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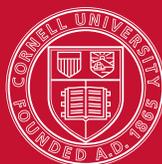


Public or Private? The Hospitality Investment Decision

Cornell Hospitality Report

Vol. 10, No. 17, December 2010

by Qingzhong Ma, Ph.D. and Athena Wei Zhang, Ph.D.



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Cornell Hospitality Reports,
Vol. 10, No. 17 (December 2010)

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the benefit of the hospitality industry by
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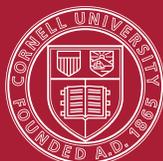
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Cornell University
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Public or Private?

The Hospitality Investment Decision

by Qingzhong Ma, Ph.D. and Athena Wei Zhang, Ph.D.

EXECUTIVE SUMMARY

As the economic recession gradually recedes, companies with sufficient capital have numerous investment opportunities. The question is what type of lodging assets are appropriate for investment, in terms of value creation. In this report we examine the choice between listed lodging assets (publicly traded firms) and those that are unlisted (privately held standalone companies or subsidiaries). Based on a large sample of acquisitions in the lodging industry from 1981 to 2006, where both listed and unlisted lodging assets are involved in the transactions, our results strongly suggest that acquisitions of unlisted lodging assets create more value to the acquiring shareholders. Further, among the acquisitions of unlisted assets, more value is created when stock is used as payment, when deal is relatively large, and when competitive bidding is avoided in the transaction.

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During economic recessions companies tend to be conservative in making investment decisions.¹ At the same time, however, plenty of investment opportunities exist, especially for companies with sufficient capital. For example, during recessions asset prices are depressed, making them attractive acquisition targets. The question, however, is what kind of assets should be acquired to create the most value. In this report we discuss the choice between listed lodging assets (publicly traded) and unlisted acquisitions (subsidiaries and privately held standalone firms).

¹ This is especially salient in terms of making acquisitions, one of the most dramatic investment decisions. It is well documented that acquisitions are highly cyclical and that acquisition activities are positively correlated with valuation level. See for example, Andrei Shliefer and Robert Vishny, "Stock-market-driven Acquisitions," *Journal of Financial Economics*, Vol. 70 (2003), pp. 295-311.

Year-by-year distribution of the number of deals

Year	N	Private	Subsidiary	Unlisted	Listed	% Unlisted
1981	1	0	0	0	1	0
1983	4	3	1	4	0	100
1984	4	1	2	3	1	75
1985	2	0	2	2	0	100
1986	2	0	2	2	0	100
1987	1	0	1	1	0	100
1988	5	3	2	5	0	100
1989	2	1	1	2	0	100
1990	2	0	2	2	0	100
1991	1	0	1	1	0	100
1992	6	2	3	5	1	83
1993	9	5	3	8	1	89
1994	18	11	7	18	0	100
1995	21	10	11	21	0	100
1996	60	29	26	55	5	92
1997	109	52	48	100	9	92
1998	52	24	24	48	4	92
1999	19	7	6	13	6	68
2000	11	3	6	9	2	82
2001	8	2	6	8	0	100
2002	8	3	3	6	2	75
2003	11	5	6	11	0	100
2004	20	9	9	18	2	90
2005	34	13	21	34	0	100
2006	42	20	22	42	0	100
All	452	203	215	418	34	92

Note: The sample consists of a total of 452 transactions of lodging assets by publicly traded acquirers, announced between 1981 and 2006. This table presents year-by-year distribution of sample deals, including total number of deals, of private deals, of subsidiary deals, of all unlisted (private and subsidiary combined) deals, and of listed deals. The last column shows the percentage of deals that involve unlisted targets. The last row reports the sample total number of deals and the percentage of deals that were unlisted.

The literature on acquisitions in the lodging industry has focused almost exclusively on acquisitions of publicly traded targets. The reality, by contrast, is that most acquisition deals in the lodging industry involve unlisted targets. Exhibit 1 illustrates the number of total deals, deals involving privately held standalones, deals involving subsidiaries, total unlisted deals, deals of listed targets, and the percentage of unlisted deals for the dataset used in this study. Ninety-two percent

of the deals involve unlisted targets.² As such, after we report the overall difference in wealth creation between the

² Based on deal value, unlisted deals consist of 39 percent of overall deal volume. This is mostly because publicly traded targets are usually much larger than privately held standalones or subsidiaries. Both percentages (92% based on number of deals and 39% based on transaction value) suggest the economic importance of understanding the wealth effect in acquisitions of unlisted targets.

Distribution of cumulative abnormal returns (CARs) to acquirers

Variables	Mean	Std. Dev.	Median	P25	P75
CAR (%)	1.231	5.432	0.672	-1.908	3.290

listed and unlisted acquisitions, we examine how to create more shareholder value for the subgroup of unlisted deals.

