of underperforming properties may include rising expenses, expanded accounts payable, accelerated staff and management turnover, erosion of guest services, sales and marketing cutbacks, and deferred maintenance.

2. Properties that need capital expenditures are good acquisition candidates. One strategy is to buy well-located property in poor condition, and completely renovate and reposition. Pressure to sell is often strongest when the immediate need for property refurbishment clashes with owner illiquidity, loss of confidence, disinterest, and pressure from bankers.

A variation of this strategy is to purchase run-down, de-franchised hotels at the end of their economic life cycle for little more than land value, say $10,000 to $20,000 per room. In many cases these old properties have the best locations in a market, and after renovation the investor is left with a franchisable mid- or upper-level hotel in a strong location at one-half the cost basis of its competitors. One of the challenges with this variation is that many municipalities require that a property, upon a major renovation, be brought back into compliance with current codes. Compliance-type improvements rarely provide an adequate financial return.

3. Reposition properties at a lower level, if it will increase net operating income.
4. Buy hotels with excess development capacity or excess land in markets in which additional development is warranted. This provides immediate cash dividends from the existing asset and future development potential upside.
5. Buy hotels with clearly definable and divisible wings and replace with multiple brands at different price points.

[5] Buying Below Replacement Cost

The principle of substitution—essentially, that the buyer will evaluate available purchase options with equivalent utility and select the property with the lowest price—is the driving force behind hotel real estate values. In the income approach, it is embodied as the concept that a prudent purchaser would not accept a return on a property that would be below an alternative investment of similar risk. In the sales comparison approach, the principle of substitution means not paying more for a property than the cost of acquiring an equally desirable substitute. In the cost approach, the principle of substitution is expressed as not paying more for a property than the amount for which a site can be acquired and improvements that have equal desirability and utility constructed.

In most markets, supply and demand conditions eventually generate investment returns that justify new construction. When this occurs, existing buildings that are of comparable quality to new construction command similar rents (RevPAR), and thereby generate greater returns to the extent that the asset was originally purchased below replacement cost. The critical variables determining profitability include the duration of time for market supply and demand balances to change, capital adequacy, and the quality and life cycle position of the facilities.

A secondary advantage to buying below replacement cost is the fact that the feasibility of new construction is limited, which protects current yields.

Hotels are often mispriced because of limited data and inefficient capital markets. Often, too, value distortions are psychologically based. Common psychological distortions include overpaying for investments that appear secure (pension funds, for instance, are mistakenly drawn to assets with high dividend yields), overestimating risks, and overcompensating others for those risks.

A good way to separate value from emotion is to emphasize fundamental research, disciplined valuation techniques, and strict buy-and-sell rules when making a buying decision. While it is important to be able to identify unrecognized opportunity, one must avoid the tendency to overestimate the likelihood of a favorable but unlikely occurrence.

Financial projections should not automatically project that each year will be better than the preceding one. Recessions do occur. Real estate is a depreciating asset with a finite economic life that includes not only a growth phase, but also maturity and decline. Few operating histories trend steadily upward. Most properties move upward and downward.

Stabilization is an important concept in this regard. A stabilized occupancy and average rate is the average performance for the property *over its remaining economic life,* and not a point reflecting the hotel's current life cycle position. The danger occurs when a property is incorrectly stabilized at a peak level during the acquisition analysis, but the holding period is for a longer term. The buyer often ends up trying to exit the investment at a performance level below the level at acquisition, resulting in a loss. It is important to realize that most projection periods are longer than the ability to project new supply. Consequently, it is a good idea to have short holding periods, as well as an exit strategy developed prior to acquisition.

[6] Short-Term Holding Periods

Hotels have a definite functional life. Because exterior architectural styles change regularly, many lodging facility exteriors appear dated after seven to ten years. Major exterior renovations are usually required after twenty years.

Asset values decline exponentially after the mid-life point of a hotel. However, major renovation and repositioning can postpone a hotel's mid-life for many years, depending on the strength of its location and market.

