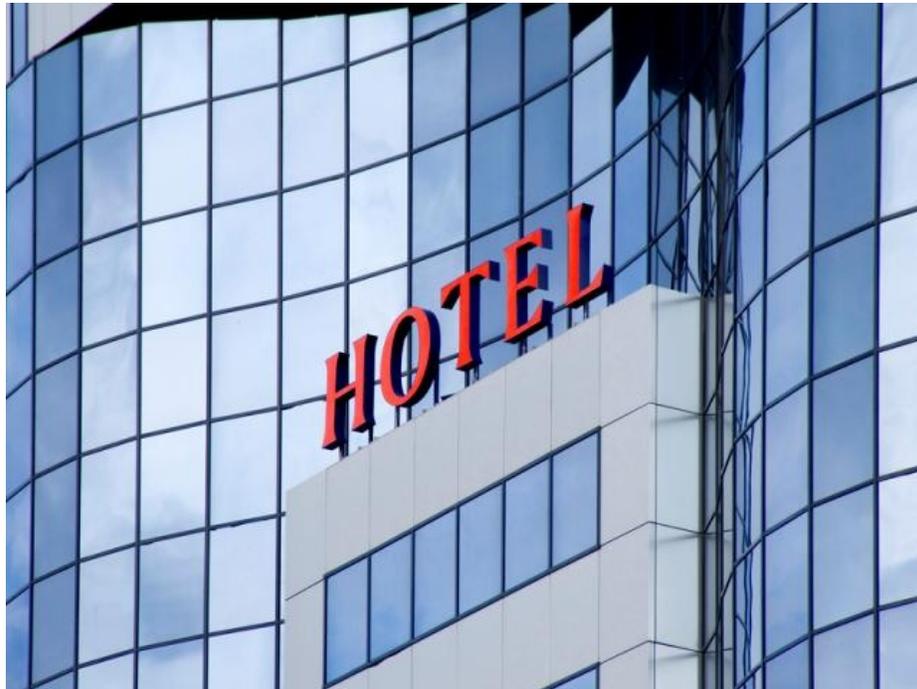




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Stressed and Distressed Hotels

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Stress...a constraining force or influence

Distress ...the state of being in great trouble; implies an external and usually temporary cause of great physical or mental strain and stress¹

An increasing proportion of HVS's consulting and valuation work concerns distressed hotels. This trend is a logical – if not inevitable – result of the recession and concurrent downturn in travel that has affected all sectors of the lodging industry. Virtually every market in the U.S. has experienced decreased demand and falling average rates, some more dramatically than others. However, some properties within a market area or sector are proving to be more vulnerable to these macro influences than others. This article reviews some of the stresses that can intensify the degree of distress affecting an individual asset.

Introduction

The recession and concurrent downturn in travel activity and spending are having a direct effect on most hotels in the U.S. Demand levels have decreased dramatically, causing occupancy rates to fall to levels at which it is difficult to maintain efficient operations. In response, most hotels and markets have begun to use price as a marketing tool, initiating discounts and special offers, if not actual price decreases, in an effort to stimulate demand. The reduced level of demand is affecting all aspects of a hotel's operations, including food and beverage, with the result that revenues are down in all operating departments at most properties. And although managers and management companies are working diligently to control or reduce costs, lower revenue levels are causing net income levels to drop, in some cases dramatically.

Although most hotels in the U.S. are operating in these circumstances, the degree to which individual properties are affected can vary widely. These variances can be attributed to property-specific characteristics, including capital structure, management expertise, franchise, and the condition of the hotel. Properties that are well positioned with respect to these components will still be stressed by the downturn, but should be able to survive. Those hotels that are constrained by one or more of these factors are far more likely to end up distressed, and may well be the subject of a foreclosure or disposition sale.

¹ Merriam-Webster On Line; www.merriam-webster.com

Capital Structure

Obviously, the single greatest influence on a hotel's vulnerability to the weak market conditions is the asset's capital structure, and the principal issue is the debt that encumbers the property. The amount of the debt along with the cost of that debt determines the amount of net income necessary to pay the debt service. Properties that were not financed based on the peak values of the 2006/2007 time frame have a much lower debt service hurdle than those that were financed at high leverage rates during the height of the market. The existence of mezzanine financing on top of first mortgage debt can exacerbate the situation. Similarly, hotels with floating rate debt are in a much better position than those encumbered with fixed rate debt, as the drop in interest rates that has accompanied the downturn has lowered monthly debt service costs.

Management Concerns

While managing a hotel is never an easy task, high occupancies, rising average rates and the resultant strong revenue levels can mask a multitude of sins. When the tide turns, management shortcomings quickly become evident, and may affect both revenue levels and the bottom line. Inept management can increase a hotel's vulnerability to distressed market conditions.

