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MEMO TO DISTRESSED HOTEL INVESTORS: UNDERSTAND THE OPPORTUNITIES AND RISKS

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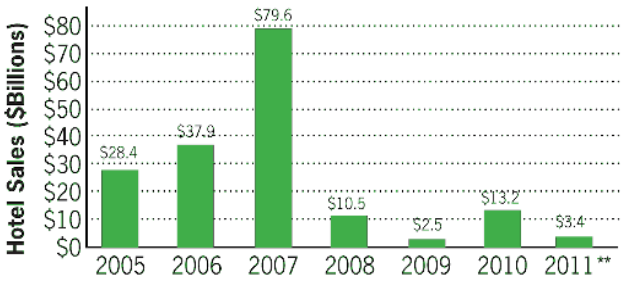
Many investors and other potential buyers have been trying to determine whether the time is right to invest in distressed hotels. The recovering U.S. economy and hotel market indicate that the hotel industry's severe recession has bottomed out, which has investors wondering whether they should make some investments in the near term before prices rise and the steep discounts disappear.

The good news is that, despite improving fundamentals, there still are a lot of distressed properties, though many of them have not yet appeared on the market. When, and how, can investors best take advantage of distressed opportunities?

Hotel Buyers on the Prowl Again*

After reaching nearly $80 billion in 2007, the sale of hotel properties nose-dived to $2.5 billion in 2009 before recovering to $13.2 billion in 2010.



* based on property sales $5 million and above
** year-to-date through March
Source: Real Capital Analytics

ECONOMIC AND MARKET CONSIDERATIONS

There are opposing trends that have both encouraged and discouraged investment in distressed hotels. The encouraging signs include recovery in the capital markets, improvement in hotel operating fundamentals, an increasing number of sale transactions, and muted construction activity.

- Uncertainty regarding the government's policies pertaining to taxes and the budget;
- An insufficient supply of distressed properties, and resulting high prices for those assets;
- Investor fears of making mistakes, given their experiences during the Great Recession;
- Lenders' general state of indecisiveness stemming in part from an "extend-and-pretend" strategy;
- Ability of properties to get "bailed out" by the active junk bond and IPO (initial public offering) markets;
- Wall of debt. Many investors are waiting for a large number of loans to mature over the next few years, believing that many owners will be unable to refinance and will need to sell at distressed prices.
- Reluctance of owners to take large losses on their investments, making it hard for them to sell.

Some owners are expecting to refinance or will wait to sell at a higher price, assuming that the economic recovery, and hence improving fundamentals, will lead to higher values.

In addition, so-called "bad boy" guarantees in commercial mortgages —which holdowners personally liable for a loan if a company files for bankruptcy — have resulted in fewer bankruptcies and fewer properties coming to market.

Despite several trends that have largely discouraged distressed investors, many loan extensions that have been granted will eventually expire and lenders are going to have to finally work out the loans. When that happens, property owners will be forced to sell or give the keys back to the lender.

Since most traditional lenders don't want to be in the real estate business, there will probably be an increase in distressed properties on the market. In addition, many owners will come to the realization that stabilizing a property is too expensive and risky when compared to a sale.

INVESTMENT ISSUES TO CONSIDER

Investing in a distressed property requires a different mindset and careful due diligence in order to ensure that the potential risks and future value are properly considered. One of the most important questions to ask is, "What is the underlying reason for the property's distress?"

The answers could be as diverse as capital structure, operations, location, underinvestment and market demand, and also could be a combination of several causes. When asking this question, some of the key issues to consider include:

- ***Highest and best use for the property*** — Given changes in markets over the past few years, the property in question might be a more attractive investment if converted to apartments or another form of real estate.
- ***Current/future market position*** — Properties that currently have strong positions in a market appear to be more attractive on the surface. However, investors need to take into account key market dynamics that could affect their longer-term position.

Those factors include: planned projects affecting supply; competitors' strategies; the local business environment, including business relocations into or out of the area; existing and/or planned local attractions, including the local government's marketing efforts and support; and the regulatory environment, including local taxes and wage laws.

- ***Condition of physical plant*** — The amount of investment required to refurbish or renovate a property could make investment prohibitive, even at distressed prices.
- ***Flag*** — Branding an independent property can be a great way to reposition a property and improve the economics. Similarly, changing the flag on a branded property can be a cost-effective way to change the financial condition of the property.
- ***Operational performance*** — It is far more difficult to turn around a property with operational and managerial issues than a property with an unsustainable capital structure, or one suffering from underinvestment.Therefore, operational issues and their potential short- and long-term impact on the property must be identified and evaluated.

Financial projections — Creating financial projections in an uncertain environment is challenging. It can be even more challenging depending on the quality of the historical financial information received from the current owner and management, and the extent of change to the property that is anticipated such as repositioning or renovation.

Realistic short- and long-term cash flow projections are essential in determining not only the appropriate capital structure, but whether the property can meet an investor's minimum return threshold requirements.

WAYS INVESTORS CAN GET INVOLVED

There are a number of different approaches investors can take to acquire distressed hotels. However, with few properties having come to market, one of the most prevalent strategies has been "loan to own." Under that scenario, the property's impaired debt is purchased at a discount. The debt buyer then uses its position as lender to foreclose and take possession of the property.

In fact, some of the largest distressed investors in the commercial real estate industry purchased special servicers over the last couple of years primarily to get information and access to large pools of distressed properties. Then they can selectively pursue loan-to-own strategies.

Another approach is to buy properties out of bankruptcy, where the sale is typically structured as an asset sale. Some of the main advantages of this approach are that the buyer can obtain assets free and clear of pre-bankruptcy liabilities, and can choose which contracts to assume going forward. A bankruptcy sale also enables the buyer to get out of onerous contracts, or renegotiate them to get more beneficial terms.

Getting out of onerous contracts without resulting damages can be key to an investor's ability to affect the turnaround of a distressed property. One key disadvantage of a bankruptcy sale is that it is a public process. The sale is conducted as an auction, which can result in a higher price than a private sale.

CALL TO ACTION

There are opportunities to purchase distressed hotel properties in the U.S., although risks remain. Interested buyers need to be creative about identifying and pursuing opportunities until current owners are more willing to put them on the open market for a traditional sale.

Buyers need to have a vision for the desired property and perform thorough due diligence to ensure that the low prices they anticipate paying translate into the high returns they have been seeking.

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