The industry uses a standard 4 percent replacement reserve, which some claim is less than half what it should be. The naysayers, however, demonstrate an incomplete understanding of hotel valuation. First, the 4 percent replacement reserve is meant to cover only the costs of replacing the furniture and equipment. It specifically excludes so-called short-lived building components. Short-lived building components are building systems such as a roof, parking lot, or boiler that will need to be replaced before the end of the asset's useful life. Real estate theory holds that if short-lived building component replacements are not, by industry convention, deducted from cash flow, then those costs are considered by the market in its selection of an equity yield. In this respect, short-lived building components are not unlike the asset management function and incentive fees. All three of these items are costs implicitly considered in the selection of an equity yield rate. If short-lived building components are to be deducted from cash flow, then equity yield rates must be adjusted to reflect this new assumption.

Over the long term, all investment returns trend toward the mean. Short-term holding periods accomplish the following:

- Mitigate illiquidity because of increased stability in the forecast horizon. Short-term cash flows are more reliably projected, resulting in lower risk.

- Force a full evaluation of the exit strategy before committing to the investment.
- Reduce the potential for negative event volatility.
- Reduce the likelihood of short-lived building component (e.g., roof, boiler) replacements, which rarely result in increased profitability.

Beyond the stabilization period, value increases occur at a lower (inflationary) rate. The risks inherent in owning a hotel and associated required capital expenditures are generally not adequately compensated with a 3 percent to 4 percent annual inflation-driven increase in cash flow and value. The exception is a well-diversified portfolio that is investing in hotels purely as an inflation hedge.

[7] When to Sell

Signs that selling a hotel may be appropriate include:

- When a value estimated using the market data approach (comparable sales) exceeds that arrived at using the income approach or cost approach valuations.
- When national occupancy levels exceed 68 percent–70 percent;
- When gross domestic product (GDP) declines materially;
- When new construction occurs at a rate above demand growth;
- When comparable sales occur at or near historically high levels;
- When sales occur at capitalization rates that exceed the normal cap rates of the industry over a long-term period.

Exit strategies for investments in the fee, leasehold, or leased fee estates of real property can include, but are not limited to, the following:

- Sale of assets individually, as a group or a combination of group and individual sales;
- A public offering as a real estate investment trust (REIT) or other public offering;
- A securitization or other refinancing;
- Contributing the equity value in the assets to capitalize a new investment;
- A leveraged buyout;
- A syndication; and
- Conversion to time share, an alternative use, or term interval ownership (time share for a limited number of years which then reverts back to original estate interest).

Investments that have a high likelihood of being acquired by strategic buyers and/or are likely candidates for public offerings enhance the potential profitability of the exit or residual return.

[8] Public vs. Private Ownership

Does real estate belong in a public company? Should it be privately held, either wholly or with others? Consider the following when answering these questions:

- Depreciation depresses earnings and therefore stock prices.
- The public market historically has had difficulty measuring unrealized asset appreciation and value changes.
- Hotels have an earnings volatility that is greater than other forms of real estate because of high fixed costs, high leverage, and event sensitivity. An aberrational quarterly earnings report can dramatically change a company's stock price. This causes a drive to consistently improve each quarter's cash flow. The danger of this situation is that it may change management's focus from a value creation and appreciation maximization strategy to a high current cash-on-cash yield acquisition strategy. Current income is often not a true indicator of underlying asset value, and current yield can be more than offset by capital losses.
- Because of quarterly earnings pressure, public companies are more likely to hold a property for a period beyond a one-to-three-year turnaround-and-stabilize period. This is antithetical to short-term holding periods and locking in gains, and it may minimize the value of underlying assets.
- Public market pricing often results in a significant premium over market value of the assets. Public hotel companies are currently trading at multiples of 15 to 20 times earnings before interest, taxes, depreciation, and amortization (EBITDA). EBITDA is roughly the public market equivalent of the private market's net operating income or the REIT market's funds from operations (FFO). The reciprocal of an earnings multiple is a cap rate, and therefore the reciprocal of a 20 EBITDA multiple is a 5 percent capitalization rate (1/20 = .05). The assets held by the companies that are trading at 20 multiples would not be worth a 5 percent cap rate if sold in the private markets. For this reason going public can be an excellent portfolio exit strategy. The execution of this strategy however, will require a growth story.

