LIIC roundtable

Executives address key issues facing the lodging industry

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Hotel & Motel Management

Jeff Higley: "How does a developer obtain financing right now? "

Jeff McKee: "Banks are still very active in most markets. GMAC, GE Capital are very active. Pension funds are coming back in, as well as the securitization; the conduit markets are starting to fill up. There's a push to put product out the door and get loans out the door. The pricing isn't coming in at sub-200 pricing. The money is becoming more available and driving the cost of capital a little bit more."

Higley: "That seems to be contradictory to what a lot of people are telling us. Everyone we talk to says "There's no money out there." How do you combat that impression?"

McKee: "The folks that tend to say that, the bad news comes out first, and the good news never gets talked about. The folks saying that are not well-capitalized. They're having equity expectations of putting in 25 [percent] to 35 percent when maybe the project requires, given all the changes in the particular market, requires minimum 35-percent equity to get that deal done and make the cash flow near term and longer term. For us, even if we're doing a lot of stuff floating rates, we're going to underwrite to an assumed fixed rate constant so that you have that cushion. Some folks are talking about low-cost capital and surviving based on interest costs now. Hopefully our customers are going to survive even longer than that because that cost of capital is priced in, at least over the foreseeable future. Hopefully, the growth rates as the properties continue to grow in their markets, that if and when that interest rate cost comes back up, they're not going to get caught in that shortfall."

Jim Butler: "While I wouldn't disagree with the statements that are made, if you look at them they're pretty dramatic. Developers are not used to thinking about 65-percent equity. That's probably a pretty optimistic view of what it takes. Development is way down. It's much harder to justify the feasibility of a project today. We're seeing the greatly reduced number of developers get it financed through a handful of unique ways. They either have a special relationship, like if you're going to do a Four Seasons, they have Bank of Nova Scotia as their lead lender and the Bank of Nova Scotia tends to look favorably on Four Seasons product. It means it's going to be easy money, you're not going to have to come up with a ton of equity but they know and like the product. GMAC likes Marriott product, then you have to do a deal with Marriott and you may have to give away a lot of things in your management agreement or your arrangements with Marriott to get them to provide some credit support for this situation, still a ton of equity. All of these mean the developer tends to go on what he stumps to-investors for a lot more equity or other partners who are going to facilitate it. There are fewer lenders that are willing to provide capital and are providing them at much tougher terms."

Todd Siegel: "That money is there, but at a lot lower [loan-to-value ratios] and higher prices. In equity, with the current market situation, the current numbers for the near term, there isn't enough property in these hotels to attract the equity. You need to look for subsidies. It's coming from the cities, it's [tax increment financing] money, it's rebate of taxes or doing tax-exempt bond deals, which a lot of these cities are turning to in order to get these deals done."

Rob Koger: "In terms of new development on higher-end properties, we're seeing 50 [percent] to 55 percent. One of the things missing today, which it wasn't missing 18 to 24 months ago, has been the credit enhancements from the chains. A lot of the major chains have withdrawn that because of other issues they may be having with pressure in the public markets that have prohibited them from throwing that on the table. Even [mezzanine] debt that they would have done in the past. That extra 10 [percent] to 15 percent on a development makes all the difference because the equity is hard to get when you're penciling out a new Hyatt at $250,000 a room. That's a hard number to underwrite today if you're an investor. "

Larry Shupnick: "The thing that's probably taking away the ability of the brands to credit enhance is the debt covenants have changed tremendously in public companies' borrowing situation related to what happened after 9/11. A lot of the enhancements that were there before that they could freely give when companies were prospering a lot more in meeting their obligations under the loan agreements in place. They didn't have any problem saying 'I'll guarantee 15 [percent] to 20 percent of this with GMAC or GE or whatever.' They can't do that anymore because they're under very strict restrictions because the [revenue per available room] and the income is down in the company. Consequently, they don't have that extra slack in the balance sheet."

Higley: "Rob, when people come to you to do a listing, do you find you have to explain a lot of this or are they well-versed and understand what they're getting into in this environment?"