On the revenue side of the equation, there are a number of areas where inept management can compound a hotel's vulnerability to weak market conditions. These are outlined below.

Marketing: Marketing encompasses a number of topics, not the least of which is ensuring that a hotel is participating in all appropriate marketing channels and programs. HVS recently evaluated a limited-service hotel that had been depending solely on the brand's reservation system, and was not even listed on alternate GDS channels or with any of the third-party Internet channels, such as Expedia or Hotels.com. Given the strength of the brand in question, this positioning was not a problem during the boom period. But with demand down dramatically throughout this market, this property was left with few resources with which to navigate the downturn.

Yield Management: Yield management is widely viewed as a tool that enables a property to maximize revenues in a rising market. While this is true, the fundamentals of yield management are even more important in a falling market, when every guest and every dollar of average rate matter. Balancing the need for sufficient occupancy to support efficient operations with the corresponding need to achieve rates that cover the costs of that occupancy is a challenging but critical task. Managers that do not consistently implement yield management strategies can expose their property to even greater impact from a downturn.

Market Knowledge: Hotel managers today have a wide array of tools at their disposal to monitor market conditions in their region and among their competitive set. It is not sufficient to simply review the data provided in the Smith Travel Research and other daily and weekly reports; this information must be interpreted in the context of the local economy and lodging market. An understanding of the trends reflected in this market data is an essential corollary to yield management. Failure to utilize these tools can undermine a property's performance and thus place increased pressure on a hotel's bottom line.

On the expense side, the necessity of implementing cost controls is obvious. Management's inability to execute these tasks can put further pressure on the bottom line and compound the distress affecting the asset. Critical tasks include the following:

Review every category of expenditure. Such a review should include the necessity of each expenditure; the specific costs incurred; whether the vendor is the best source in terms of the quality of the goods or services; the cost structure; and payment requirements.

Review employees and monitor staffing levels. A review of the employees must be undertaken to determine that each employee is in the correct job. Redistributing tasks and responsibility can result in a higher level of productivity both for individual employees and the property as a whole. The staff positions and staffing levels must be continually monitored to make sure they are responsive to, and appropriate for, the number of guests and the needs of those guests on any given day. Failure to execute this degree of vigilance can put added pressure on a property's bottom line.

Management shortcomings with respect to the above tasks are most often found at properties managed by owner/operators, or management companies with limited depth and experience. However, it behooves any owner or lender to review the management practices and procedures in place at their hotels to minimize the property's vulnerability to broader market conditions.

Franchise Concerns

While the merits of any one franchise affiliation can be debated, the importance of having the right affiliation is never more evident than when lodging industry fundamentals are weak. Such an affiliation not only links a hotel to the brand's marketing programs and distribution channels, it can also provide resources and support to the management and marketing team at the property level. Properties that do not have a solid relationship with an appropriate brand are proving to be more vulnerable in the current downturn. This vulnerability is evident in day-

to-day operations, and can also have a significant impact on the value and marketability of the asset.

Concerns related to a hotel's franchise affiliation fall into two principal categories: 1) maintaining an existing franchise affiliation that works for the property, and 2) replacing an underperforming affiliation with a more effective alternative.

Maintaining an existing franchise affiliation

Any property affiliated with a brand is required to comply with the hotel company's standards for that brand. These standards encompass both operations and the condition of the property. In terms of condition, the brand standards may mandate upgrades to the property or FF&E that can be expensive. Examples of this include requirements with respect to bedding packages, or the installation of flat-panel TVs. Operational standards can encompass a wide array of requirements, including 24-hour room service, cooked-to-order complimentary breakfast, and the availability of concierges or bellmen. Compliance with these standards can constrain management's ability to control costs. Failure to do so can result in the loss of the affiliation, a circumstance that would almost certainly increase the property's vulnerability in this – or any – downturn.

For some properties, the issue is one of bad timing. These are the hotels whose affiliations will expire at some point in the near term. Many properties may be eligible for a new license agreement with the same brand; however, the new license will almost certainly be accompanied by a PIP (property improvement plan) detailing the renovations and upgrades required to comply with the brand's current standards. Anecdotal evidence suggests that, in recognition of the prevailing weak market conditions, the branded hotel companies are working with owners to curtail the amount of expenditures required in the near term. Nevertheless, some immediate capital expenditures are required; moreover, the items that are deferred will ultimately need to be completed.

Those properties that are not eligible for a new license with the same brand must seek out an alternate affiliation. This situation adds the further stress of identifying appropriate affiliations, securing a license agreement, and undertaking any required PIP renovations and expenditures. While some of the required renovations may be deferred, changes to the property's signage and collateral materials must be done immediately, and can be costly. Moreover, management has the added burden of managing and marketing the property through the transition.

The alternative is to operate independent of a brand affiliation. While this alternative is appropriate for some properties, most hotels that move from affiliated to independent status experience decreases in revenues that are often significant, and can more than offset the elimination of the expenses required under the license agreement.

