

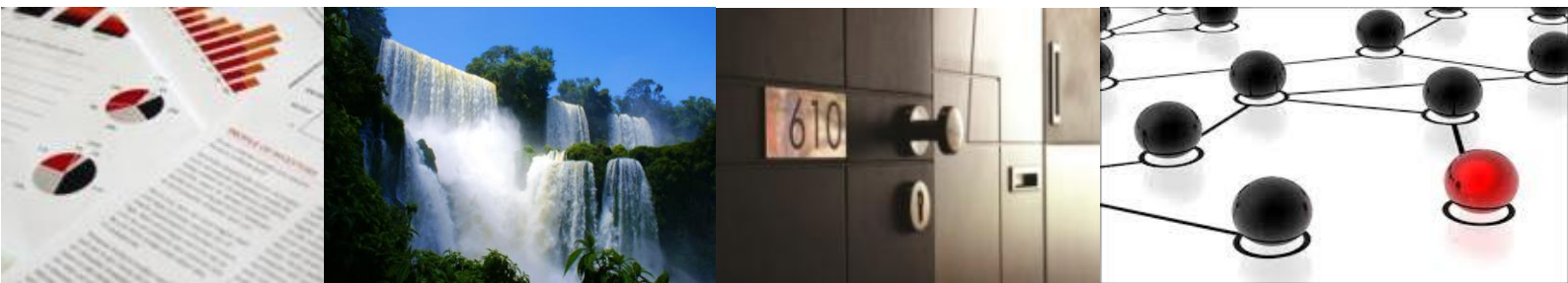


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HOTEL MANAGEMENT COMPANIES AND EQUITY CONTRIBUTIONS: BENEFITS AND RISKS

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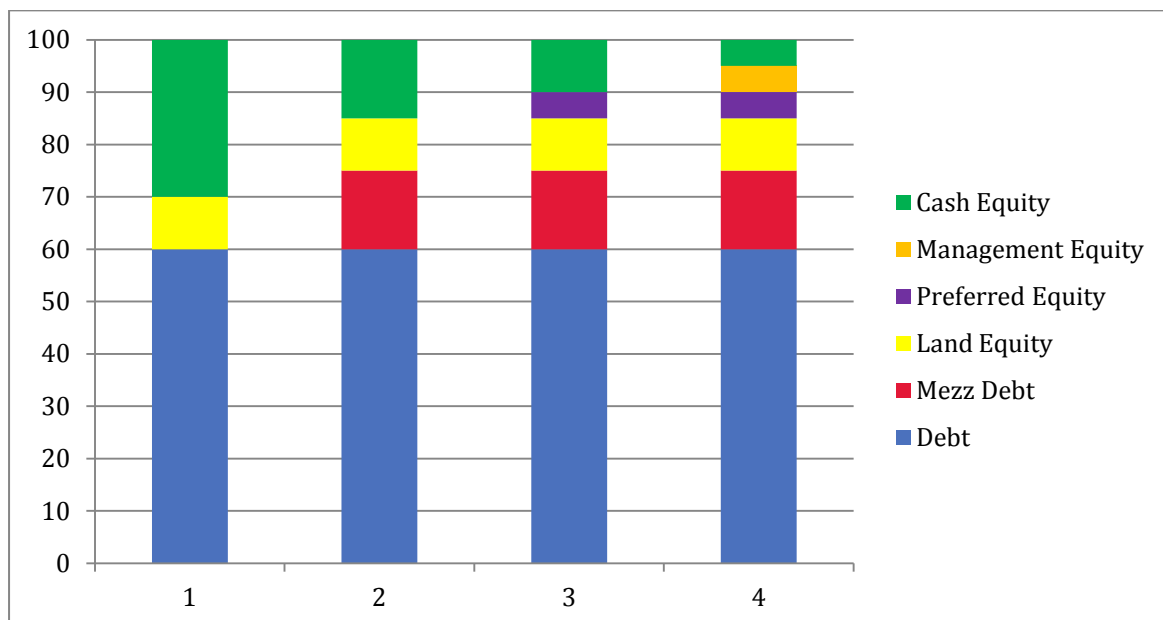
Introduction

Hotel financing takes different forms based on the capital requirements of the developer and the availability of alternative financing sources. These factors vary with the economic climate. Typically, hotel developers attempt to finance new hotel construction projects with a combination of debt and equity. Within these two general categories of capital, various sources may be required to fund the project. This article investigates the benefits and risks of seeking equity participation from hotel management companies.

Financing Scenarios

In today’s lending environment, active hotel lenders are generally willing to offer first-mortgage debt in an amount that equates to roughly 50- to 75-percent of the property’s “when complete” market value. For the purpose of this article, let’s assume a developer is able to obtain a construction loan for 60-percent of the project’s total development cost. Furthermore, let’s assume the developer owns a vacant site with an appraised market value equal to 10% of the project’s total development cost. For simplicity, we’ll also assume that the project’s total development cost is exactly equal to its “when complete” market value, so the project is just barely feasible. The following table presents four hypothetical financing scenarios:

