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Private Equity Investment in Public Hotel Companies: Recent Past, Long-term Future

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by John B. Corgel

Cornell University
School of Hotel Administration

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EXECUTIVE SUMMARY

The first decade of the 21st century saw a rush of transactions in which publicly held hotel firms were purchased by private interests. Among the notable private equity deals were Blackstone's purchase of Prime Hotels and its purchase of Hilton. An analysis of these and other transactions shows that, compared with publicly traded firms, private equity has an advantage in ownership of real estate holding firms, including hotel companies. Private firms' advantage over public companies has a strong financial basis. Among other advantages, private equity firms have more consistent access to capital than do public firms, and the overall cost of that capital is typically lower for private firms. Moreover, the values of publicly held assets tend to be understated. Private firms can exploit the discounts of net asset values. At the same time, private firms are able to make greater use of debt financing. Some leveraged buyouts have resulted in debt levels approaching 80 percent of value. Publicly held real estate investment trusts (REITs), by contrast, are criticized by analysts if their debt-to-equity ratio exceeds 50 percent. Other factors contributing to the privatization of publicly held hotel companies are the change in the regulatory environment for public companies, notably with the Sarbanes-Oxley legislation, and the fact that private owners have a freer hand to make operational changes in their new acquisitions, the better to realize full value. Finally, one additional advantage for private equity operators is their ability to repackage and resell the assets that they acquire. Returning to the example of Blackstone's purchase of Prime Hospitality, Blackstone quickly sold off the AmeriSuites chain to Hyatt, which allowed that privately held company to jump start its new Hyatt Place brand.

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Privatization of publicly traded companies arguably represents one of the most important trends in North American business during this decade. The sweep of private equity (PE) through the hotel and other industries was dramatic, until the 2007 credit crisis slammed on the brakes. Because these transactions are leveraged buyouts (LBOs), the reduced availability of debt capital stemming from recent problems in the credit markets appears to be responsible for the disappearance of PE deals. Notwithstanding those matters, conditions unrelated to debt financing sparked the PE surge during the early 2000s. As detailed in this report, these conditions are property market liquidity, real estate investment trust (REIT) shares trading at deep discounts to net asset values (NAVs), high regulatory costs for public companies, public company incentive problems, and factors specific to real estate ownership companies that make them poorly suited for public trading. The same conditions could motivate another wave of public-to-private transactions when debt for large-scale transactions again becomes available. A principal source of this funding is found in pension accounts. Despite problems in the credit markets and the U.S. economic slowdown, money continues to flow into the pension accounts from a record number of workers. Fund managers must invest this capital somewhere! Forecasting how much will flow to finance PE-led LBOs during the coming years, particularly hotel company LBOs, requires consideration of a variety of underlying economic, financial, and regulatory conditions.

Exhibit 1

Selected public-to-private hospitality-firm transactions, 2004 to present

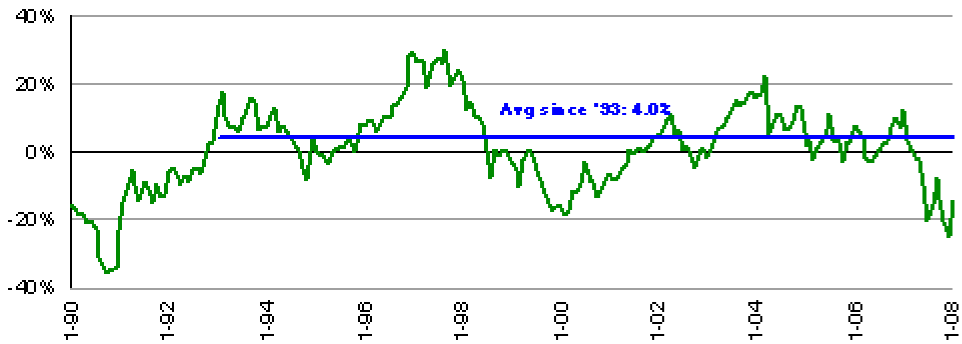
Date	Public Company Target	Private Company Acquirer	Price
2004	Extended Stay America	Blackstone	$2.0B
2004	Prime Hospitality	Blackstone	$790M
2004	Boca Resorts	Blackstone	$1.1B
2005	Wyndham International	Blackstone	$3.2B
2005	Raffles Colony*	Capital	$1.0B
2005	La Quinta Corporation	Blackstone	$3.4B
2006	Fairmont Hotels & Resorts	Kingdom and Colony Capital	$3.9B
2006	Meristar Hospitality Corporation	Blackstone	$2.6B
2006	Kerzner International	Investor Group	$3.8B
2006	Boykin	Westmont and Caisse de depot	$416M
2006	Jameson	JER Partners	$371M
2006	Intrawest Corporation	Fortress	$2.8B
2006	Four Seasons Hotels	Kingdom and Cascade and Triple Holdings	$3.4B
2007	CNL Hotels & Resorts*	Morgan Stanley Real Estate	$6.6B
2007	Inkeepers USA Trust	Apollo	$1.5B
2007	Highland Hospitality Corporation	JER Partners	$2.0B
2007	Eagle	Apollo	$237M
2007	Crescent Real Estate Equities	Morgan Stanley Real Estate	$6.5B
2007	Harrah's	Apollo and Texas Pacific	$17.1B
2007	Hilton Hotels	Blackstone	$26B