Koger: "When we go to talk to the owner about putting their property on the market, they know the business, they know what the market is. It's a simple situation of owners generally have higher

Charlie Muller, left, of CNL Hospitality, listens to Angelo Stambules of GMAC Commercial Mortgage make a point.

Photo taken during a previous roundtable of more than 30 LIIC members.

opinions of value than what the market will bear. That's true in any market. That was true in 1997, 1998 and 1991. Our goal is to educate the owner in terms of where the market is to determine whether they're a seller at the market level and determine their motivations, because in this market you can spend a lot of time marketing assets that don't sell unless the seller has a reason to sell. The worst reason to sell is that he can get his number. That's a guy who probably doesn't have any real interest in selling unless he can get the top price, which is very hard to achieve today. We look at motivation. Why is someone selling? Does he need money because he needs to pay off a loan? Is he tired of the hotel business? What is his real motivation, and the rest is education on where buyers are. In terms of explaining the nuances of RevPAR growth and changes and things like that, that's not a big learning curve. The big learning curve is what are buyers paying today vs. what they're paying 12 months ago or 12 months from now."

Higley: "That's not easy to figure out. Charlie, you've said that you would think about selling. Have you seriously thought about it?"

Mike Blahosky of CB Richard Ellis speaks as Vicki Richman of American Hospitality Management Co. listens.

Photos taken during a previous roundtable that included more than 30 LIIC members.

Charlie Muller: "We haven't looked to sell any of our properties. We'd certainly consider the opportunity for a sale. Being a real-estate investment trust, we have limits on any kind of gain we can make on sale of property unless we held them for a significant period of time. That's primarily something that's been put in place in tax code to protect the investor so they're not investing in programs that are flipping product. They have some surety of the longevity of their programs. We certainly would look to divest in some of our assets in certain markets if the right price is there. But we are an active acquirer in the long-term, not an acquirer to hold for the short period and sell it for a great gain in the short term. We value a more longer-term appreciation opportunity."

Higley: "If you were to have the right price, the right buyer for an asset, would you use the same criteria you used to buy? Would you annualize the 2002 results? Would that be your sales price? Is there a different mentality in buying and selling?"

Muller: "No, I don't think there is. What has happened in our industry in the last several years is the role the sales agents have been playing in the marketplace has been incredibly valuable to the industry. It's a great educational tool for the seller. Not just from price, but all the other points of the transaction that the buyer has difficulty connecting with the seller on, whether it be due diligence or indemnification or other points necessary to bring a buyer and seller back together. These guys are doing a great job of putting good information out there and facilitating out there. It's making the transactions a little bit easier to do."

Mark Tobin (right) of HREC Asset Management makes a point while C.A. Anderson, managing director, hotel group for Cornerstone Real Estate Advisors takes notes.

Photo taken during a previous roundtable of more than 30 LIIC members.

Higley: "In a few words, what's your take on the transaction market?"

C.A. Anderson: "Waiting for opportunity. From an institutional perspective, we're real-estate investors. We buy an asset and tell our clients we think we're going to get X on this portfolio. When someone knocks on your door, maybe one of Rob's clients, and says I'm going to give you a 7-cap on a reasonably good year, they're probably a seller. Everything in our portfolio is always for sale, provided we get the right strike price and we're going to be able to get the forecast yield on the assets. That being said, we have not been able to underwrite assets as aggressively. I don't think our money is that expensive, it's certainly not venture capital cost, but I don't think it's as cheap as Charlie's money. We have not seen value-added opportunities out there, either in terms of turnarounds or repositionings or just pure cash-flow deals."

Mike Cahill: "You're seeing what's out in the market, what buyers are paying, what's going on. From your chair, is it better to be a buyer right now or a seller?"