Figure 1 Hotel Financing Scenarios



Source: HVS

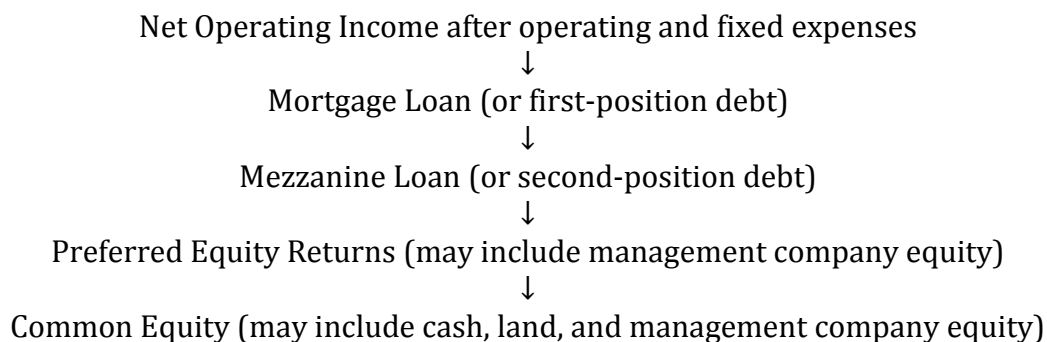
In the preceding figure, the amount of capital that the developer must contribute to finance the project progressively *decreases* in each scenario. These scenarios present financing options that require the developer to contribute as much as 30%, or as little as 5%, of the project cost in the form of cash equity. The recent trend of management company equity participation is represented in scenario 4. Each scenario progressively

minimizes the developer's need to contribute cash equity, thereby increasing leverage. In scenario 2, the presence of mezzanine debt reduces the need for cash equity to 15%. In scenario 3, preferred equity contributions further reduce the developer's need to contribute cash equity to 10%. In scenario 4, the equity contribution of a management company reduces this need to just 5% of the total project cost. In some cases, management companies may be willing to provide even larger equity contributions. Our interviews identified a wide range of contributions ranging from less than 5% to over 25%.

Debt is generally a less expensive financing source than equity. Therefore, the return on the investment for a principal investor *increases* as the equity contribution *decreases*, assuming a profitable investment. Once the debt is fully paid, the borrower has no additional obligation to the creditor. Equity participation, by contrast, continues throughout the holding period. By identifying and securing different forms of debt in the financing portfolio, the equity contribution needed to finance the project is minimized.

The Waterfall Effect

A common illustration used to explain the relative risks of different components in a project's capital stack is that of a "waterfall," which shows the priority of various debt and equity payments. A waterfall for scenario 4 would be as follows:



The willingness of a management company to contribute equity to a hotel development project may reduce the developer's need to contribute equity. However, it also implies a larger number of equity partners with whom the developer must share profits that make it to the bottom layer of the waterfall. The equity released to a management company may have preference over common equity, if structured as preferred equity. Or it may be structured on a pari-passu basis with common equity, depending on how the contract is negotiated.

Risks

The benefit of reducing the developer's need to use his or her own cash is a powerful incentive. However, developers should also recognize potential risks or tradeoffs associated with forming equity partnerships with management companies. For example:

- More partners => More parties to split profits
- Less developer equity => Increased chance of losing control of property
- Equity from operator => May come with strings attached
- If operator is partner => May be difficult to replace operator

Additionally, equity relationships with management companies can carry challenges associated with termination. A standard management contract without equity involvement involves the management company as an agent of the principal. These contracts are relatively easy to terminate when clear termination clauses are written into the contracts. A principal may wish to rebrand the hotel and bring in a different management company more familiar with brand needs, or he/she may wish to remove the management company for performance reasons. Having a relationship with the management company as an equity participant may limit the principal's ability to terminate the management agreement.

Developers seeking equity contributions from management companies should carefully investigate the company's performance history. Developers should also investigate whether potential management company partners have been terminated from prior management contracts. And they should evaluate whether the management company has been involved in prior litigation pertaining to equity partnerships in other hotels or management contract terminations. In cases where the management company is also an equity partner, special attention should be given to crafting appropriate language in the management agreement that pertains to termination.

Returns

The authors suggest there are a few primary reasons why it has become increasingly popular for developers to seek equity contributions from hotel management companies.

1. Equity contributions from management companies reduce the amount of cash needed to develop a hotel. This increases the pool of potential parties who can become developers.
2. Equity contributions from management companies increase leverage for developers. This, in turn, can (a) increase the developer's internal rate of return and (b) free up the developer's capital to target additional investments or development projects.
3. When a management company becomes an equity partner in a hotel, this may bring the management company's interests more into alignment with the owner's or developer's interests.

When capital is spread among a large number of debt and equity sources, a benefit arises for a principal investor. The initial cash investment required for this investor can be quite low. Even though the developer's risk increases because his/her capital occupies the bottom rung of the bottom layer of the cash waterfall, this may not matter much to a developer who is not committing substantial capital to the project. This is especially true if the developer is earning a large developer's fee when the construction loan closes.

Equity contributions by management companies may help to align the interests of the principal with the management company. Typical management contracts incentivize management companies to maximize revenues, while owners seek to maximize profits. Unless incentive management fees are designed to broaden the management company's interests, the management company traditionally does not benefit from maximizing profits, but this changes when a management company becomes an equity partner in the hotel. Under this circumstance, there could be a strong incentive for the management company to keep operating expenses low, since they earn a share of the hotel's profits through their equity participation.

Conclusion

Developers seeking equity partners to help fund a hotel project may now be able to turn to certain management companies as a potential solution. As with any equity partnership, this option has certain risks and certain rewards the developer should carefully consider. Several management companies have shown a willingness to provide equity to certain deals. In the highly competitive market for hotel management contracts, this has become an increasingly popular way for certain management companies to distinguish themselves from competitors. Without large-scale consolidation in the hotel management industry, the authors anticipate this market to remain highly competitive. As such, we anticipate the trend of equity participation by management companies to continue.



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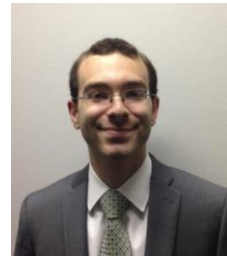
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