MARKS PANETH

ACCOUNTANTS & ADVISORS

PIGS GET SLAUGHTERED: DO'S AND DON'TS FOR BUYERS AND SELLERS IN A RED HOT HOTEL REAL ESTATE MARKET

Lawrence Cohen

04.2014

DO'S AND DON'TS FOR BUYERS AND SELLERS IN A RED HOT HOTEL REAL ESTATE MARKET

A hot real estate market can be exciting for both buyers and sellers. That's true in general and equally true in the hospitality industry.

Today's hotel transaction market is definitely hot. After slow years, in the aftermath of the financial crisis, the pace has accelerated sharply. Financing is available, buyers are active and properties that were kept on the sidelines during the down years are now being posted for sale. Sellers can realistically expect prices much higher than they could have expected a year or two ago. Buyers, who may have struggled to secure financing not long ago, can now find their choice of lenders offering better terms than they recently thought possible.

Should you be a buyer? A seller? Both? Should you act now, or wait until an already-active market reaches its absolute peak … or slows down a bit?

The answer, of course, depends on your situation – and also on your expectations. How realistic are they? A hot market can be a good time to make money. It can also burn you. Is the market truly hot? Will it get hotter? Is that necessarily a good thing? Or, should you wait for a correction? There may be good reasons to enter the market or expand your presence in a market that isn't yet at its peak.

The main point to keep in mind is this: The hotel transaction market is a market like any other. It is subject to the same dynamics – and excesses – that govern all markets. And the conventional wisdom applies: Don't get greedy. What is said of the stock market can also be said of buying and selling in the hospitality industry: Bulls make money and bears make money. But pigs get slaughtered.

Understand market dynamics and develop a strategy

How to avoid being a pig? The answer comes down to timing – and expectations. Success depends on when you act, and that in turn depends on whether you expect the market to go up or down. It also depends on how well you understand the specifics of a particular market. In some respects, hospitality real estate is a market like any market. But in other respects, it's affected by dynamics that are particular to the industry and it follows its own rules.

The starting place for developing your market strategy is macroeconomic data. Where is the economy and where do you think it will go? On that score, the news is good – most data point toward continued growth though the probable rate of expansion is not at all clear.

As for timing the market – can you? Should you try? History and experience suggest that trying to time the market is a fool's errand. It's probably also unnecessary. True, you can generate the highest returns if you buy at (or near) the

DO'S AND DON'TS FOR BUYERS AND SELLERS IN A RED HOT HOTEL REAL ESTATE MARKET

bottom of the market and sell at (or near) the top. But there are challenges at the extremes. As buyers, at the bottom, it's very hard to find lenders, so you'll have to be nimble to find financing. At the top, peak prices will make your acquisition highly leveraged … and highly risky.

The middle of an expanding market can actually be a good place to make money. While values may not be maxed out, there's an ample supply of buyers, sellers, lenders and investors. In other words, the market functions as a market. If you are a seller, you might lose out on peak pricing, but you stand to gain as a result of peak liquidity.

Step one in avoiding excessive greed: Don't believe your own hype

This is where pig avoidance comes into play. Realistic expectations – and not holding out for either the top dollar (if you're a seller) or the best bargain (if you're a buyer) – are essential to success.

The first decision you'll have to make is what role to play. Chances are, in a lively market, you want to do something. Should you buy or should you sell? Or should you do some of each? If you already have a portfolio, your strategy might lead you in either direction – to trim your holdings and take profit, or double your portfolio and expand? Although it may have been hard to build your portfolio, doubling it might be considerably easier – money is now available, bankers are making loans, investors are looking for opportunities and sellers are looking to take profit as prices rise. So there are arguments for expansion – and for taking profits from rising prices as well. The right answer will of course depend on your own strategy and your overall financial picture.