Anderson: "That's a really good question. We're trying to sell assets but we don't think they're valued properly. I'm sure everyone around this table that has anything to do with hotels have seen recent forecast from the operating teams in the field go down from where they were last quarter. We have a fairly diverse portfolio, which would lead us to believe we should not be selling now. Being buyers, we know who beat the crap out of the seller because the forecasts are going down on the value. I just can't understand how not knowing the economy, where things are going, how you can get parity between buyers and sellers. People are buying at lodging properties [with return-on-investment percentages at] 7s, 8s, and 9s. Why would you buy a hotel at 7, 8 or 9 right now, unless it was a strategic reason or a trophy reason? There are so many better value-added opportunities, even in real-estate, than there are to by a hotel and take that kind of mitigated risk."

Higley: "I was at a conference recently where Sam Zell of Equity Office Properties said hotels aren't real-estate because there's no long-term lease with tenants. Agree or disagree?"

Muller: "I disagree. Hotels in their purest form are real-estate. It's a very operations-intensive form of real-estate. That's why you see a separation, generally, between companies that like to manage real-estate and companies that like to own real-estate. We love everything about real-estate ownership. We love the long-term, balanced value of real estate, and we look at companies-we have a great relationship with Marriott, and one we'd like to grow with Hyatt-we see the operating companies having great distribution systems, tremendous ability to drive revenue, convert revenue and to profit and to manage that aspect of the business. We can partner very well with operating companies."

Cahill: "Hotels are bought and sold as an operating business that tend to have a large real-estate component to it. The real question I have, and no one ever has a good answer, is when someone buys or sells turnaround, how much of that value is really real-estate and how much is the business? My general conclusion is that most of the smart people in this industry are making money on the business side. They buy something that has very little business value, and whether it's market, timing or geniuses that are managing, the cash flow goes up, has more business value and they sell it. The next guy messes it up, loses the business value and life goes on. Because of that, I don't think there is any direct answer. You have to look at the ratio of real property value vs. business value. I essentially think what we're doing is buying and selling businesses that are very real-estate intensive."

Anderson: "If you take Mr. Zell's position that hotels are not real-estate, the fundamentals of the business still say he has to go find a tenant to lease it. If the market's depressed, as it is now, and he was stocked with rollovers in office buildings and couldn't get out, he would have negative rent values because you'd be substantially below where you bought your investments. To a degree, he's still in an operating business of sorts. The hotel is a hybrid in the real-estate business, but people who invest in hotels are usually getting 400-wide of what you get in the rest of the real-estate components. It's just part of that entire portfolio of what's classed as real-estate investing, whether it's a REIT model, true real-estate property-level investment or portfolio value."

Muller: "Even office building trades in value based on income generation from the property. They're not really appreciating in just real-estate value, they're appreciating in income-producing value."

Anderson: "That's the misnomer. They all have business-value components. It comes back to people saying office buildings have no business value, but they do. There's office buildings that have good will, they run a little more profitable. There are shopping centers that run better because there's good will. Except for just pure dirt, or a vacant building, there is a business value component in almost all forms of real-estate.

Shupnick: "When you talk about a shopping center, it is very much like a hotel. You have to go out and find a client to rent the retail space then it's the marketing and the management company and the retailers that bring the customers in, the same way a management company brings customers into a hotel. The real-estate only has value if they're getting their return per square foot in that shopping center. If there's no customers coming in the door, they might not depend on airline lift and some of the other things we depend upon in the business, but if the economy is down and people don't have money to go shopping for extra clothes and other things, the traffic goes down the same way the occupancy goes down in our hotel. It's a very similar business. An office building is a different type of real-estate. I'd compare it more to owning an apartment building. The hotel business is really a combination of the real-estate business and the business level that is in the hotel drives the value of the real estate the same way it does in the shopping center."

Koger: "One way to look at it from my perspective is you look at the Marriott hotel at the Phoenix airport. That's a piece of real-estate and that's an operating business. If you take the Marriott name down and put up the Cahill Hotel, that real-estate and our business-no offense Mike-has a lot less value. There is a business component. I had this discussion with an owner who was going through a tax appeal, who actually argued that the tax assessment for the building should be considerably less because there was so much value in the business, which technically isn't taxable from a real-estate value basis. If you look at a building with an independent name that may not have cache compared to a strong brand, there's much different value even though the building is the same."