*Notes: Prices may not reflect assumption of debt. This table presents reported transations involving publicly companies mostly in the U.S. that were sold to private equity investors during this three year period. Raffles Colony was a public company not based in the United States. Technically, CNL Hotels & Resorts was not a public company, but as an unlisted REIT, CNL followed all SEC reporting requirements and attempted an IPO in 2005. Sources: Bear Stearns, PKF Hospitality Research.

A summary of important public-to-private hotel transactions from 2004 through 2007 appears in Exhibit 1. A few observations emerge from a cursory examination of the list. First, hotel company privatization transactions mostly involved firms with substantial real estate holdings. Operating firms drew less attention. The Hilton transaction in mid-2007 appears to be a notable exception at first glance, since Hilton's main business is as a hotel operator, but Hilton still held its "family jewels," in the form of large property holdings in New York, including the $1 billion Waldorf-Astoria site and the New York Hilton block in midtown Manhattan. Those parcels were key collateral components in financing the deal. Second, PE firm Blackstone, which purchased Hilton, stands out as the dominant private buyer. By 2006 other PE firms began to acquire public hotel companies. Private equity company Apollo and unlisted REIT Inland

Exhibit 2

REIT share-price premiums to Green Street NAV estimates, January 1990–January 2008



Source: Green Street (reprinted with permission).

American initiated two purchases each of public hotel companies in 2007. Finally, mostly small-cap companies were targets of PE acquirers.

This report analyzes the recent wave of PE-led hotel company privatizations, with regard to the following three issues. First, why did so many of these transactions occur during the past few years? Second, what are the short- and long-term consequences to the hotel industry in terms of structure, operations, and investment return? Finally, are hotel company privatizations likely to continue when economic and financial conditions stabilize? To answer these questions I evaluate several explanations for public-to-private firm transactions. In the course of this discussion, I highlight what appears to be fundamental flaws in the public corporation with regard to hotel chain ownership, which suggests a long-term trend toward privatization. I also point to legislative changes in the regulatory environment which imply that a return to prior regulatory regimes would cause a reversal in the trend. Finally, I examine the specific economic and financial conditions that existed during the early 2000s.

Market-Based Reasons for Privatization

Private-market liquidity. Defined as length of time to sell an asset, the advantages relating to private-market liquidity have shifted over time. Public corporations held an advantage over private ownership of hotel firms in the area of availability and cost of capital when private financing for hotels dried up in the 1990s (following the real-estate crash of the late 1980s). One reason for the creation of many hotel REITs in the middle and early 1990s, for example, was the difficulty raising capital in the private market after that crash. The withdrawal of private financing coincided with the entry of institutional investors (typically, pension funds operating through professional managers) that began demanding greater liquidity for their property portfolios because they needed to offset the restrictions on redemptions caused by having real estate commingled in their funds' investments. The pension funds expanded their liquidity while retaining their exposure to real estate by purchasing shares of operating companies with significant real estate ownership and REIT shares.