Theoretical Background

When examining value creation or destruction in acquisitions, the common argument of economists is that acquiring companies pay out all synergies or even overpay, leading to destruction of value to shareholders of the acquiring firms.³ One commonly offered explanation for overpayment is managerial hubris. When managers hold overly optimistic views on their ability to manage acquisitions and thus make irrational acquisition decisions they tend to believe that value could be created when two companies merge under their control.⁴ This mental calculus on the part of acquiring managers is at odds with the empirical evidence. In acquisitions of publicly traded targets acquiring shareholders on average at best achieve breakeven and in some cases have seen big losses.⁵

When it comes to acquisitions of unlisted targets, however, the finance literature consistently reports significantly better performance.⁶ The common rationale, which contrasts the overpayment in listed deals, is that when acquiring unlisted targets, acquirers enjoy a liquidity discount.⁷ This phenomenon arises from the demand for liquidity by the

³ When a widely held, publicly traded corporation is targeted, the shareholders tend to ride “free” on takeover synergy, forcing the successful bidders to pay out all synergies. See Sanford J. Grossman and Oliver D. Hart, “Takeover Bids, the Free-rider Problem, and the Theory of the Corporation,” *Bell Journal of Economics*, Vol. 11, No. 1 (1980), pp. 42-64.

⁴ The hubris hypothesis was first proposed by Richard Roll, “The Hubris Hypothesis of Corporate Takeovers,” *Journal of Business*, Vol. 59 (1986), pp. 197-216.

⁵ See Michael Jensen and Richard Ruback, “The Market for Corporate Control: The Scientific Evidence,” *Journal of Financial Economics*, Vol. 11 (1983), pp. 5-50; and Gregor Andrade, Mark Mitchell, and Erik Stafford, “New Evidence and Perspectives on Mergers,” *Journal of Economic Perspectives*, Vol. 15 (2001), pp. 103-120. See also: Sara Moeller, Frederick Schlingemann, and Rene Stulz, “Wealth Destruction on a Massive Scale? A Study of Acquiring-firm Returns in the Recent Merger Wave,” *Journal of Finance*, Vol. 60 (2005), pp. 757-782.

⁶ See, for example: Kathleen Fuller, Jeffrey Netter, and Michael Stegemoller, “What Do Returns to Acquiring Firms Tell Us? Evidence from Firms That Make Many Acquisitions,” *Journal of Finance*, Vol. 57 (2002), pp. 1763-1793.

⁷ See, for example: Michael Officer, “The Price of Corporate Liquidity: Acquisition Discounts for Unlisted Targets,” *Journal of Financial Economics*, Vol. 83 (2007), pp. 571-598.

selling firms. This might occur, for example, when a large company is in financial distress and needs a quick capital infusion to survive. In that instance, it is more likely to shed assets and be willing to do so at a discount price. For privately held standalone companies, owners are also willing to accept a lower price when their incentives to exit are strong. These factors create lucrative opportunities for potential acquirers.

Sample and Methodology

Our sample consists of 452 acquisition deals in the lodging industry, involving 34 listed firms and 418 unlisted targets. The acquirers in all these deals are publicly traded companies. We choose to focus on publicly traded acquirers simply because we are able to estimate value creation or destruction for these acquirers because the price of their publicly traded stock reacts to announcements of acquisitions. For these deals we searched news articles from *The Wall Street Journal* and Dow Jones News Retrieval to collect critical information, such as whether the acquirer and target had a prior business relationship, and whether competition for the target exists.

We follow the standard even-study methodology to calculate cumulative abnormal returns to acquiring firms surrounding announcements of transactions. The key in estimating abnormal returns is to subtract the expected portion from the raw returns. Following the literature, we use the CRSP value-weighted market return as the expected return.⁸ We then accumulate daily abnormal returns over a five-day event window of two days before and two days after the acquisition [mathematically, -2, +2, where day 0 is the announcement date]. Specifically, the cumulative abnormal returns (CARs) of acquirer j are defined as

$$CAR_j = \sum_{(t=-2)}^2 (R_{j,t} - R_{m,t}),$$

where t represents days relative to the announcement date ($t = 0$), $R_{j,t}$ is the raw stock return for acquirer j on date t , and $R_{m,t}$ is the CRSP value-weighted market return on date t .

