AVOID BECOMING "THE DOG THAT CAUGHT THE CAR"

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APRIL 2013

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WHEN YOU ACQUIRE A DISTRESSED HOTEL LOOK OUT FOR MAJOR, UNSEEN CHALLENGES

Hotels Aren't Like Other Properties – They Have a Distinctive Culture and Need Hands-On Supervision; A Long Downturn Compounds the Complexities and Requires Both Careful Handling and Specialized Management

Some years ago, a well-known shareholder activist bought so many shares that, to his surprise, he suddenly found himself in control of a distressed company whose management he'd been targeting.

A few weeks after he became the majority shareholder – and after he'd seen the true state of operations and finances inside the company – he confided in a colleague.

"I feel like the dog that caught the car," he said.

Acquiring any distressed property can feel like that. The acquirer, caught up in financial concerns in the run-up to the acquisition, is at risk of overlooking the serious problems that result when a property has been "orphaned" in many ways by its owners and/or lenders. Nowhere is this more true – and nowhere are the consequences more challenging – than in the hospitality industry. A hotel isn't just a property. It's a living, breathing entity with a culture all its own. Whoever first said that "a hotel is a soap opera with rooms" got it right. A long downturn in finances or a period of bankruptcy only makes things worse. A distressed hotel isn't an acquisition you can make and then forget. It won't run on its own. It requires daily, hands-on, operational management – a specialized, knowledgeable kind of management sensitive to the particular realities of a hotel in turnaround, a management that is able to work with the hotel's people and its physical plant and set the property back on the road to success.

The risks of acquiring a distressed hotel shouldn't be overstated – but they shouldn't be understated either. In many cases, the upside of a distressed acquisition is so high that the property will eventually be profitable. But how long does it take to get to that point? A poorly executed turnaround can tie up your capital and your attention for years. A well-executed turnaround can reduce the timeframe for recovery from years to months – giving you a much faster return on your investment and time to move on to your next acquisition. An effective turnaround plan will anticipate, and therefore help you avoid, a worst-case outcome.

Different acquisition scenarios can create different problems

Many different kinds of buyers acquire distressed hotels through foreclosure, deed-in-lieu or otherwise. There are professional investment groups – large and small, with varying degrees of experience – that are looking for the return from a turnaround and exit. There are hotel chains looking to expand into new markets. There are small hotel owners and family ownership groups that see the opportunity to acquire a rival's property and simplify the competitive landscape in their local market.

For all these investors, the acquisition is complex. Different acquisition paths lead to different operational realities. A hostile foreclosure can have a significant negative impact on the hotel's staff. A deed-in-lieu acquisition is generally friendlier and less damaging.

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The biggest challenge isn't closing the deal – it's running the property. Once you take over, you can be blindsided by problems with the physical plant and the staff's morale

But it's after the acquisition, not during, that the challenges really set in. This often comes as an unpleasant surprise to the acquirer. It's not uncommon for an acquirer to develop "target fixation" and focus on the property's financials, ignoring its operations until too late in the process. Acquirers are also in danger of looking at the acquisition through rose-colored glasses, anticipating market expansion or competitive advantage, and underestimating (or not understanding at all) the amount of work and the kind of work that will be needed to turn the hotel around.

While you've been busy buying the hotel, other things have been happening, too. Competitors are busy spreading rumors about how bad the hotel is, as a result of its financial distress. Managers and staff are in survival mode, trying to keep the operation going from day to day without thinking about the long term. They're booking rooms at discounted rates just to keep cash flowing. They're deferring maintenance so that the physical plant is literally decaying under their feet. Or they're just too demoralized to function at all. They're gathered around the water cooler spreading rumors of their own – about the acquisition, the future of the hotel or their own careers. Or they're caught up in staff gossip. Or they're floating resumes and planning their exits.

All of this is waiting to greet *you*, the new owner, the minute you walk in the door. If you're not prepared for it, the state of the property is going to come as a shock. And shock is just the first step – after that comes the realization that if you don't act quickly, your business plan and your financial projections are going to be severely disrupted, because the task of setting things right is going to take much more time and cost much more money than you anticipated.

Many problems aren't obvious. A broken culture creates hidden traps

It takes skill and experience to understand what's really going on at the hotel, the implications for your ownership and what to do about it. You might, for example, find on initial inspection that the bathrooms don't look good and the plumbing needs to be upgraded. But it will take more work to discover, for example, that the narrow areas behind the walls make such an upgrade extremely costly and time-consuming.. The task of stripping out this old, defective plumbing and replacing it with modern equipment will fall to you as the new owner.

Then there are the problems that the managers and staff don't even realize are problems. When I worked for Merv Griffin as CEO of the Griffin Group, we acquired a distressed hotel in Scottsdale, Arizona. We were excited about the acquisition and thought we had a good handle on what was going on. We thought the sales manager was particularly effective. When she sat down with us for her first formal presentation, she proudly told my team and I that in February, a year ahead, she had two weeks solidly booked. She'd even gotten 10 percent more per room than the usual rate. While boiling inside, I had to point out to her, gently, that those were the two weeks leading up to the Super Bowl in Phoenix. It was a really bad move to book the rooms so early. If we'd been smart about the sales process, we could have gotten two to three times our usual rate, with minimum stays and ancillary bookings for such things as meeting rooms.