The cycle reversed with the recession and catastrophic events of 2001. With equity markets falling, the confluence of strong real estate fundamentals and historic capital flows into pension accounts created unprecedented liquidity in the private real estate market.[1] The ensuing cascade of equity capital significantly reduced public firms' access to capital, which usually is an important financial advantage of operating as a publicly traded company. Abundant equity capital combined with low-cost debt to ignite the single-asset and property-portfolio transaction market. Not coincidentally, hotel brokerage firms reported record numbers and dollar volumes of hotel property and portfolio transactions between 2003 and 2007.[2] The liquidity of the private property market cannot match that of public share trading, but the many private market transactions eroded investors' concerns about private market illiquidity during the early 2000s.

[1] Oil prices increases during the past few years also contributed to foreign capital flows available for real estate investment.

[2] See, for example: Jones Lang LaSalle Hotels, *Hotel Investment Outlook 2008*.

Many observers believe that the public market does not grant full value to real estate.

Relative Pricing

When Equity Office (EOP) was taken private in 2007, founder and major shareholder Sam Zell claimed (not surprisingly) that the public market was not granting "full value" to EOP real estate. His comment highlights the inequities between private and public real estate market pricing. Comparisons of the two sectors usually begin by studying net asset value (NAV) premiums and discounts.[3] For privatization to be driven by relatively favorable asset pricing from the private market, an observable share price discount to NAV must exist. In this situation, properties would have higher values in the private market than in public company portfolios. That phenomenon gives rise to Zell's contention that the public market does not grant full value to real estate.

Testing this contention would require specific company data and a formal empirical analysis of REIT NAVs preceding any public-to-private REIT transactions. Although I cannot directly test this hypothesis involving privatization of a specific real estate company, I note anecdotally that just prior to the announcement of apartment REIT Archstone's privatization, it was reported that the company was trading at a 13-percent discount to NAV.[4] A commonly held belief is that hotel REITs traded at discounts to NAV throughout much of the early 2000s.

In his January 29, 2007, Hotel Law Blog, Jim Butler quotes Green Street Advisors analyst John Arabia as attributing the hotel privatization phenomenon to the NAV pricing advantage. Exhibit 2 presents data from Green Street Advisors (reprinted with permission) on aggregate levels of REIT NAVs over time. These data indicate that a discount to NAV for REITs did, indeed, prevail during most of the recent period of intensive privatization. That said, the NAV discount was more pronounced in other periods that did not see rampant privatization. To this point, Linneman argues that the recent surge in privatizations is related to the remarkable expansion of private equity firms to a scale from which they can more efficiently exploit pricing and leverage opportunities, as I discuss below.[5] I also note that the NAV discounts became much deeper in late 2007 and early 2008, as the price increases of all real estate accelerated. (The implications of the public market repricing are discussed in the final section of this report.)

Financial economic theory holds that transactions such as private equity-led LBOs are the product of two decisions that are made independently. One of the decisions, that of whether to invest involves pricing, while the other, financing decision involves raising capital. With regard to the investment decision, the relative pricing argument appears to have considerable validity in explaining hotel company privatization. Many REITs traded at discounts to NAVs. At the same time, private equity firms had the scale and resources to **(1)** use arbitrage to address pricing disparities and **(2)** creatively use leverage in financing decisions.

Cost of Debt and Leverage

One of the most potent market-based arguments put forward to explain recent privatizations centers around leverage levels and cost of debt.[6] In the low interest rate environment of the past several years, the large spread that developed between equity costs (e.g., 12 percent) and debt cost (e.g., 6 percent) created opportunities for increased financial leverage for hotels and other real estate owners. The advantage for PE firms comes from their ability to take on more debt than was possible for the public real estate ownership firms they acquired. Typically, PE firms in LBO transactions make their purchase mostly with equity, but add substantial debt in short order, often bringing the debt-to-total value ratio up to

[3] The NAV per share equals the equity market value of all assets owned by the public company, usually determined by capitalizing the aggregate NOIs of the properties by one or more private market rates, divided by the number of shares. This number is compared with the price of the public company shares to obtain premiums and discounts.

[4] Dennis K. Berman, Alex Frangos, and Jennifer S. Forsyth. "Big Apartment REIT Nears Sale," *Wall Street Journal*, May 29, 2007.