If you choose to be a seller, you will need to be careful not to believe your own bu*$!, er, hype. Consider a seller in an up market who starts high – then, as buyers approach the asking price, keeps negotiating higher. That's a great technique if you can pull it off. But chances are, you can't – because timing the top is impossible. This kind of seller often keeps escalating the price right past the market top, only to have to capitulate as the market recedes. Yes, if you "settle" for less than the absolute maximum price, you might experience seller's remorse. But you'll never know until after the fact when the absolute maximum price has arrived. And you can still feel a sense of satisfaction as you watch prices fall, counting your blessings and your profits while other sellers are left high and dry.

The same is true for buyers. A buyer who believes his or her own hype is a buyer who's likely to oversell the deal to underwriters. True, every deal has an upside. But it has a downside as well. Trees don't grow to the sky. Just because you're able to "sell" a deal to a lender or investor doesn't mean that you should. Consider the buyer who worries about being outbid – and is in fact outbid – only to see the winning buyer struggle to keep up with financing when the market reverses.

DO'S AND DON'TS FOR BUYERS AND SELLERS IN A RED HOT HOTEL REAL ESTATE MARKET

Practical steps include auctions, planned negotiations, and worst-case forecasting

For sellers and buyers alike, the fundamental advice is clear: don't be a pig.

This is easy advice to give. But it leaves open the question of how to avoid piggishness. What, specifically, should sellers and buyers do to avoid the risks that come with excessive greed – and maybe realize the benefit of just the right amount of greed?

For the seller, one practical approach is to run an auction. Many sellers like to do this no matter what the market conditions. However, there are many reasons not to do it: for privacy, or to avoid disruption in the operation that comes from an extended sales process, or because they dislike brokers, or because they just don't want to pay the fees involved. Nevertheless in a hot market, there is an added advantage – the auction "broadcasts" the news that your property is for sale, and that serves to drive demand and you will usually walk away confident that you received the best price

To help ensure a successful auction, make certain you conduct it in a professional way. Hire a qualified, competent broker or investment bank. Be prepared to pitch all the upside you see in the property. If there is the potential to build more rooms, develop condos or develop adjacent land, invest a few dollars to build detailed plans. A development plan will help give the broker selling tools and make it easy for the buyer to dream.

A real-life example of this scenario occurred a few years ago when I was CEO of the Merv Griffin Group of Companies. We had a property that had both an untapped development parcel as well as a secondary structure that was not in use. We invested a few dollars in permits and architectural drawings as well as prepared pro-formas for the potentially enlarged hotel. The buyer purchased the property based upon a multiple of projected cash flow for not only the existing rooms but for the potentially newly developed structures. Needless to say, we were a happy seller and the investment in the development plans paid off. It was one of my better deals.

When it comes to sales terms, have your wish-list ready. If you want to keep some equity in the property, ask. Make that part of the deal. If you want to keep an adjacent parcel of land, be ready to negotiate. But, as in any negotiation, don't get locked in. Prepare to be a creative negotiator – your creativity and flexibility will pay off in the long run.

For the buyer, the best practical advice is to get your underwriting right. Look at the deal as if every penny involved was your own money, not the bank's or the investors'. It's critical to set realistic assumptions. One way to do this is to perform sanity checks – a downside sensitivity scenario and historical comparables. Make sure the comparables extend farther back than just six months – that will enable you to see and model the market downturn scenarios. Does the deal still work with some downside in it? If it does, then go ahead.

DO'S AND DON'TS FOR BUYERS AND SELLERS IN A RED HOT HOTEL REAL ESTATE MARKET

Be mindful of industry-specific risks

Many of these cautions and practical steps might apply in any commercial real estate transaction, not only in the hospitality industry. But buyers and sellers alike need to be mindful of the risks that are hospitality industry-specific. The hospitality market is apt to turn downward much faster, and with much less warning, than other forms of commercial real estate. The owner of an office property might benefit from a 10-year lease on the upper floors – a lease term that will provide a substantial cushion in the event of a downturn. A hotel owner might be just as dependent on a prime customer – say, a company that holds its firm-wide conference every year at your slowest time. But that conference is likely to be run on a year-to-year contract, and if the economy weakens, travel and conference expenses are among the first cost items that your client will cut. That cushion is gone without warning. Hotels are also reliant on leisure travelers, and in a downturn, they'll give up their travel plans equally fast.