The current difference between public and private market hotel valuation creates the question: Why are the public markets valuing these hotel companies so highly? The standard answer is that they will grow quickly and that today's 5 percent cap rate will grow into a 15 percent cap rate. The second question is What distinguishes a public company's growth prospects from a private company's growth prospects? The answer to this question is simply that public companies typically have greater access to capital. In essence, today's public companies are realizing a value arbitrage that doubles their value simply because they have ready access to capital.

In order to maintain this value arbitrage, public companies must meet the market's growth expectations. This can put pressure on the acquisition and development strategy at public companies. Valuations of public companies are often based on a single quarter's or a single year's performance. Therefore, fluctuation in revenues and cash flows leads to increased risk and volatility of share values. To attract investors, properties may be chosen on the basis of their *current* cash, which translates into the desired yield. As a result, sourcing product on the basis of high current yields may favor short-term, high-risk properties over high-quality, but developing, long-term prospects.

The public markets are fickle and do not completely understand real estate. Today's favorable valuation could easily be tomorrow's unfavorable valuation. The public markets are best used either as an exit vehicle or as a means to fund an aggressive growth plan and achieve critical mass.

Because of high fixed costs, marginal revenue creates disproportionate increases in net income. Publicly held companies, whose critical mass (growth) is supplemented by ready access to capital, should increase market share.

[9] Equity Leveraging

Equity leveraging, like debt leveraging, is designed to maximize the impact and return of equity capital. Equity leveraging generally consists of either (1) selling a partial interest in an asset, or (2) making acquisitions through a joint-venture arrangement. A joint-venture arrangement may consist of a new joint venture with, for example, one-third of the funding coming from an operator contributing the equity value of its owned real estate and a passive capital source contributing two-thirds in the form of cash. The advantage to the capital source in its investment is, for example, one-third specified, and is not completely blind. This arrangement provides an immediate cash-on-cash return. Presupposing that both joint venture partners receive the majority of their compensation on the same bottom line, this arrangement is very effective in aligning the interests of the operator and the passive capital source.

Selling a partial interest is a similar idea applied to a single asset. By selling a partial interest in an asset, generally 49 percent to 90 percent, the seller is able to free up equity for additional investment while still retaining a portion of a property's future appreciation. Equity leveraging is particularly useful when an investment strategy includes a market recovery bet. Equity leveraging a single asset occurs most often with larger more expensive hotels.

[10] Diversification Strategy

Because of event sensitivity, several smaller investments of any type are better than a single big bet. Because hotels are market- and management-sensitive, diversification is particularly beneficial. A strategy designed to accumulate a well-balanced portfolio that spreads market and product risk among different hotel types, affiliations, and sizes in a variety of locations reduces volatility. Diversification by strategic objective, quality of facilities, age, types of demand generators, financial structure, and seasonality as well as market segmentation increases stability and reduces risk.

[11] Miscellaneous Strategies

[a] Broker Relations

It is important to maintain regular and honest communication with the brokerage and investment banking community. A steady and consistent deal flow ensures that an investor is in tune with market conditions. Additionally, strong personal relationships with the agency community means that investors will be exposed to listings with short marketing periods.

Often the highest bidder is not the prevailing party. Issues such as speed and track record are important considerations. A personal relationship with your broker can help you in these "soft" considerations.

[b] Brand Creation and Critical Mass

Buy assets that can be leveraged into chains. Critical mass in the hotel industry is central to the success of most hotel companies and essentially separates the major chains from the minor ones. It may best be defined as the minimum number of hotels and hotel rooms that will economically support a full-service corporate structure. Typically, one hundred hotels in the US constitutes critical mass. Included in the full-service corporate structure are the advertising and consumer brand awareness of the

chain as a whole, a central marketing staff, and a central reservations system. Additional benefits that might be derived from critical mass include the availability of chain-wide purchasing contracts for both goods (furniture and equipment as well as consumables) and services (notably advertising and marketing services), and may also include such items as insurance.

When critical mass is achieved, having your own brand is cost-effective. Royalties paid to franchise companies are usually 3 percent of rooms revenue and generally represent the franchise's profit. Three percent of the rooms revenue for 100 hotels represents a substantial expense savings. The development of a brand also creates franchising as an option. Upon reaching critical mass, franchising can be very profitable. One of the criteria for a hotel to be a trophy hotel is whether its name is well-known enough to merit development as a brand name. If this criterion is met, part of the purchase price may be allocated to launching a brand as opposed to the acquisition of real estate.