[5] Peter Linneman, "The Privatization of Real Estate," *Wharton Real Estate Review*, Vol. 10, Fall 2006, pp. 5-26.

[6] The same forces that led to enhanced private market liquidity discussed in this report underlie the heightened availability of debt capital for public-to-private company transactions.

The availability of debt for private equity–led leveraged buyouts was abundant until recently.

80 percent or more.[7] The added leverage increases investors' internal rates of return to 20 percent or more. If the spread between equity and debt costs were smaller, this "leverage effect" on investor returns would not be so large. Not only has debt been relatively cheap (and still is), the availability of debt for PE-led LBOs was abundant until recently.

Hotel REITs and those in other sectors benefited from the low cost and general availability of debt, but even so they rarely see debt-to-total-value ratios above 50 percent. Let's examine why REITs are unable to take on as much debt as PE firms. One explanation is that publicly traded firms of any type rarely finance businesses with 80 percent debt, as the private equity firms are willing to do. To say the least, underwriters and investors shy away from heavily leveraged public firms. Second, along the same line, respected REIT advisors, such as Block, recommend that investors follow risk-averse guidelines regarding debt when selecting REITs for investment. For example, in 2002 Block advised:

- Anything over a 50-percent debt-to-total-market-cap ratio makes some REIT investors uncomfortable, particularly in the more volatile sectors, such as hotels, where cash flows are not protected by leases;
- A ratio under 40 percent is almost always conservative and indicates a REIT with a good track record and sound investment strategies that is likely to have access to reasonably priced capital; and
- If competition is heating up or there is a danger of overbuilding, even a 45- to 50-percent ratio might be risky.[8]

The other prominent explanation for conservative REITs' leverage involves their tax-exempt status. The opportunity for a tax deduction provides an incentive for firms to use as much debt as is reasonable for their situation. The trade-off between high debt levels and low debt involves greater risk of default and loss of equity at high debt levels as compared with moderate debt. To offer competitive returns, REITs use some debt, but without the ability to benefit from the tax deductibility of interest, REITs have no incentive to allow high ratios of debt-to-total-value.

Setting aside the broader issues of whether debt creates value and the existence of irresponsible loan underwriting, the fact that private equity firms possess an advantage over many public companies supports the argument that widely available, relatively low-cost debt substantially contributed to REIT privatization. The box accompanying this section presents a numerical example showing how PE firms are able to create value through the aggressive use of leverage.

Regulatory Costs and Privatization

The costs of operating as a public company cannot be overlooked as an explanation for the recent privatization trend. Indirect costs include agency associated with analyst oversight and the "tyranny of quarterly earnings." The incentive implications of relationships between public company management and the capital markets are discussed in the next section of this report. Indirect costs notwithstanding, the direct costs of reporting under the regulatory regime created by the Sarbanes-Oxley legislation impose heavy burdens on public companies, especially smaller ones.

Beginning with a survey by Block, a number of professional and academic articles contain evidence regarding the effect of the Sarbanes-Oxley law on public-to-private transaction volume.[9] Using survey responses from 236 public firms that became private companies from 2001 through 2003, Block finds the number-one reason for conversion was the cost of being public as opposed to being private. The second most often mentioned reason was the pressures and time constraints for top management. A recent study by Engel, Hayes, and Wang empirically links the passage of Sarbanes-Oxley to firms' decisions to leave the public market and supports the hypothesis that smaller firms are

[7] For a discussion of private equity funds' use of leverage, see: "Q&A: Could '08 See a Reversal of Public-to-Private Trend?," *Commercial Property News*, May 14, 2007 (online).

8 Ralph L. Block, *Investing in REITs* (Princeton, NJ: Bloomberg Press, 2002, p.217)"

[9] Stanley B. Block, "The Latest Movement to Going Private: An Empirical Study," *Journal of Applied Corporate Finance*, Spring/Summer, 2004, pp. 36-44.