Butler: "There's another spin as well. In part, it's because of the current structure favored by the industry, namely the management-contract model. There was a time in the 1970s and 80s, when sale/lease-backs were used. Companies bought and sold hotels because they had a 20-year lease from Marriott, with Marriott guaranteeing the rent like a tenant in an office building. The operating elements of the operating business were still there, but it had a different format than was commonly used. We don't happen to be in that mode as widely today. It looked like it might be making a comeback when the REITs were in their vogue, but that seems to have receded. At the very least, we are special-purpose real-estate, with an operating business that's intimately associated with it, that has it's own norms and customs and players that make what Charlie mentioned for the need of people who like to own and those who like to operate, and that operating business is often taken on by the owner to different degrees than they are in other businesses."

Higley: "Speaking of management contracts, will we see a fundamental shift in the way they're written?"

Muller: "You've already seen that shift. I don't think it was driven by the lawsuits that have taken place, I think it's driven by more savvy set of investors in the marketplace that understand the business better and have worked with operating companies to try to draft better agreement language for the owners. A lot of the agreements that are in play in the lawsuits are older agreements. I don't think it's the effects of how the business has changed over the last several years. Clearly we'll continue to get that, but I think the shift started before the lawsuits."

Geoff Davis, president of HREC Investment Advisors.

Photo taken during a previous roundtable of more than 30 LIIC members.

Siegel: "Around our office, transparency is a big buzzword. I can already tell in the last few agreements that I've done the attorneys keep giving me more stuff to put in the documents, which is basically giving more transparency, more detail, not necessarily people asking for it but we're making sure it's all out on the table, answering questions before they get asked. Obviously what's happened now is part of the reason, but also the inherent transparency that we like to have with our owners."

Shupnick: "A year or more ago, we put together a 10- or 11-page disclosure letter related to charges and sent it to our clients. Every new management contract proposal we send out now, we send this letter, along with the management proposal, and if we have operating statements, we tell them if they want to participate in some of the areas, for like [information technology] services or some of the other items we charge extra for, based on your volume, this is what it would cost you on an annual basis. You have to disclose everything up front to the client if you want to be in the management business."

Muller: "If there was a watershed in the management agreements it was Woodley Road that created it. We clearly look to that when we launched into some of our agreements when we started to work with Marriott, Hilton and other operators. We were very focused on issues that came up there and how could we protect ourselves and we are taking the right advantage of the opportunities that the management companies that are gaining and managing assets for us."

Butler: "The changes are already under way and have been for maybe five years. We do dozens of management agreements each year and could almost chart the areas where operators were focusing on year-by-year, as to where the changes were coming in the management agreements to deal with issues. I may disagree that I think there are many areas that have been addressed by most of the brands and certainly the independents that are currently going to be greatly affected by the litigation. These issues continue to evolve."

Higley: "What about consolidation? Larry, MeriStar and Interstate joined forces. Are we going to see any more of that going on or will it be a slow consolidation process?"

Shupnick: "There will be more consolidation, but I don't know many more of the size of the MeriStar-Interstate. There aren't really any around, if you look at the list of management companies of any size. The thing that happens through a merger like that, is we can make things for our clients much more efficient on a combination of the systems, the buying power, the muscle you bring to the table. The infrastructure that we can afford from the standpoint of our IT systems and technology, human resources, our buying and the marketing. We have a marketing staff that's included in our management fee that allows us to do things to shift and change in markets where a smaller company doesn't have that infrastructure and can't afford that infrastructure. There will be more consolidation. I can't say who or when."

Higley: "Does anyone think this environment is a good environment or bad or conducive to consolidation on any front, whether it's franchising companies, management companies, ownership companies?"