Devotion to expanding a brand, however, might slow the pace of growth and cause an investor to miss good hotel real estate and business investment opportunities. The ideal situation, provided there is sufficient capital, is to have the ability to grow both a proprietary brand and other brands.

[c] Barriers to Entry

Because supply increases are driven by capital availability and not by industry fundamentals, it is a good idea to search for markets with high barriers to entry. The premium hotel in a premium market strategy should be combined with high market barriers to entry to justify the premium price paid. Barriers to entry include hotel mortgage financing and hotel equity availability, market values that are less than replacement cost, tax laws, interest rates, environmental issues, local protectionist sentiment, prevailing mechanisms for project approval, and local politics.

¶ 14.05 MANAGEMENT ISSUES

[1] Aligning With a Hotel Management Company

The investor should carefully choose and then limit the number of people he does business with. Funding long-term relationships and not deal-by-deal transactions and aligning with a value-adding management company willing to be compensated on the bottom line are ways to accomplish this. The profit on management fees enables management companies to pay more (10 percent–20 percent) than passive investors, to whom management/affiliation fees are simply an expense.

[a] Congruent Interests

Passive institutional investors, the public capital markets, and savvy but passive, high net-worth individuals are now focused on aligning their interests with management's interest. These entities generally recognize hotels as retail-oriented, labor- and capital-intensive businesses that depend on customer acceptance and require a high level of managerial expertise. They acknowledge that unlike hotel operators, they are not industry insiders and are not comfortable relying solely on the management contract to align their interests with management's. Therefore, many passive investors require, or are attracted to, the following:

1. Management that has enough confidence in itself to invest in the asset.
2. Management compensation that is based on net income rather than gross revenue.

One way to align the interests of operators and passive investors is for the passive capital source to purchase a majority interest in the real estate and a minority interest in the management company. This feature, ownership in both the operator and asset, is similar to the paired-share real-estate investment trust (REIT) now known as Starwood Lodging Trust. Starwood purchased its predecessor REIT, Hotel Investor Trust, not for its poor-quality assets, but because it is the only hotel REIT in the United States that pairs shares in the operator and asset with every share purchase. This structure provided investors with such confidence that they were able to raise almost one-half billion dollars. Several REIT initial public offerings, including Hospitality Investors Trust, were not successful because the market was concerned about the nonaligned interests of the passive investors (shareholders) and management.

Investment performance is maximized by aligning the goals of the owner and manager so that both entities benefit mainly from residual capital appreciation and equity cash flows rather than from front-end and ongoing fees that are unrelated to financial performance. Management contracts with competent operators should be structured at reduced base fees (2 percent or less), for much shorter lengths of time (one to five years is not uncommon now), with meaningful incentive payments (a percentage of improved cash flow after debt service and after a preferred equity return) and performance clauses and guarantees. Earnout provisions by which the management company forgoes some cash flow in exchange for a percentage of the residual and/or refinancing proceeds are also a good idea. The manager, for example, may be compensated with a percentage of the return earned by the investment, after a 9 percent–15 percent preferred return to the investors. There should be no charges for acquisition or asset management and no placement fees of any kind for property selection, underwriting, due diligence, or technical service fees for the management of property renovations.

To maximize capital return upon divestment, management contracts should be cancelable without penalty upon a sale. That way, property can be sold unencumbered by a management agreement. Meaningful performance clauses should be negotiated where possible so that non- or underperforming management companies can be terminated. Considering the recent consolidations of management companies, an investor should attempt to eliminate the right of any management company to sell, transfer, or assign its rights, except to a wholly owned subsidiary.

[b] Selecting a Management Company

Selecting a hotel management company with the specific capabilities necessary for running a particular property is a key step in a hotel investment. Knowledge of the financial and market capabilities of a variety of management companies is helpful in selecting appropriate management companies. One should match the various characteristics of the asset (e.g., size and type of hotel, class, geographic representation in local and feeder markets, critical mass, market segments served, and facilities offered) with the operator that has the best track record, operating performance, and experience in handling these characteristics profitably. Factors to consider when selecting a management company include the following:

- Geographically clustered hotel companies with strong centralization tend to outperform the median.