The problem wasn't that the salesperson lacked skill. It's that she was operating in a culture of desperation. Managers were too distracted to give her supervision. Her focus was on getting bookings, period, because to the extent that managers were focused on anything, they were focused on occupancy and cash flow. She was simply trying to keep her job. No one was able to give her a bigger, more strategic perspective.

This is a prime example of a broken culture. Like broken plumbing, it's something you'd typically find in a distressed hotel. And unlike broken plumbing, it won't turn up in due diligence. Therefore, too often, these major problems only surface after the fact.

Problems are created not just by the staff and the physical plant, but by the community as well

It's hard to anticipate everything that needs to be set right. In both Scottsdale and at another property in Florida, when we walked in with our new financing and our turnaround plan, we were greeted by local officials lined up with paperwork and demand fees. There was nothing illegal going on – it wasn't that they were looking for payoffs. They were simply ready to have the hotel brought up to code. Because the previous owners were in financial straits, the local government had given them a break – allowed them waivers on inspections and deferred or ignored requirements. Officials concluded, reasonably, that it wasn't possible to get blood from a turnip and that it was best for the community to keep the hotel in business. Now that the new ownership (and its new funding) was in town, however, the locals decided that it was time to reinforce the code, reinstate inspections, ask that the owners pass the architectural review board and such. Practically speaking, this was a consequence of a different kind of deferred maintenance – the regulatory kind. Again, this isn't the sort of thing that would be evident in a review of the financials or even the local regulator's paperwork.

You need help. Hiring the right manager is a critical step

Poor morale, poor management, lost market position, a distressed physical plant, hidden costs… what's a new owner to do?

The obvious – and right – answer is to call for help. A hotel turnaround calls for specialized experience and special talents. The people who have that experience and those talents probably weren't part of the acquisition team, because the acquisition team was probably heavily biased toward finance. But now that you've acquired the hotel, you need to acquire the people who can save it, fix it and run it.

What should be the composition of the turnaround team? The most critical hire is an experienced manager (an individual hired directly by you or by your management company with your active participation). To put it more precisely, the manager needs not only to be experienced but also needs to have the right kind of experience. Turning a hotel around is different from running one or even opening one. The ideal turnaround manager is one with a track record in other turnarounds. He or she is someone who's skilled at spotting and fixing problems, cutting costs, quickly getting staff re-energized and on track with your program. At a later stage you may want to replace the turnaround manager with another manager, someone who specializes in taking a successful hotel to the next level. And the turnaround manager will probably want to move on to another turnaround. But those next-

stage managers – marketing specialists, show-people, really – are not the right talent right now.

The turnaround manager is at the heart of your on-site operations. This is the person who will get it across to the sales force that paying the mortgage month-to-month is no longer the prime consideration – which means that it no longer makes sense to scramble right now to fill the hotel with discount airline groups during next year's Super Bowl week. This is the person who will break up the clusters of frightened employees who are gathered at the water cooler and get them back to work – and perhaps get rid of the employees who continue to sow discontent. The manager is the catalyst for the hotel's new culture.

The pace and complexity of a turnaround puts severe demands on you, the owner

But the manager can't do it alone. Clearly the staff has to perform. But the ownership group has to perform as well. When the manager spots an issue, the resolution may require action – fast action – on your part. You need to be ready to adjust your strategy and perhaps even your business plan "on the fly" in order to respond to the constant, unpredictable flow of demands that the property is likely to generate.

The first step in a turnaround is to put the right advisory team in place

Of course, you as an owner can't do it alone, either. You need to assemble a team of advisers that may include asset managers, attorneys, accountants, engineers and business strategists in addition to financial professionals – who understand that hotels aren't like other properties, and distressed hotel acquisitions aren't like other kinds of hotel investments. A good team will help you anticipate problems and build responses into your business plan or revise it quickly – ensuring that the timeline is realistic and the financing is adequate for what the turnaround will really entail.

In the absolute best case, much of your advisory team should be in place during the planning phase. In a subsequent article, I'll discuss what you and the team will need to look for during the period leading up to the actual acquisition. For now, it's enough to say that the more you can flag operational problems during the due diligence phase, the more effective your turnaround plan will be. You'll also have the chance to walk away from an acquisition that looks good but really promises disaster long road to success.

With the right team and the right expectations, you can complete the turnaround – and come out ahead

Acquiring a distressed hotel is not for the faint of heart. Nor is it for the irrationally optimistic. The turnaround process is complex and drawn out. It's the equivalent of stopping and changing the course of a damaged battleship. Changing the course of any battleship (or hotel) is difficult and takes time. The damage makes the process harder and longer.

But if you know what to expect going in, you're much less likely to lose sleep, or time, or cash. By assembling the right advisers, hiring the right turnaround manager and being ready to adjust your plans on the fly, you can put the odds in your favor. Now, when you're the dog that catches the car, you'll know how to drive it and use it to get where you need it to go.

About Lawrence Cohen

Lawrence Cohen is Hospitality Group Leader at Marks Paneth & Shron LLP. He rejoined the firm after having served for many years as the President and Chief Executive Officer of The Griffin Group, the investment and management company of the late Merv Griffin.

Drawing on his deep experience in the media, entertainment, hotel, casino, retail and real estate industries, Mr. Cohen provides counsel in the areas of mergers, acquisitions, financing and operational management. He is also well versed in the needs of high-net-worth individuals. Mr. Cohen has had business interests in the Los Angeles area for more than 25 years and shares responsibility for the firm's operations on the West Coast.

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