The Luxury Hotel Market and the Emperor's New Clothes

The elements of ego, greed and easy credit, tailored with a lack of personal accountability and styled with a touch of misrepresentation, offer up an ill-fitting suit in any transaction, or in any industry. The early 1990's provided a strong measure of distress for the hotel developer, owner and lender, and for some operators and consultants as well as the result of overdevelopment in the 1980's. The industry's problem did not arise simply from an economy weakened by recession and lessened demand for hotel rooms. The main problem arose from an oversupply of hotels in a bewildering array of market segments, such that the industry was not so much "fragmented" as it was "powdered" with hotels.

That decade witnessed the development of some of the most expensive, glitzy and glorious hotels in history, from destination resorts to small, elegant five star inner-city hotel restorations, to aggressive expansion of luxury hotel chains. At per room costs then of $250,000 and up for these jewels, the question became whether the owners would make a respectable investment return, any return, or be lucky to even get their money back? Would the lenders be looking at luxury hotels as the next big addition to their portfolios of foreclosed property? Would the operators be struck down with serious financial obligations from struggling hotels? Would new opportunities for profits be presented, how would they manifest themselves, and to whom? Does this sound like deja vu all over again for the development of hotels in the 2000's? This article was initially written in 1990, and is equally applicable to the predicament for reworking assets in this new recessionary cycle. A look at the evolution of the ownership structure of the luxury hotel business, particularly as it relates to the basic relationships among developer, owner, operator and lender, may help to answer those questions.

In the earlier years, the hotel developer, operator and owner were one and the same. Requiring large amounts of labor and management skill, together with substantial capital to develop long term improvements with little or no alternative use potential, and centrally located on the most expensive properties, the hotel business was not for the weak of purse or spirit. As urban communities developed around such hotels and land values and construction costs escalated, it was competitively difficult to build a new hotel next to an established and successful hotel. But improvements in transportation opened up access to more reasonably priced real estate for development of new hotels. The geographic area within which hotels had historically competed began to grow, radiating outward from the city centers.

These newer hotels could offer fresh amenities and services <u>designed into the improvements</u> which the older hotels could not match, and often at attractive prices. Unable to compete on amenities, and with their location of lessened importance, the older hotels had to compete on price or suffer reduced occupancies. When possible, they used their old and low land and improvements base cost as the source of financial strength. In other words…the older hotel had to sacrifice the rate of return on the real property portion of its investment to generate a reasonable return on its hotel operations. When that was inadequate, costs often associated with labor intensive personal service were cut. Hotel developers/ owners/ operators awakened to the fact that the once ever appreciating feature of the land and building was either no longer true, or of lesser strength, and that, in many cases, land ownership was becoming a liability. Furthermore, great amounts of capital were tied up in real estate assets which could be applied elsewhere in the business.

The issue was becoming clear; *how to sell the property but still keep ownership of the hotel business?* The first solution was simple; sell the real property and lease it back. The operator received a nice sum of cash for the property, but business continued as usual. The new owner received some prestige with his new ownership, and didn't really need to worry too much about the rent because the property was occupied by an established business, the tenant was a financially strong credit, the commitment was long-term, and the operator still owned the hotel business and took the primary risk of its operational success. *And so the tailor did without his thread.*

As the operator began his expansion to new regions and financed expansion with commercial borrowings it soon realized that the long-term lease commitment was more liability than desired. Furthermore, the hotel business response to stay competitive with new and varied products was to continually spend money on refurbishments and improvements, keeping pace with marketing trends in rooms, bars, restaurants and common areas. These trends drove a continuous stream of capital investment back into the leasehold improvements to keep pace with the competition. Clearly, the sale/leaseback of the property was not the answer if the hotel business required one to plow back the proceeds on sale of the real property into the operation of the hotel business. The problem now was *how to sell the hotel business but keep the profits*. The solution was to market a package of real estate ownership with hotel business ownership to investors, with a management contract for the operator. Now the operator had little or no capital investment in the business, nor future obligation to keep it competitive with its own dollars, and no long-term leasehold liability. *And so the tailor did without his cloth.*