An Example of How Private Equity Firms Add Value through Acquisitions and Leverage

Assume a hotel REIT has $75 million in FFO (funds from operation – similar to earnings) and its stock is trading at $20 per share. The REIT has the following cost of capital components:

R_e (equity cost of capital) = .12

R_d (debt cost) = .06

D/V (ratio of debt-to-value) = .50

E/V (ratio of equity-to-value) = .50

The weighted average cost of capital (R_t) is

R_t = .12 (.50) + .06 (.50)

= .09 or 9%

The estimated value (V) of the REIT based on FFO and R_t becomes

V_t = $75 million / .09

= $833,333,333

The REIT has 17,500,000 shares outstanding. Thus the equity value (V_e) is

V_e = $20 x 17,500,000

= $350,000,000

Coincidently, $350,000,000 is the NAV – total equity value of all the hotels owned by the REIT. Thus, the hotel REIT currently trades at a discount to NAV.

The value of the outstanding debt also equals $350,000,000 making the market value $700,000,000.

An opportunistic PE firm recognizes that they can buy the hotel REIT worth an estimated $833,333,333 as a private company for a total cost including debt assumption and a 28 percent price premium for the stock ($25.60 per share) of approximately $800,000,000 (value as a public company). The firm completes the transaction. Immediately thereafter, the PE firm introduces additional borrowing that brings the debt-to-total value ratio up to 80 percent. The PE firm has the same R_e and R_d as the hotel REIT, therefore, their R_t is

R_t = .12 (.20) + .06 (.80)

= .072 or 7.2%

The value (V_t) of the REIT based on FFO and the PE firm R_t becomes

V_t = $75 million / .072

= $1,041,666,667

Given the PE firm's ability to quickly act on the market undervaluation of the hotel REIT, the PE firm added $33,333,333 ($833,333,333 - $800,000,000) in value for their investors. Given that the PE firm can add leverage to the investment, they added another $208,333,334 ($1,041,666,667 - $833,333,333) in value. These value enhancements elevate investor IRRs by several percentage points as long as the hotel properties continue to produce cash flow of $75 million or more.*–J.B.C.*

more inclined to convert because of their relatively larger regulatory cost burden.[10]

Management-Based Reasons for Privatization

In a seminal article published in the *Harvard Business Review* nearly twenty years ago, Michael Jensen presents the case against the continuation of the public company and highlights PE as a new and powerful model of general management.[11] Jensen's arguments, recently updated in a keynote address, follow three basic lines of thinking.[12] First, PE firms are established with a period of temporary funding (typically five years) that generates a "natural horizon and toting up point for the board." Second, managers of public companies have established a tradition in strategic planning and execution to be measured on results they can control, such as sales and new product introductions. Managers have avoided being measured by how firms are valued in the market. Jensen argues that strategic value accountability is the "missing concept in governance."

[10] Ellen Engel, Rachel M. Hayes, and Xue Wang, "The Sarbanes-Oxley Act and Firms' Going Private Decisions," *Journal of Accounting and Economics*, Vol. 44, September 2007, pp. 146-165.

[11] Michael C. Jensen, "The Eclipse of the Public Corporation," *Harvard Business Review,* Vol. 67, No. 5 (September-October 1989), pp. 61-74.

[12] Michael C. Jensen, "The Economic Case for Private Equity," Slides from Keynote Address given at the Harvard Business School Centennial Conference on Private Equity, New York, February 13, 2007.

In reference to analysts and quarterly earnings, Jensen argues that PE firms can avoid "out-of-integrity gaming with the capital markets." Such common activities as smoothing earnings, managing expectations, and meeting Wall Street's forecasts dominate the relationship between management of public companies and capital providers (shareholders), with the detrimental consequence of destroying value.

Finally, some argue that public ownership does not naturally fit real estate ownership. Blumberg claims that the focus on quarterly expectations fails to match the long-term opportunities of real estate, and that the public markets naturally wanted REITs to be valued like operating companies with a dominant emphasis on income growth coupled with too little consideration of the break-up value of the assets.13 Linneman contends that many major shareholders of REITs who initially took portfolios of properties public did so reluctantly, in defiance of their own entrepreneurial spirits and appetites for debt.[14] Blumberg further argues that due to the management distractions of running public companies, opportunities were missed—as he put it, "the blocking and tackling of real estate." These disconnects between the public company management model and ownership and real estate in general apply to an even greater degree for hotels, given the management intensity of hotel real estate.