- Because of high fixed costs, incremental business is most profitable. Therefore, marketing skills add the most value.
- Technology (yield management) can improve marketing, income, and value.

The investor should also consider the management company's rate of growth, expertise and track record, depth of management, turnover of corporate staff and key personnel, years that management has been together as a team, present and future company profile and philosophy, reasons for any past contract terminations, operating policies and procedures, owner references after a competitive bidding process, and fee structure.

¶ 14.06 CONSOLIDATION

Mergers and strategic alliances can enhance returns through synergy, economies of scale, a harvest strategy (otherwise known as milking the cash cow), and risk-pooling. Principal reasons for mergers include access to capital for future growth, improved critical mass and economies of scale, and shareholder value enhancement. When two complementary companies are brought together with minimal initial cost, earnings may receive an immediate boost.

Mergers can be a quick way to grow, but they are not without risks. Mergers present the risk of an unsolicited, and possibly hostile, offer from a third company. Another problem with mergers is that the number of reasonably priced available suitor companies with real growth potential is often quite small. Early on, a decision should be made as to whether the goal is simply to acquire real estate assets at favorable pricing or whether the acquisition of an ongoing effective company is the goal. It is a good idea to seek valuable business assets locked inside weak capital structures. If there is a desire to keep the target company operating, then issues such as the following are important:

- Cultural fit, style, trust, similar philosophy;
- Product compatibility, with manageable hotel location overlap;
- Credibility and reputation;
- Financial strength, performance, and value of assets.

Tender offers for REITs and public hotel companies when their stock market capitalization is less than the value of the assets also constitutes an attractive consolidation strategy.

¶ 14.07 MEZZANINE FINANCING

Mezzanine financing is supplemental debt financing that is either (1) wrapped around an existing first mortgage, like a bridge loan or second mortgage; or (2) a single debt instrument tranched (split) into a first mortgage component and a mezzanine, earnout, subordinated, or "B-rated" component. Generally, mezzanine financing is flexible and customized and provides for a high loan-to-value ratio (ratios in excess of 90 percent are not uncommon) or a below-market interest rate. In return, the provider of mezzanine financing receives interest payments and a significant portion of a property's future appreciation. Additionally, the mezzanine financing provider may receive other "equity-like" rights, including management contracts and affiliation agreements. A

mezzanine financing arrangement, which generally includes a sharing of future appreciation, can be structured so that appreciation sharing is a percentage split, predetermined fees paid upon maturity, or as a negative amortization loan. Mezzanine debt is usually short term (two to five years). Mezzanine financing can be used in the following ways and under the following circumstances:

- To bridge the gap between low loan-to-value public bonds and equity downpayments.
- When the buyer does not have sufficient cash, or chooses to deploy his cash resources elsewhere.
- For asset repositionings that involve a renovation.
- To achieve full or partial takeout of existing financing at a higher loan-to-value.

In many cases the operator/owner becomes the prevailing bidder when buying hotel assets because they receive the additional benefit of management and/or affiliation fees and are able to economically offer a higher price than the non-operator. This "operator arbitrage" could be applied to the debt markets.

Buying nonperforming debt, with a subsequent foreclosure planned, is another way to gain control of property. However, foreclosure laws vary by state and this strategy is more viable in certain states. Further, this strategy carries the additional risk that the foreclosure may not be successful and the debt buyer will remain a debt buyer. In a worst-case scenario, some or all of the debt buyer's expenditure could be dismissed by a bankruptcy court. This strategy works best when the principals have legal backgrounds.

¶ 14.08 DUE DILIGENCE

As discussed in detail in Chapters 6 through 10, the following market and site/property items should be reviewed.

[1] Market Analysis

The economic vitality of the area encompassing the subject property and its feeder markets is an important consideration in forecasting future demand and income potential. Trends that foreshadow probable future economic patterns of the market as well as the vulnerability of the lodging market to economic trends should be evaluated. The size of the market and the demand for transient accommodations should be investigated to identify the various generators of visitation operating within the local market. The current and anticipated potential of these demand generators should be evaluated. An investigation should be made of the respective strengths of the market in terms of seasonal volatility and other demand fluctuations, price sensitivity, required facilities and amenities, and changes in travel patterns and other related factors. The market's diversity, or reliance on a few demand generators, and the economic volatility, seasonality, and prospects of significant demand generators should also be analyzed.