The investors accepted from the operator a critical and important shift in risk taking. First, by owning the property and the hotel business they not only absolved the hotel operator of the business risk of a particular site, but they lost the credit backing of the operator to assure returns on their investment. Second, they confused hotels as real estate investments that make a special use of real estate with their true nature, which is a highly competitive service business that happens to need intensively, uniquely, and continuously improved real estate. A key is that service can change rapidly, as can marketing, but real estate needs time to generate returns. Furthermore, owners, even lenders, may come and go, but the fixed real estate improvement will last 50 years or more, and usually no reasonable or commercially rational alternative use for the property exists. With a properly drafted long-term management agreement the operator will always have a property and business to generate fees from. *And so the tailor did without his shears.*

The management contract form evolved and sharpened into a device for taking income "off the top" to assure the operator of its return. Then it became a funding device for expansion of the operator's chain, to support marketing with special fees therefore, special reservation system fees, interior design fees and furniture supply commissions to controlled subsidiaries, etc. Then the turnabout became even more dramatic, with owners undertaking affirmative obligations to fund reserves for furnishings, fixtures and equipment, essentially financing the ever more

competitive efforts of operators against each other. Maintaining competitive product and image for the operator, at the owner's expense, became the name of the game, with profitable investment returns to the owner a very secondary concern. And just in case it all worked out successfully, incentive fees were inserted into the contracts to give additional profits to the operators.

Indeed, there are more than a few management contracts where the operator may enjoy performance bonuses based on formulas unrelated to bottom line returns to the owner, so the owner will be digging into his pocket to pay bonus incentives to the operator while the hotel loses money. In some contracts, the operator may even earn greater income from closing the hotel and totally refurbishing it than the operator would by operating it, due to fees for design, furnishings, supplies and contractor supervision.

Operators then became developers and active participants in the construction of new hotels, putting together teams of equity and debt to facilitate the development of new hotels where the operator wanted to expand. *And so the tailor convinced his Emperor that he looked great.*

Employees of the hotel became employees of the new owner, under the direction of the operator and with labor negotiation control under the operator. The hotel operators became even more fiercely aggressive in their handling of labor matters, but also less predictable. Labor and union issues remained a problem for operators, with significant costs and potential liabilities associated with direct employment. With the labor issues in hotel management often transcending the significance of any one particular property, a tension developed in the conflict of interest between a single hotel owner's best financial interest in labor negotiations and that of the chain operator.

As the number of hotels under common management in a specific geographic region became greater, the operator could engage in support services for all of them. For example, some operators established service companies for laundry, and for hotel supplies, flatware, landscape maintenance, and so forth, and caused those companies to service multiple hotels under their management and control. *And then the Emperor paraded into the market place.*

The management contracts currently used are loaded with scores of techniques to shift the risks and responsibilities to the owner, and it should be no surprise since that is the fundamental purpose of the structure. Apart from the hotel operator's consummate skill at marketing, how did the balance get shifted so far to the detriment of owners and lenders? How did the Emperor get out of the palace stark naked? And very importantly, how is it that with all of this observed and understood, could it happen again just twenty years later?

Clearly, many persons got involved in the business without having the slightest idea about it or about the evolving trend of the business. Ten years is a "generation" of working experience, so that lessons learned personally from 1990-1993 were not branded into the new legions of banker,s developers and prospective investors in 2005-2007 . Second, there remained a strong reliance upon consultants and third party experts, hired to advise the new owner and lender about the future prospects of success for the hotel. Dazzling arrays of data were accumulated and presented to show all manner of historical evidence to support speculation of future demand. Predicting the future, especially the long term future, of any endeavor is at best a dismal science.

On the demand side of the equation, the experts probably did as good a job as could be done, analyzing existing inventories, existing competition, demographic facts of all relevant manner, etc. But the supply side was not understood. The logic used was that supply would stop when demand did not justify the addition of more rooms. But that simple and logical assumption was completely wrong in the expansion of the 1980's and it remained wrong in the expansion of the 2000's. The business of the hotel operator was now predicated upon expanding as aggressively as possible, with other people's money, and when necessary into a market already overbuilt, to predate upon competition with a new and better product. That certainly is not a point of view reflected in most consulting reports, and it probably wasn't communicated thus by any operator to a consultant so it could be put into a report; perhaps it wasn't even realized by the hotel operators themselves n the 1980's, though how it could escape understanding in the 2000's is questionable. But it did happen, and at a rapidly increasing velocity of development in a rush to get as much approved and built and under contract as possible. Luxury hotels struggled to reach 65% occupancies at $175 room rates for a product that costs $250,000 per room to build in the 1990's. The same thing is occurring now, though at significantly higher adjusted costs for the improvements. *And now the cold breeze of reality chills the Emperor's "equities".*

