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"Tears to cheers" prospects of recapitalizing through joint venture

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The second half of 2010 marked the long awaited early stages of a period when the hotel investment community commenced a transition from "tears" to "cheers" with significant increasing opportunities. Industry fundamentals indicate that the downturn is safely behind us, and it is evident that the hotel investment community is firing on all cylinders once again. Transaction volume is anticipated to approach $15 billion in 2011. Hotel real estate investment sales recently consisted of both core full service hotels in CBD locations as well as distressed midscale or limited service assets in secondary or tertiary markets. The prospects for joint venture scenarios were largely ignored through 2010. It is our belief that significant opportunity lies within recapitalizing existing assets through joint venture repositioning in product improvement, branding, and up-branding.

Transactions have largely been dictated by the outright purchase of hotel real estate. Hotel transactions on one end of the spectrum represented premium pricing in major markets such as New York, Washington DC, Boston, and San Francisco. REITs, Institutional Capital Investors, and Private Equity Funds for select transactions paid up and strategically invested in the top five performing MSAs projecting a quick uptick in performance indices. On the other end of the spectrum, midscale products in secondary or tertiary markets continued to trade in the form of REO, distressed, and discounted pay off sales. Billions of dollars in hotel real estate debt remains in limbo and distressed sales are anticipated to continue at higher rate through 2011 and 2012. There was limited transaction activity in the form of joint venture scenarios, and there is back log of hotel renovation projects. Furthermore, new owners have the burden of making a lot of property improvements. As the industry enjoys a long awaited recovery in performance, it would behoove the investment community to explore alternative recapitalization scenarios. Owners have lost a significant portion of their demand over the past two years as consumers have traded up for superior hotel products as average rates have yet to increase albeit moderately; it is now necessary to provide an improved quality as we head into this next real estate cycle.

Brand governance over the past two years could be perceived as lenient. Representatives from the largest hotel corporations including Marriott, Hilton, Choice, Hyatt, IHG, and Starwood allowed for extended timelines implementing critical brand elements. As cash flow declined at an unprecedented level, debt service obligations were at the forefront of concerns. Property Improvement Plans "PIPs" comprised of new bedding packages, flat screen televisions, wireless service, new lobby layouts, or restaurant and function space improvements were pushed to the bottom of the list of survival items. The reality is that for the past two years maturity on debt obligations for hotels has not allowed owners to spend on costly property improvements. For example, Courtyard by Marriott's new lobby design has included some modifications such as replacing the traditional front desk with separate welcome pedestals, and a signature 57 inch LCD flat screen touch board. These lobby improvements in some cases required an average a capital infusion exceeding $1 million. Discussions with brand representative from each hotel corporation revealed that over 50% of franchised hotels properties had not experienced the implementation of critical brand elements. It is also necessary to note that debt availability for PIPs was all but non-existent for the past two years.

Property Improvement Plans will provide significant opportunity to recapitalize an existing asset in a joint venture scenario. The end of 2010 saw an emergence of hotel renovations and brand representatives are putting more pressure on owners to retain their flags. As the industry continues to recover a number of owners are also seeing opportunity to brand independent hotels or to switch flags. Significant capital is required for these PIPs to create a product quality that exceeds that of the competition. It may benefit owners to solicit the necessary capital sources to fund PIP requirements, and in return the new investor acquires an ownership interest in the hotel. This alternative recapitalization scenario is relevant for existing owners looking to retain a level of ownership interest in their hotels, rather than an outright acquisition of the hotel. Investor expectations must coincide with the existing owner's capital structure. A joint venture may allow the existing owners to associate themselves with better brands and generate the necessary equity to execute these projects.

Matthew LaBarre is the managing director at O'Connell Hospitality Group. LaBarre, hospitality investment veteran and Dartmouth College graduate, brings to O'Connell Hospitality Group extensive experience, primarily in hotel/real estate finance and operations. He has operational experience working for Marriott International and Ocean Hospitality as well as analytical and transactional experience after completing four years with Pinnacle Realty.

His experience includes efforts to raise equity for several hotel acquisitions exceeding $100 million and has acted in an advisory role to clients' disposition projects with single asset values that exceed $50 million. LaBarre spearheads the effort to work closely with private equity groups and institutional investors assisting with acquisitions and disposition of both hard assets and debt.