Cumulative abnormal returns as estimated above are used as a measure of changes in shareholder wealth that can be attributed to the announcement of a transaction. Posi-

⁸ See, for example: Fuller *et al.*, *op.cit.*

Abnormal returns (in percentages) by listing type and other deal characteristics

Subsamples (Listed/Unlisted)		Listed	Unlisted	
Panel A: Whole sample				
All (34 listed / 418 unlisted)	Mean	-0.68	1.36	***
	Med	-1.85	0.72	***
Panel B: By method of payment				
Stock (7 listed /6 unlisted)	Mean	-2.67	9.63	**
	Med	-4.47	10.56	
Mixed (21 listed /58 unlisted)	Mean	0.04	2.89	***
	Med	-1.56	1.14	***
Cash (6 listed /354 unlisted)	Mean	-0.88	0.97	***
	Med	0.76	0.67	***
Panel C: By relative size (transaction value/acquirer market cap)				
Below sample median (4 listed /222 unlisted)	Mean	-1.18	0.65	**
	Med	-0.63	0.55	**
Above sample median (30 listed /196 unlisted)	Mean	-0.61	2.17	***
	Med	-1.85	1.35	***

Note: The sample consists of a total of 452 transactions of lodging assets by publicly traded acquirers, announced between 1981 and 2006. The dependent variable is the acquirer's announcement period abnormal returns, by percentage. This table lists the mean and median of subsamples classified based on method of payment and relative size, as shown in the panels. The numbers of observations for the listed and unlisted subgroups are reported in the first column following subsample names. For example, in Panel B, Cash (6/354) means that, among all 360 cash deals, 6 involve listed firms and 354 unlisted targets. Method of payment can be all stock (stock), all cash (cash), or a combination of the two (mixed); Relative size is the ratio of the transaction value to the acquirer's market value of equity at the month end before the announcement. Significance is indicated by *** (1% level), ** (5% level), and * (10 percent significance level).

tive CARs are interpreted as creating shareholder value, and negative CARs as destroying shareholder value.

The following two examples illustrate how the cumulative abnormal returns are calculated and how they differ across the two types of acquisitions. On July 15, 2004, Harrah's Entertainment Inc. announced that it would acquire Caesars Entertainment Inc., a listed company. On the announcement date, the stock price of Harrah's Entertainment (HET) dropped by 6.02 percent while the value-weighted market index changed only by negative 0.33 percent, indicating a daily abnormal return of -5.69 percent. The five-day cumulative abnormal returns surrounding the announcement date were -10.27 percent. By contrast, on January 17, 1997, Starwood Lodging Trust acquired HEI Hotels and ten joint venture hotels held by HEI and PRISA II, a

unit of Prudential Real Estate Investors, for \$493.063 million. Both HEI and the ten hotels were privately held.⁹ The stock price of Starwood Lodging Trust increased by 3.20 percent on the announcement date while the value-weighted market index increased only 0.71 percent, for a daily abnormal return of 2.48 percent. The five-day cumulative abnormal returns to Starwood Lodging Trust were total of 7.82 percent.

Findings

Exhibit 2 (previous page) shows that the average CARs for the sample is 1.231 percent with a standard deviation of 5.432 percent, and a median of 0.672 percent. (Both mean and median are statistically significant at the 1-percent confidence level.) This result, as expected, is driven by the positive returns of the unlisted subsample. As shown in Exhibit 3, the average CARs for the listed deals are -0.68 percent, while

⁹ SDC classifies the assets as "private," because HEI Hotels was a private company.

Regressions of announcement period acquirer abnormal returns

	Model (1)		Model (2)		Model (3)		Model (4)	
	Coef.	T	Coef.	T	Coef.	T	Coef.	T
Unlisted, 1/0	3.354	2.47**	4.766	3.21 ***	2.559	1.67*		
Private, 1/0							0.413	0.92
Stock deal, 1/0			2.233	0.90			5.026	1.50
Cash deal, 1/0			-1.727	-2.08**				
Any stock, 1/0							3.238	2.15**
Unlisted x Any stock					4.301	3.08		
Listed x Cash					-0.716	-0.30		
Ln(1+relative size)	3.142	2.63***	2.739	2.37**	2.476	2.21**	3.430	2.54**
Number of bidders	0.080	0.05	-0.162	-0.11	-0.800	-0.49	-1.788	-3.85 ***
In merger wave	-0.188	-0.39	-0.100	-0.21	-0.066	-0.14	0.097	0.21
Constant	-2.523	-1.33	-2.228	-1.07	-1.117	-0.50	2.025	2.82 ***
Adj. R ²	0.032		0.052		0.075		0.104	
N	452		452		452		418	

Note: Four ordinary least square (OLS) regression models are presented. The first three models are based on the whole sample of 452 transactions while model (4) is based on the 418 unlisted deals only. The dependent variable is the announcement period abnormal returns to acquirers. Unlisted is equal to 1 if the target is not publicly traded at the announcement; Private is equal to one if the target is a private company; Stock deal is equal to one if the method of payment is 100% stock, and zero otherwise; Cash deal is equal to one if the method of payment is 100% cash, and zero otherwise; Listed is equal to one if the target is publicly traded at the announcement; Listed x Cash, and Unlisted x Any stock are the products of two variables; Relative size is the ratio of deal value to the acquirer's market value of equity measured at the month end before the deal announcement; Number of bidders is the number of bidders for the assets in transaction, according to data at SDC; In merger wave is equal to one if the deal is announced during the most recent merger wave (between year 1997 and 2000). The t-stats are based on heteroskedasticity-robust standard errors. Significance is indicated by *** (1% level), ** (5% level), and * (10 percent significance level).