Obtaining a more appropriate franchise affiliation

Some properties are finding that the current brand is not sufficiently supportive in these depressed market conditions. This can occur for a number of reasons, including marketing programs that are not compatible with the property's current circumstances, ineffective or insufficient marketing support, or an overabundance of similarly branded properties. In these instances the best course of action is often to find an alternate affiliation. However, this strategy is encumbered by the PIP and management and marketing issues noted above, which can make the execution of the strategy difficult in the near term, although it may well be beneficial over the longer term.

The impact of these franchise-related issues on the operations of the hotel is obvious. Less obvious, but equally compelling, is the impact that these issues have on the value and marketability of these assets. Prospective investors may be unwilling to consider an asset for which a new license agreement with the existing brand is not readily available. Even in these circumstances, the risks associated with obtaining the new license can be a downward influence on price. Those assets that are faced with a significant PIP and/or change in affiliation may warrant an even greater price discount.

Condition Concerns

The condition of a hotel can have a significant influence on its ability to ride out the current, weak market conditions. Condition issues can be divided into two broad categories: cosmetic and structural. Cosmetic issues encompass the furniture, fixtures and finishes, and principally concern the guestrooms and public areas of the property. As discussed above, many of these are monitored by the brand. In addition to jeopardizing the franchise relationship, a property that appears dated or worn may be at a significant competitive disadvantage when compared to newer or more well-maintained competitors in the market.

Of greater concern are condition issues related to the structure itself. These can include anything from a leaking roof to fire and life-safety systems that are substandard. While some issues may be more clear cut than others, any such problems must be dealt with promptly, or risk a potentially significant erosion in the value of the asset, which could far exceed the cost of curing the existing problem. A leaking roof or inadequately sealed exterior walls can permit water intrusion that could

result in mold within the building or other damages. Substandard fire and life-safety systems not only risk guest safety; they can also result in higher insurance costs, fines levied by the governing municipality and may subject the property to closure if the code violations are severe.

Problems related to the condition of a property can make the hotel significantly more vulnerable in a downturn. Prospective guests are more likely to choose hotels in better condition, and may well avoid those properties that are perceived as dirty or unsafe. And prospective purchasers will require a greater discount to the price in recognition of the risks associated with undertaking a renovation of the property.

Fixed Expenses

Fixed expenses incurred by a hotel typically include property taxes and insurance and may also include lease or rental payments. A hotel that is burdened with a high level of fixed expenses is likely to be more vulnerable in a downturn, as these expenses can consume a significant proportion of a property's house profit, leaving insufficient funds to cover debt service. The structure of these fixed costs also influences a hotel's vulnerability. A ground lease with a flat or minimum rental payment (i.e., not tied to the level of revenue at the property) is an example of a fixed expense that can materially impact a hotel's net income in a down market.

High fixed costs may cause management and/or ownership to implement strategies designed to alleviate the present pressures, but which may be adverse to the best interest of the property over the long term. Such strategies could include failure to invest in necessary capital expenditures, reductions in operating costs that adversely affect the guest experience, and elimination of expenditures that affect the image and profile of the property in the market. While these solutions may be effective in the short term, the long-term impact is almost always erosion in the market position and the value of the asset.

Conclusion

The current downturn is so deep and so widespread that virtually every hotel in the U.S. has been – and will continue to be – affected. However, not all hotels will be affected equally. Key issues that influence a property's vulnerability to the macro conditions include capital structure, management expertise, franchise affiliation, property condition and the property's fixed cost structure. Those properties that are well positioned with respect to these issues are the most likely to succeed in weathering the current storm and emerge from the downturn intact, and potentially stronger. Conversely, properties that are not well positioned with respect to these elements are likely to be among the first "officially" distressed properties. Depending on the nature of the stresses affecting a property, these assets may also be attractive investment opportunities for buyers with the expertise and willingness to tackle the various issues affecting the hotel.

About the Author



Anne R. Lloyd-Jones, CRE is Senior Vice President of the New York office of HVS, the premier global hospitality consulting firm. Since 1980, HVS has provided various consulting services for over 20,000 hotels worldwide. HVS operates out of over 25 offices in twelve countries. Since joining HVS in 1982, Anne has provided consulting and appraisal services to over 5,000 hotels. She is responsible for the sale, supervision, and administration of over 200 appraisal and consulting assignments annually. Anne's particular areas of expertise include market studies, feasibility analyses, and appraisals. She is also an expert in the field of the valuation of management companies, franchise companies, and brands; and the negotiation and valuation of management contracts. Her experience includes a wide range of property types, including spas and conference centers. She has appeared as an expert witness on numerous occasions, providing testimony and litigation support on matters involving bankruptcy proceedings, civil litigation, and arbitration.

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