Hotel revenues are often a leading economic indicator – they surge quickly in an upturn and are among the first to crash when the economy sours. The causes are often extraneous to market conditions. The September 11 attacks came without warning and devastated the industry. The market crashes of 1987, 2000 and 2008 were, of course, grounded in economic factors – but not in hotel economics. Sharp changes in the industry often have nothing to do with the hotel market – with the prices of properties or with what people are buying and selling. Therefore, you may not see the reversal coming. But when it comes, it will hit you hard and fast. That's even more reason to steer clear of piggishness and other forms of greed.

Don't be afraid of a hot market – but be careful about how you participate

A hot market – as the current market certainly is – can be an exciting time for both buyers and sellers. And both can reap major rewards. The caveats are few – but they are important. First, determine what side you are on – buyer or seller – and be satisfied with the decision you make. That will help you avoid being burned or suffering post-transaction remorse, no matter what you do.

Second, make sure you've evaluated all economic consequences – including taxes, opportunity costs and downside scenarios. The more complete your forecast, the less likely it is that you'll be unpleasantly surprised.

And finally – we can't say it too often – remember that if you want to make money, you can participate in the market in many different ways. You can be many different animals – any, except for a pig. Because when the slaughter happens – and it will – it will in fact be the pigs that get slaughtered.

DO'S AND DON'TS FOR BUYERS AND SELLERS IN A RED HOT HOTEL REAL ESTATE MARKET

About Lawrence Cohen

Lawrence Cohen is the Hospitality Group Leader at Marks Paneth 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.

Mr. Cohen has strong roots in the hospitality industry. The Griffin Group and its affiliates owned and managed properties that ranged from high-end resorts to limited service properties. Mr. Cohen spearheaded all aspects of the business including acquisition, development and redevelopment, financing, management team hiring, supervision of operations and eventual sale.

At Marks Paneth, Mr. Cohen draws on his deep experience and serves his clients as a business ''coach.'' For mature companies, he will advise entrepreneurs, CEOs and CFOs on strategies to reposition their companies in the current business environment. For start-up companies, he will delve into the business plans and advise on the growth of their infrastructure. While Mr. Cohen will usually directly assist in the business plan preparation process and support the money-raising process, he will also often ''roll-up his sleeves'' and assist with the execution of his advice including negotiating the business points of lender agreements, leases, distribution agreements, etc. as well as hiring and/or terminating employees.

In addition, 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.

Contact Lawrence Cohen:
Phone: (212) 503-8855; Fax: (212) 503-8856
lcohen@markspaneth.com

About Marks Paneth LLP

Marks Paneth LLP is an accounting firm with over 500 people, of whom approximately 65 are partners and principals. The firm provides public and private businesses with a full range of auditing, accounting, tax, consulting, bankruptcy and restructuring services as well as litigation and corporate financial advisory services to domestic and international clients. The firm also specializes in providing tax advisory and consulting for high-net-worth individuals and their families, as well as a wide range of services for international, real estate, media, entertainment, nonprofit, professional and financial services, and energy clients. The firm has a strong track record supporting emerging growth companies, entrepreneurs, business owners and investors as they navigate the business life cycle.

DO'S AND DON'TS FOR BUYERS AND SELLERS IN A RED HOT HOTEL REAL ESTATE MARKET

The firm's subsidiary, Tailored Technologies, LLC, provides information technology consulting services. In addition, its membership in Morison International, a leading international association for independent business advisers, financial consulting and accounting firms, facilitates service delivery to clients throughout the United States and around the world. Marks Paneth, whose origins date back to 1907, is the 33rd largest accounting firm in the nation and the 10th largest in the Mid-Atlantic region. In addition, readers of the *New York Law Journal* rank Marks Paneth as one of the area's top three forensic accounting firms for the fourth year in a row.

Its headquarters are in Manhattan. Additional offices are in Westchester, Long Island and the Cayman Islands. For more information, please visit www.markspaneth.com.