The Hotel Company Case

Let's turn now to the issue of why were hotel companies became one of the principal targets for private equity leveraged buyouts. Certainly the relative growth of corporate income and property values certainly was a contributing factor. Not bound by long-term leases, hotel revenues and income freely grew in synchronization with the post-2001 recovery. Capitalization rate compression also contributed to positive hotel property value movements, although that was also true for other property types. Unlike other investment opportunities, however, hotels offered PE acquirers the special attraction of particularly favorable, risk-adjusted dividend returns. With limited supply growth across the usual horizon of a five-year holding period beginning in the early and middle 2000s, PE firms also felt confident about their ability to liquidate their hotel positions. Adding to the favorable supply dynamics and pushing prices upward was a wave of condominium conversions that absorbed transient rooms, as typified by the New York Plaza. Portfolios of acquired hotel companies often included hotels in hot conversion markets, which provided PE acquirers the early opportunity to realize option value through resale or conversion.

Finally, from anecdotal evidence, it appears that PE firms found ways to aggressively seek out operating inefficiencies in the hotels they acquired. Just as Conrad Hilton in an earlier era devised ways to make money from hotel lobbies and other unused and non-revenue-producing spaces, so did PE firms find underperforming areas of their newly acquired hotels.[15] Jokingly, observers of PE post-acquisition actions claim that the initial phase of managing their new businesses includes "counting rolls of toilet paper." Kidding aside, in a *Financial Times* article, former Savoy chef Anton Edelmann discusses how Blackstone increased revenues by adding rooms to Savoy Hotel properties (i.e., in some instances by eliminating living areas provided for the hotels' chamber maids) and by adding charges for room service.[16] In a mature hotel industry that has not experienced sizeable labor productivity gains, it is not difficult to comprehend that highly motivated and incentive-driven PE managers would identify lucrative inefficiencies in hotels that were overlooked by public ownership and contract management.

PE acquirers worked on managing both operations and assets. If PE managers focused on finding the operational "nickel," they also executed transactions involving combinations of previously and newly acquired assets. A classic example of profitable portfolio management is the series of transactions executed by Blackstone following the 2004 acquisition of publicly traded Prime Hospitality. As a public company, Prime operated two brands; AmeriSuites and Wellseley Inns. Blackstone recognized, likely from information obtained through its hotel brokerage channels, that Hyatt intended to launch a mid-price limited service brand to be known as Hyatt Place (that is, without F&B), but did not want to enter the market entirely with newly built properties. The well located AmeriSuites properties offered a perfect solution for Hyatt (and for Blackstone). Blackstone recouped much of its acquisition cost for Prime through the sale of AmeriSuites to Hyatt, which then successfully launched Hyatt Place by converting AmeriSuites. Simultaneously, Blackstone converted some Wellesley Inns to extended stay hotels, a market in which Blackstone already owned a sizeable share.[17] Completing the circle, the converted Wellseley Inn properties became part of a sale of Blackstone's extended stay portfolio to Lightstone in 2006. The box accompanying this section presents an estimate of Blackstone's

[13] "Philip F. Blumberg of American Ventures on Why REITs Are Feeling the Heat," PRWeb, May 31, 2007.

[14] Linneman, op. cit.

[15] Early in his career, Hilton sold sleeping space in unused function rooms and later tucked restaurants and stores into odd spaces of the Plaza, Palmer House, and Waldorf-Astoria. See: Daniel R. Lee, "How They Started: The Growth of Four Hotel Giants," *Cornell Hotel and Restaurant Administration Quarterly*, Vol. 26, No. 1 (May 1985), pp. 22-26.

[16] Roger Blitz, "Savoy's Ex-Head Chef Sampled Flavours of Private Equity," *Financial Times*, July 12, 2007.

[17] Some Wellseley Inns became La Quinta properties and others remain Wellseley Inns.

How Much Did Blackstone Realize on the Extended Stay and Prime Transactions? A Rough Estimate

In 2004 Blackstone purchased Extended Stay America and its 475 properties for $2 billion. Earlier, Blackstone acquired Homestead Village for $740 million and its distribution channel, all of which were rolled into Extended Stay. Also in 2004, Blackstone acquired Prime Hospitality and its AmeriSuite and Wellesley Inn properties (112 owned properties) for $790 million. A total of 37 Welesley Inns were converted to Extended Stay. Within months, the AmeriSuites were sold to Hyatt for approximately $600 million. Finally in 2007, 683 extended stay properties were sold by Blackstone to Lightstone for $8 billion.