For the part of the operators, is it possible to say that they knew, but didn't care? That's a difficult judgment, and one for case by case decision which, with the inevitability of litigation as some projects fail, will be addressed. But given the legions of lawyers, accountants, advisors and other professionals engaged, it seems unlikely that accountability for investment outcomes will fall there.

The fact is the hotel operators tailored up a suit that the investors and bankers were willing to wear. Unfortunately, a half-understanding of the business still amounts to a complete ignorance of the whole, and the financial embarrassment will rest in large part with the investors and bankers. The transactions were driven to a structure style where those who did take decision making responsibility were not financially accountable. The hotel operators clearly shifted or attempted to shift responsibilities of ownership by contract to the owner. The owner, often seeking finance from a lender, sought blessings of feasibility from an independent third party consultant. Could the "experts" have foreseen the ruinous direction of oversupply fomented by the expansion strategy of the hotel operators? Perhaps, but writing negative reports that kill projects that investors, bankers, and hotel operators want to build, buy, or lend upon is a good way to go out of business in a hurry. After all, who is better able to refer the next consulting assignment than the hotel operator? The consultant, banker, broker and manager got fees or points for doing their job, but not for looking after the basic issue of whether this process made any fundamental and long-term sense. Indeed this time around the packaging up of the loan and its resale through syndication removed a risk control of the lenders, as they no longer held the default risk, or it was managed differently.

If the financing was non-recourse and the equity syndicated, even the general partner of the owner had little to lose except someone else's capital. And if there was enough of that misguided capital in front of the lender's equity the loan was available. And if the debt rating was strong enough, it was passed on to a security portfolio and project risk no longer retained by the originating lender. With the emphasis by operators on enlarging their fee incomes and competitive positions by developing as many hotels as possible, the very persons most able to forecast the market demise had perhaps the least incentive to hold back the development. Certainly the hotel industry will take quite some time to recover, and it will be longer still before extensive development of new properties, or extensive refurbishments of existing ones, can be justified in most U.S. markets. The credibility of some hotel operators will be damaged, and perhaps some in certain areas will even be held accountable by disgruntled owners and lenders, as the inevitable litigation process rolls across failed hotel projects, many of them new or barely opened. But fundamentally, the existing assets have to be preserved, repositioned, and made operationally successful. That will prove in most cases to be a far more difficult task than getting them built in the first place. Having a team of professionals that understand how we came to be where we are, and what it takes to get us out of where we are, is critical.

Investors will be called upon to put in more capital. Bankruptcies and foreclosures may divest or threaten the continuation of many operator management contracts, and operators will be given an opportunity to show their true enthusiasm for projects by advancing monies to preserve those contracts. But in a collapsed market it is hard to believe that many will want to step back into the equity risk they have spent four decades moving away from. And which they successfully dodged two decades ago. Many persons in the hotel development and consulting areas will be without work, except as expert assistants in workouts and as expert witnesses in litigation.

The tailor may receive a whipping, but the Emperor can hardly execute him. The focus will shift away from building new hotels to running the ones already built. The most successful in operating at a profit will survive, and be in a position to acquire, sometimes at deep discount, those that cannot. There may be room for newcomers with large amounts of capital and courage to reassess the market and move into it while competitors are stunned.

Opportunity will exist for predatory equity to pick up recently completed or soon to be completed luxury hotels. Look for the source to be hotel operators trying to enter new markets and offering equity or debt infusion, either at the behest of the lender or owner, in exchange for the management contract. It should prove to be a healthier, though no less competitive process, where prestige may be reflected most on the owner's bottom line. *The tailor will be asked to make another suit, and perhaps the Emperor will judge the product with a keener eye*.

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Respectfully,

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