Economic diversity within the local market has an important effect on the area's stability, growth, and risk. Economically diversified markets generally have reduced volatility. Seasonality creates volatility and risk. Large variations between months or daily occupancies and weekday versus weekend occupancies limit upside.

In analyzing demand, the overall transient lodging market should be subdivided into individual segments based on the type or nature of travel because individual classifications generally exhibit unique characteristics. Market segmentation helps to define major types of demand and to estimate future growth rates and customer characteristics. The market's and the subject property's reliance on or diversification by market segment, including contract business, should also be evaluated.

Competitive lodging facilities should be evaluated to determine their position, rank, and other pertinent operational characteristics with respect to the subject. An analysis of existing and proposed competition provides an indication of the current accommodated and latent demand, relative market shares and penetration, and price/value relationships for customers. Some of the competitive factors that should be specifically reviewed include:

- Number of rooms;
- Average rate;
- Occupancy;
- Market orientation and segmentation;
- Location;
- Chain affiliation;
- Age;
- Quality;
- Condition;
- Rate structure and pricing strategies;
- Class and type of facilities;
- Size of meeting facilities;
- Level of services and recreational amenities;
- Type of food and beverage outlets;
- Management difficulty and expertise;
- Frequent guest programs;
- Travel agent commission policy; and
- Market perceptions and the comments of property management.

The nature and status of projects under construction, proposed or merely rumored, that might be competitive with the subject property should be evaluated. Barriers to entry for new competition should be evaluated. The probability that existing, older, noncompetitive lodging facilities will receive substantial capital upgrades and thereby increase their level of competitiveness should also be considered.

[2] Site and Neighborhood Analysis

A thorough inspection should be made of the subject site that takes into account its physical and functional utility for hotel use, including its size, shape, topography, utilities, access, visibility, zoning, neighborhood, and other relevant location factors (e.g., proximity to both transportation systems and lodging demand generators). The supportive nature of surrounding land uses and patterns reflecting growth, stability, or decline should also be evaluated. The subject hotel's location, as compared with

competitor locations and vacant developable hotel sites and relative to current and future demand generators, is a prime location issue. Plot plans including frontages, total site dimensions, access points, orientation of the improvements, and survey and legal descriptions should be reviewed. In addition, soil tests and seismographic studies may be advisable.

[3] Subject Property Analysis

The physical improvements, facilities and amenities, should be inspected for their quality, style, design, layout efficiency, functionality, and effect on operating efficiencies and profitability. An evaluation considering size, condition, and suitability relative to the local market demand, segmentation, and competitive supply is necessary. As-built architectural/floor plans detailing the layout and relationship of spaces and areas within the property should be reviewed. This evaluation should include public areas, meeting facilities, restaurant and lounge facilities, back-of-the-house areas, mechanical equipment, and a sample of all guestrooms. Furniture and equipment are essential to the operation of a lodging facility, and their quality often influences class, image, and income. An assessment of the subject property's remaining useful life and the quality of its construction and materials used, including furniture and equipment, should also be required.

Historical refurbishment, FF&E and capital expenditures, maintenance records and programs, current budgets, engineering studies, ADA Compliance Reviews, and Phase I and II environmental studies should be reviewed. Deferred maintenance and other mechanical, building, or FF&E issues that require remedial attention must be identified. The sufficiency of proposed capital budgets, FF&E reserves, and insurance coverages should also be evaluated.

Franchise agreements; reservation reports; franchise inspection and deficiency reports; health, fire and building inspection reports and employee manuals should be reviewed as aids in evaluating the probability of losing or changing the current chain affiliation.

It is important to inspect the subject property's technology. This technology includes systems for yield management, accounting, property management, point of sale, building operations, sales and catering, life safety, security, and guestroom access. Yield management maximizes the ability to sell more higher-priced rooms during times of peak demand periods by specifying a varying number of rooms available at discounted rates during a given period, depending on overall demand. This technique reduces the likelihood of turning away guests who are willing to pay a higher rate because the units are occupied by patrons paying lower rates.