Blackstone's cash flows from the above transactions:

Outflows

$2 billion + $740 million + $790 million + $? for additional properties (individual and small portfolios, total unknown) + $? for upgrades and refurbishments = $3.53 billion +? +?

Inflows

$600 million + $8 billion = $8.6 billion

Even if Blackstone spent another $2 billion on additional property purchases, upgrades, and refurbishments, their gross profit approaches $3 billion (ignoring gains and losses on debt financing). With a standard PE 20 percent carried interest, investors received $2.4 billion and Blackstone received $600 million.—*J.B.C.*

return on the Extended Stay and Prime Hospitality transactions.

Viewed in this light, Blackstone and other PE firms may be viewed as useful agents of change in the hotel business. They bring both a heightened level of operational oversight and provide restructuring services otherwise unavailable to the industry.

The Consequences of Private Hotel Ownership

I will leave it to future historians to determine the effect on the hotel industry of the wave of private ownership. Here, however, I can examine whether it really matters whether hotels are owned by public or private companies. After all, a hotel's location does not change with the name listed in the records at the county courthouse. The franchise relationships typically cannot be disturbed without considerable pain to the new owner, and many important drivers of hotel income and value go undisturbed by PE acquisitions.

Beyond those issues is the realization that despite what seems like a tsunami of acquisitions, ownership changes resulting from public-to-private transactions have involved only a small percentage of the hotels properties in the U.S. Most were already in private hands. While working at PKF Hospitality Research in the early 2000s, for instance, I helped perform an analysis of U.S. hotel ownership and found that more than 80 percent of hotels in the nation at that time were privately owned. Prudential economists estimated in 2001 that only 17 percent (6.7 percent REITs, 10.3 percent operating companies) of the U.S. hotels were publicly held.18 In 1997, public ownership represented about the same percentage (17.9 percent). Thus, if all of the hotels currently in public ownership tomorrow were deeded to private owners, the broader hotel management and ownership landscape would not dramatically change.

Although I have outlined many advantages for the private acquirers of hotels, public ownership of hotel real estate creates certain positive externalities for the industry that unfortunately are lost through privatization. For one thing, pure-play hotel real estate companies provide daily mark-to-market observations of consensus asset pricing not available when assets are held in private hands. With fewer publicly traded REITs providing asset pricing information, the decisions of capital suppliers to the hotel industry become more difficult. In calculating the net benefit to the industry of hotel real estate privatization, one cannot ignore the fact that "private is private!"

Conditions for Future Hotel Privatizations

I cite several factors in this report underlying the recent cascade of LBO transactions sponsored by PE firms that resulted in publicly traded hotel firms becoming private companies. I summarize these factors below in no specific order, along with comments regarding whether each factor is likely to motivate future PE-led hotel industry LBOs.

Liquidity. Prolonged periods of instability in the credit markets and slow economic growth substantially lengthen the time it takes to sell and refinance hotel real estate. Ultimately, increasing time on the market diminishes property values. Thus, reduced liquidity lowers the probability of future PE-led public-to-private firm transactions because of greater uncertainty about the values of exiting positions over a five-year horizon. Collett, Lizieri, and Ward find that holding periods for real estate more than double during soft markets.[19] The PE firm business model for investing in hotel real

[18] See: Robert Hess and Youguo Liang, "A Sector View of Public Market Ownership of Commercial Real Estate in the United States," *Journal of Real Estate Portfolio Management*, Vol. 8, No. 3 (2002), pp. 271-284.

[19] David Collett, Colin Lizieri, and Charles Ward, "Timing and the Holding Periods of Institutional Real Estate," *Real Estate Economics*, Vol. 31, No. 2 (2003), pp. 205-222.

estate could change to a less opportunistic approach (e.g., ten-year holding period), but to date I have not yet seen examples of changes in PE investment behavior. In part this is a function of the continued massive fund flows into pension accounts that likely will not moderate until a sizeable percentage of Baby Boomers retire. Should financial market and economic conditions brighten, PE firms would have the capability (and experience) to resume allocating capital raised from pension funds to buy public hotel companies.