Muller: "There is a reasonable scarcity of capital in the business, and that creates consolidation opportunities. The bigger companies generally have better access to capital. The Interstate/MeriStar merger is a different breed, because they were both very large. You look at some of the hotel REITs, or even some of the smaller operating companies, it's difficult for them to be successful right now because they have a tough time attracting capital. The bigger you are the more diverse you are, the more apt you are to get rated, the more apt you are to be a better borrower. There will definitely continue to be consolidation, and I don't think it'll be on the high end. It'll be on the low end. "

Koger: "Any business, if you have one guy running one McDonald's and then all of a sudden he has 30 McDonald's, he can't clone himself 30 times. He's not going to run all 30 McDonald's as well as he ran that one. If I have Interstate running my hotel, and they put some guy fresh out of college that doesn't know what he's doing, and I'm the owner, I'm going to raise my hand and say 'Hey, you guys aren't putting the right guy in here and put the right guy in here.' Be proactive as an owner and get involved in the operation of your property. That would be my preference as opposed to finding the right regional guy who may be perfect for seven hotels, but once he gets three or four more, then you have a bigger problem than with a bigger company. We haven't had this problem in 12 to 18 months, but one of the biggest issues we had in 2000 and early 2001 was personnel. If you were a small management company, you had a hard time getting good people, whether they were g.m.s or directors of sales or even housekeepers. But if you were a big company, Marriott, Hyatt, MeriStar, you had the ability to move people around, offer them some benefits, stock program or whatever. There's a benefit to you as the owner. You're right, if the owner is asleep at the switch, the management company is going to take liberties. That's human nature, but if you're watching your investment then you should be asset managing your management company."

Anderson: "You'd be surprised at how poorly responsive people are to asset managers, and how poorly responsive a lot of management companies are out there. We've seen some of the big companies that are actually horrendous at operating hotels. A lot of hotels you've sold in the past 12 months were managed by a large company, sold to individual owner-operators who are going to double the cash flow, and that's how they make their money. I'm not going to name properties, but basically the larger hotel company didn't operate it efficiently, the owner-operator comes in, raises the cash flow and then hires you to sell the thing based on twice the cash flow.

Higley: "Think back a year ago at this time. What were you thinking in terms of recovery. The general consensus was at this time this year we'd be OK. Now we're hearing the lodging stocks aren't going to recover until '05 or '06. Where are we at today, and where are we going?

Siegel: "Where are we going is the question. There's a lot of uncertainty. As much as some of the companies don't want to admit it, the Internet leaves open a huge question. It is affecting pricing. The other thing affecting pricing is lack of demand. Those two are converging at the same time. I think we'd be naïve to think that long term it's not going to have some impact on the pricing, and maybe because of it rates aren't going to go up as fast as everyone thinks. Maybe occupancy does, and then in the end bottom line is a wash. You have airlines cutting back, the threat of terrorism scaring people, you have business travel budgets slashed and you don't know when it's going to come back, but I think the hotel industry comes back when the economy comes back and when everybody's business starts coming back. I think we're right in the cycle with everyone else in that regard. I think this year will be another down year. Next year we're looking at 2 [percent] to 3 percent RevPAR growth, and you have to look at 2004, but who's to say at this time next year we won't be saying it's not 2004, it's 2005. That, getting back to an earlier question, is going to cause some movement in the sales markets. When you have an owner saying, 'Last year they told me it was 2003, now they're telling me 2004, maybe now it's 2005, I don't want to hold this thing anymore. I want to get out, and get out now.'"

Butler: "What are we looking for? I hear everyone talking about growth and that there will be growth. Growth to what extent? We're assuming 2 [percent] to 3 percent historically Gross Domestic Product growth is OK. Is the hotel market looking 5 percent growth, 10 percent growth? What's the magic number? There is still real profitability in the segment. Flip to the other side, and there is still so much lack of confidence in the marketplace right now. Until there is something people can grasp onto and say we'll be OK for the next six to 12 months, I don't see how anyone can accurately predict, near term, what this segment is going to do."

Shupnick: "There are too many variables at this time to be able to predict. My own feeling is around 2004, if we don't have any major tragedies or terrorist attacks, I think we'll see a little improvement. The American public will not sit back as long as they've sat back up to this point. They started back a little in the first quarter of this year, when we saw a little surge in business, and everyone upped their forecast for the balance of the year. The 2nd quarter took a dump, and a worse dump in the 3rd quarter. We're in a cycle with a lot of variables. The big question is what happens in a war with Iraq. Will there be terrorism attached in spotted places in the United States. That will have a great factor on when and how we recover because the world has to react in a different way than what we're used to in the Western world of doing business."

