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# COMMITTING TO A HOTEL CONVERSION? LOOK BEFORE YOU LEAP

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# THE HOSPITALITY MARKET IS HOT, BUT BEFORE YOU JUMP IN, CONSIDER – A HOTEL MIGHT NOT BE "HIGHEST AND BEST USE" OF THE PROPERTY

*You've just acquired a sleepy office building in an up-and-coming neighborhood – one with an influx of restaurants and galleries, and great transportation. It would make a perfect hotel – trendy, glamorous and with more than a small dose of cool. Now's the time to get started on the conversion. Isn't it?*

*Or – you own a small entertainment company on the West Side of Los Angeles. All around you, hotels are springing up, and they're generating more revenue that you could hope to realize from your studio/office building. You begin to think about converting the studio into a boutique hotel. Those plans are worth pursuing – aren't they?*

*Or – you're a hotel operator, and it goes without saying that you need to keep the edge over your competition. That loft building will give you a foothold in a trendy district, and help give your brand a new, stylish profile that will appeal to a youthful demographic and lift sales across all your operations. Time to commit to the project – right?*

*The answer in each case is, "Not so fast."*

Conversions are a hot topic in the hospitality industry – understandably, because the hotel market itself is hot, and converting a property is a quick way to establish or expand your footprint. In many cases, it's far easier and much less expensive to convert an existing building than it is to build from scratch. Why wouldn't you want to get a fast start on an opportunity – and possibly a jump on the competition – by committing to a conversion? For all players in hotel property – real estate investors looking to move into hospitality, business owners who want to claim a share of hospitality industry revenues and established hotel owners in need of an expansion path – conversion looks like the smart way to go. Is it? Not always.

**Hospitality is booming – but that doesn't make every hotel conversion plan a good one**

Although there seems to be an ongoing boom in hospitality, that doesn't mean that hotel conversion is necessarily the highest and best use of a given property. The industry boom is a general phenomenon. But a specific property has particular features that may point toward other uses – or suggest that, although a hotel conversion has long-term potential, in the near term, there are better ways to generate revenue from the site.

**Be realistic – take a hard look at the pitfalls of your conversion plan**

Discipline is essential, and no matter what kind of participant you are in the market, part of that discipline involves taking a hard look at the pitfalls. If you are a property owner, keep in mind that when a hotel operator knocks on your door, while that means that your building is in play, it doesn't mean that you have to go ahead with the transaction, or that you should. In the opening examples, a Los Angeles entertainment company needs to look at all the possibilities –

if the goal is greater revenue, the best course might be to build a bigger studio, or convert to commercial or residential use, instead of a hotel.

The same discipline applies to operators. If you're an operator, you need to make sure you're being realistic in your assumptions. Trees don't grow to the sky. Just because your competitors are moving into a new hot neighborhood, that doesn't mean that you should, too. The local area may already be saturated and, therefore, unable to support a hotel. Yours could be the one too many, with predictable impact on your business. A hot market may also drive the purchase price beyond reasonable reach. Put yourself in the property owner's shoes. Given demand in the neighborhood and the many options available for development of a property, can the owner afford to give you a price on a purchase or ground lease that leaves you with an upside?

If rushing into the conversion market isn't the best course of action, what is? What should prospective players do, and how should they come to a decision about the use of the property?

**For owners, a public auction will reveal maximum value and best use**

For owners, the advice is clear – run an auction. On the face of it, the idea of an auction is likely to make owners uneasy. Many like to run their own sales. There are multiple reasons. It may be for the sake of privacy, because they dislike brokers or because they don't want to pay the fees involved in a public sale.

Many of these reasons are valid, provided that the market is tough, or even average. But in a hot market, holding a public auction will pay off almost every time. It will create demand for your property and make certain that it sells at the highest possible price. And it helps ensure that you don't get so locked into the idea of a particular use for the property – a hotel for example – that you wind up blind to other opportunities.

Several years ago, when I was CEO of The Griffin Group, we had undeveloped land that we envisioned as a mixed-use project for a resort. However, after hiring an investment bank, we ended up with a joint venture for mid- to high-end homes and realized value that was multiples of what we expected.

To conduct a successful auction, manage it in a professional way. Hire a competent broker or investment bank. And be prepared to pitch all the upside you see in the property – no matter what the use. If there is potential for residential, commercial or hospitality, invest a few dollars in developing the plans for each and thoroughly evaluate all alternatives.

**Operators need to stress-test their plans: Be honest and accurate about downside sensitivity**

For operators, the most important discipline is to get the underwriting right. Look at the deal as if every penny was your own money, not the bank's or investors'. And be realistic – even harsh – in your assumptions. Put the screws to your business case, stress-test every scenario and don't believe your own sales pitch.

In technical terms, this means you need to run a downside sensitivity scenario as well as other reality (and sanity) checks such as historical comparables. Make sure these are sufficiently long term – not just covering the past six months. If the deal works with some downside, then do it. But be honest about that downside and make sure that you've taken a hard look at all the reasons not to go forward. You may want to consider engaging an independent professional – someone versed in both financial modeling and the realities of the hospitality and real estate industries – to run the analysis and take an objective look at all the downside and upside scenarios.

**Seize the moment – but only after taking a long, hard look**

After you've run your analyses, you may decide to go ahead with your conversion. That's great – seize the moment – as long as you're confident that the conversion will perform as you expect, and that it will perform better than other possible uses of the property. But again, be careful with your assumptions. Don't just follow your competitors or your fellow property owners, or the momentum of the marketplace. Make sure you've evaluated all scenarios, and don't fall in love with the potential of that glamorous hotel – even if your neighbors have committed to similar developments. Caution, objectivity and a generous dose of self-protective skepticism will help ensure that your property achieves its highest and best use – whether that's the next great hotel, or something completely different.

**About Lawrence Cohen**

Lawrence Cohen is a Partner and 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.

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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.

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 Washington, DC, Westchester, Long Island and the Cayman Islands. For more information, please visit www.markspaneth.com.