Debt cost and leverage. Without the availability of debt capital, PE-led takeovers likely will not happen. At the time of this report in early 2008, the condition of the hotel mortgage market is highly uncertain. The Mortgage Bankers Association survey of member lenders indicates that through quarter four of 2007 hotel loan originations remained extremely strong (i.e., up over 300 percent from the same quarter one year earlier), while mortgage originations for most other property types were down.[20] A continuation of uncertainty about future economic conditions will likely reduce hotel loan availability from the levels seen at the end of 2007. Declining Treasury rates provide a bright spot in the mortgage markets. Lower interest rates in the capital markets help to offset rising risk and liquidity premiums for rates in hotel mortgage contracts, having the net effect of keeping hotel mortgage rates low by historical standards and maintaining the interest of PE firms in hotel company investments.

Regulatory costs. The relative burden of regulatory costs associated with operating as a public company will continue to make private ownership attractive. Some evidence recently surfaced of improving compliance with Sarbanes-Oxley provisions, but no indications of reduced compliance costs are reported.[21]

Incentive problems associated with public companies. Jensen's arguments regarding the various agency and incentive problems that plague the public company form of ownership persist as important reasons to believe that the recent surge in public-to-private transactions is a long-term trend.[22] Despite public attention to some of these problems, little real progress has been made to correct them since Jensen's 1989 article.

Relative pricing of public and private real estate. Returning to Exhibit 2, it can be seen that Green Street Advisors' estimates of REIT share price discounts to NAV are as large in early 2008 as any time during the past twenty years. Unless REIT share prices rebound or property prices fall by more than 10 percent, a substantial arbitrage opportunity exists for PE firms to purchase property-heavy companies and either hold these assets or profitably liquidate them. Specifically for hotels, Dickinson of SNL Securities reports discounts to NAVs of 33.29 percent for hotel REITs and 21.13 percent for all REITs.[23]

The most important predictor of future levels public-to-private hotel transactions will be hotel property values. Liquidity, availability of debt, and arbitrage opportunity strongly depend on current and expected property values. If property values decline, either due to falling net operating incomes or rising capitalization rates, privatization activity in the hotel industry will remain at a standstill. If, however, property values remain firm as they did through the stormy period of the early 2000s, then conditions will ripen for a renewal of PE-led public hotel company LBOs.[24]

Recommendations to Owners

Private equity firms have the particular ability to quickly act on acquisitions where they see unharvested value, and pay premiums for hotel companies, portfolios of properties, and individual properties. Wealth maximizing owners who recognize that there are opportune times and prices at which to sell should be prepared to execute a transaction when PE firms resume investment activity in hotels. With that in mind, I offer the following recommendations to owners.

- Frequently mark properties to market so that property values are always known. This does not necessarily involve commissioning regular appraisals. Several sources are available for comparable transaction data (e.g., openpcomps.org) and capitalization rates (e.g., Real Estate Research Corporation);
- Move as much debt as possible either off the balance sheet, in the unencumbered category (i.e., no mortgage), or refinance mortgage debt with a friendly assumeability provision;
- Maintain capital expenditures schedules and reserves; and
- Whenever possible, minimize the financial obligation of new owners for changing management and franchise affiliation. ■

[20] *Q 4 2007 Quarterly Survey of Commercial and Multi-family Mortgage Banker Originations*, Mortgage Bankers Association, 2008.

[21] Jeremy Grant, "Big Fall in Sarbox Breeches," *Financial Times*, November 26, 2007.

[22] Jensen (1989), *op.cit*.; Jensen (2007), *loc.cit*.

[23] Moira Dickinson, "Data Dispatch: Majority of REITs Trading at a Discount to NAV," *SNL Securities Interactive*, January 10, 2008.

[24] P.J. Corcoran, "Firming Property Prices and Weak Cash Flows," J*ournal of Portfolio Management* (Special Real Estate Issue), September 2003, pp. 35-44; and John B. Corgel, "What We Know about Hotel Real Estate Markets," *Journal of Portfolio Management* (Special Real Estate Issue), September 2005, pp. 91-99.

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