Muller: "The industry is in great shape. It's weathered a tremendously difficult time. 2001 was the watershed year for the business. It slowed down and then fell apart, but the industry is still very, very profitable. The future can't be anything but bright. It doesn't mean it gets there quick, I think rates will grow back very slowly. Demand is going to depend on peoples' psyche, threat of terrorism, how business comes back, etc. It's a great time for the business right now because we've been through a real down time, and we've figured out how to survive and make money on less revenue. That's been helpful for the business. We went through 10 or 11 years of growth in RevPAR, growth in rate, and you ended up with a few more mints on the pillow and maybe one more guy at the front door than you should have. Fortunately or unfortunately, a lot of that has been cut out. Unfortunately for the people in that, who lost their career opportunities. There was a lot of creep that's come back in the business that's been taken up because of this tremendous slowdown. It gets a little better over time."

Koger: "That's the one thing we, as brokers, always look at when there's uncertainty in the near term. We focus on the long term. From our position, the industry long-term is a great business. If you view the business as a long-term business, you can buy at any time and not go wrong. It's true with the stock market, it's true with real estate. If you buy and invest in the long term, and you're there to stay, it doesn't matter when you buy."

Higley: "How long can the industry withstand the current environment?"

Muller: "It's withstanding it right now. The industry is doing fine. It just ends up creating a different set of expectations."

Butler: "It depends tremendously on location and market segment. San Francisco can't withstand the current condition for a prolonged period of time, as certain other markets and segments cannot withstand it for a period of time. Ultimately, in the long term that Rob talks about, that would bring opportunities for the smart money and the smart people. Change is what creates the opportunity. Everything staying the same is what makes it difficult for a lot of people. Change can be up or down."

Siegel: "What's sustaining a lot of people and groups are the low interest rates. When those spike, there's going to be a lot of blood."

Butler: "Usually, high interest rates also go along with high inflation. When you get inflation, that's usually when the economy is heating up. That's usually when you get your rate movement. In a sense, it might be higher interest rates that are the saving factor for the industry if everything else is getting inflated."

Cahill: "I don't think the industry is in that bad of shape, predominantly due to the lower interest rates and low leverage. There's a lot of people who say we're doing well in Alaska, we're down in California, we're even in Omaha. At the end of the day, we're OK. One thing we need from the consultants is accepting that change is good for our business. The market can be going up or down, but the problem is if you describe a healthy industry as one that has little transaction volume in the real estate as it is right now. When is transaction volume going to pick up? In reality, it's transaction volume that feeds the consulting business, and drives renovations and ad pages in your magazine. Either as Charlie said, we're having a whole new environment where people buying apartments on unleveraged yield of 8 percent and maybe people are happier and say hotels are going to be a low-yield environment or sellers are going to put stuff on the market and be realistic and the volume is going to pick up and people like Rob, Jim and myself and you, Jeff, are going to get busier.

Koger: "From our perspective, transactions are still occurring at a fairly rapid pace, it's just the average deal is a smaller deal. You don't have the $150 million properties out on the market. You have some, but not a lot. A lot of the deals are $20 [million to] $25 million and under.

Shupnick: "If you take San Francisco as a single market, up until 2001, San Francisco is probably a city that ran the highest occupancy for seven years straight in the hotel business. Consequently, a lot of people that bought in those seven years, if they didn't adjust to keep their business profitable in a tougher time, they're basically going to give up the hotel. We bought a hotel in 1996 that was doing 84 percent occupancy, took it a couple years at 88 percent or 89 percent occupancy, and now last year it dropped to 73 percent. It's back up to 76 [percent] this year, but you're used to operating at such a higher level. Business is good, it's just that our expectations were a lot higher because we bought in at higher prices, because the property being a business-driven industry had a much better bottom line as a business. You just have to adjust your expenses accordingly. That's why properties aren't going back to the lender, because you're still creating enough cash flow to pay the mortgage and leave hopefully some profit for the owner."