[4] Supply-and-Demand Analysis

A supply-and-demand analysis should be used to understand and quantify the subject property's competitive positioning with respect to other lodging facilities. This analysis integrates all information regarding the data and information gathered during the fieldwork inspection, such as the subject site and facility analysis, area hotel and economic trends, demand characteristics, and competitive analysis. The supply and demand analysis results in a quantification and documentation of probable future trends in the subject property's market share, occupancy, average rate, and overall rooms revenues. Markets in which competitors have a lower cost basis should be carefully evaluated, because the competitors can then profitably afford to undercut your rates.

[5] Financial Analysis

All practices and procedures involving financial management and results should be reviewed. In particular, the following items should be analyzed:

- Historic income and expense statements with full supporting schedules for the past three years (if available). Any audits or financial reviews should also be considered when available;
- Balance sheets (audited when possible);
- Operating budgets and projections;
- Annual reports (if a public company);
- Actual operating data from comparable lodging facilities;
- Marketing plans;
- Reservation system reports;
- Current definite and tentative pre-bookings and rate structures;
- Historic pre-booking conversion rates, booking pace, and rate structures;
- Occupancy and average rate summaries by month;
- Local expense factors relating to items such as labor, food and beverage costs, energy rates and bills, assessed values and taxes;
- Contractual obligations under frequent traveler programs;
- The relationship between rooms revenue and total revenue; and
- The level of fixed costs.

A projection of income and expenses representing future expectations of income potential, and corresponding to the level of activity and quality of operations indicated by the projected occupancy and average rate, should be developed. Various scenarios or "stress tests" (including best and worst case) should also be developed to test the sensitivity of various assumptions and projections. Actual inflation that varies significantly from projections can alter anticipated yields. The sensitivity of projected investment yields at different inflation rates should be tested. Because of the effects of compounding, a small deviation in assumptions can have a large impact on value.

[6] Other Analyses

Any property, equipment, ground or tenant leases or subleases, management contracts, union agreements, service contracts and key supplier relationships, or trademarks/trade names and any documentation pertaining to in-lieu of property taxes or other property tax concessions should be reviewed by a hotel real estate professional for business issues, as well as by an attorney for legal issues. Appraisals, market and feasibility studies, and impact studies should also be reviewed to discover any previously unknown facts, and to evaluate the reasonableness of the assumptions and conclusions. An accountant should be used for financial audits and reviews and to evaluate tax returns and other relevant tax and accounting considerations.

Payroll is generally a lodging property's greatest expense. The current staffing level, any wage and benefit surveys, qualifications, and compensation of on-site management should be reviewed and compared to industry norms, as should existing labor control systems.

A detailed ownership record and history of the subject property with names of legal owners is important. Legal due diligence should include all contracts and current letters of intent, including any existing mortgages to be assumed or wrapped, title reports and insurance, stock or partnership agreements, major group booking contracts, frequent traveler programs, and service and maintenance contracts. A zoning and life safety compliance analysis should also be undertaken and any Hart Scott Rodino and tax issues investigated. The existence of any violations and the transferability of all licenses, permits, franchises, and other documents also must be evaluated.

In the case of mortgage due diligence, the borrower's credit history and reports, track record, and references should be reviewed, along with the history of any existing indebtedness, both secured and unsecured. If due diligence is for a purchase, an inventory list of all furniture and equipment, supplies, and consumables will be necessary, as will a list of all employees and appropriate personnel information. Due diligence for acquisitions should also include a detailed list of advance room and catering reservations and bookings, including the name of the party, deposit received, rate guaranteed, dates, status, and other relevant information.

Understanding and staying current with the hotel industry is a full-time endeavor. Third-party due diligence is not a substitute for full investigation by principals to a transaction. Instead it is an extra set of trained eyes and independent confirmation that appropriate questions have been asked, answered, and understood. In addition, third-party due diligence may save time for principals by focusing their time and efforts on areas of greatest need. Due diligence is analogous to insurance in that it reduces, but does not necessarily eliminate, risk.