the average CARs for the unlisted deals are 1.36 percent with a median of 0.72 percent, both statistically significant at the 1-percent level. To give some sense of economic significance of these percentages, if an acquirer of median market capitalization of \$514 million earned the median CARs of 0.72 percent created value of about \$3.7 million. In Panel B of Exhibit 3 the deals are put into six subgroups based on method of payment (stock, cash, or mixed) and listing status (listed or unlisted). As one can see, the unlisted deals have on average positive CARs, most of them statistically significant, irrespective of the method of payment. In particular, when stock is paid for the unlisted targets, the average CARs are 9.63 percent with a median of 10.56 percent. By contrast, the CARs in listed deals when stock is paid are negative on average. We also look at the role of relative size in affecting CARs, with results presented in Panel C. It is clear that when making acquisitions of unlisted targets higher relative size means higher value creation.

To take all these factors into consideration, we examine the relationship between CARs and the target listing status in multiple regressions. Results are presented in Exhibit

4, with a total of four ordinary least squared (OLS) regressions. The first three models are based on the whole sample of 452 transactions while model (4) is based on the 418 unlisted deals only. The dependent variable is the acquirers' announcement period CARs. For each model we report the regression coefficient, the corresponding t-statistics, and the statistical significance for each of the independent variables included. The coefficients represent the direction and magnitude of the marginal effect of a unit of change in the independent variable. We note statistical significance at 10 percent (*), 5 percent (**), and 1 percent (***). For example, in model (1) the coefficient on "Unlisted" is 3.354 percent with a t-stat of 2.54, which carries a 5-percent significance level (two stars). It means that CARs are 3.354 percent higher in unlisted deals (than in listed deals) after controlling for the other independent variables listed in the exhibit. (There is a 5-percent probability that the true marginal effect is actually equal to zero but we erroneously conclude that it is significantly different from zero.)

Across the first three models, it is clear that making acquisitions of unlisted assets in the lodging industry creates

more value than does acquiring listed targets. This conclusion holds even after controlling for the deal type that creates the greatest value: namely, acquiring unlisted assets with at least some stock payment, which in itself has a strong significant positive coefficient. In model (4) we focus on the subsample of unlisted deals and document the following results: (1) paying some stock for the acquisition creates even more value; (2) the greater the relative size of the deal, the higher the value created; and (3) bidding competition for the target lowers abnormal returns. On the other hand, it does not matter whether the asset in a particular transaction is a privately held standalone or a subsidiary. Whether the deal occurs during a hot-market period (merger wave) or a cool period also does not matter. In addition, after controlling for paying at least some stock, paying all stock only has a marginally insignificant, albeit positive, effect on creating value.

Implications for Executives and Owners

Our analysis speaks to two essential questions: (1) Between listed and unlisted lodging assets, which assets to acquire? and (2) Among the unlisted deals, how to create even more value? To the first question our answer is clear: unlisted assets fetch greater value. To the second, our analysis suggests that paying some stock (but not necessarily an all-stock deal), choosing relatively larger assets, and avoiding bid competition can further enhance value creation in acquisitions of unlisted assets.

To the extent that stock market reactions represent the overall value creation in making acquisitions, the analysis presented here has direct implications to lodging companies that make acquisitions. First, whenever available, the acquirers should choose unlisted lodging assets to take advantage of the liquidity discount. This implication is especially timely, as our results appear to hold in both hot and not-so-hot market conditions. Second, when making acquisitions of unlisted assets, acquirers should use some stock payment, choose relatively larger assets, and avoid bid competition.

Our analysis is based on publicly traded acquirers because only these firms have stock price and return data. For privately held hotel companies that wish to make an acquisition, the questions remain open regarding whether and to what extent our analysis extends without directional alteration. Given that privately held lodging companies operate (and manage acquisitions) in a similar way as do their publicly traded counterparts, there is no doubt that at least some of the value-creation outcomes apply to privately held lodging acquirers as well. For example, conditional on making acquisitions of unlisted assets, privately held lodging acquirers can also apply the rules of choosing relatively larger assets, avoiding competition, and awarding partial ownership, whether as privately held shares or other equity stakes. ■

It is clear that making acquisitions of unlisted assets in the lodging industry creates more value than does acquiring listed targets.

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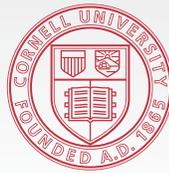
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