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Public Entities & New Hotels - A Fine Balance

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In today's real estate development and capital market environments, developing new hotels may be the toughest and most complicated projects to complete. Debt and equity markets are often very restrictive in terms of access and cost. Depending on the scale of a proposed hotel development project, deal economics (development costs versus cash flow potential) often inhibit the investor's ability to achieve an adequate return on capital. Unlike other real estate assets, hotels are unique in their intensive management requirements, daily lease turnover, high operating and financial leverage, time to stabilization, and capital markets liquidity. Additionally, operator agreements, development contracts, franchise agreements, and land leases can cause the capital structures of these projects to become quite complex endeavors. Newly built (or expanded) convention centers and airports typically require additional hotel rooms, in order to house the forecasted increase in localized human traffic. Due to logistical purposes, the proximity of available hotel rooms to these publicly-owned facilities is imperative. As such, ideal convention center headquarters hotels are usually built adjacent to their convention halls, and airport hotels are built either in-terminal or only a shuttle's distance away. Therefore, when planning the development or expansion of convention centers and airports, sponsoring cities and counties are faced not only with their public facilities' issues, but also with various questions and concerns regarding new hotel supply. Most public entities have traditionally solicited private interest for new hotel developments utilizing an RFP/RFQ process. Although this process has, at times, been managed internally, because of the difficulties in actually transacting a deal, public entities have begun seeking out third-party consultants in greater frequency to assist them with their new hotel projects. This is generally due to the frustration in understanding all of the construction, financial, and operational aspects inherent in new hotel projects, leading public entities to draw on the broad expertise of seasoned hospitality professionals. Prior to a new convention center or airport hotel breaking ground, several hurdles typically must be cleared. First, the public entity must have confidence in, and an understanding of the economic, political, and legal soundness of the project. If, for example, a project's economics add up, however, the risk of serious adverse effects to the local hotel industry is significant (potentially due to the introduction of a publicly-funded hotel, below market rents, etc.), a public-private hotel development project may not move forward. Likewise, if it is determined that the local hotel community will benefit from a convention center hotel (indirectly due to an increase in overall tourism in a city or county), but financing alternatives to develop the hotel are too expensive to yield a profitable project, the end result might likely be the same. This leads to several key issues regarding financial sponsorship that a public entity should consider when planning a hotel development project. These include the amount, form, duration, and financial return (to the municipality) of the public support, but most importantly, a public entity needs to evaluate the necessity for such consideration. In order to resolve these issues, a public entity will first engage an advisor (usually external) to perform a feasibility analysis. This study will recommend the optimal size for a given project, identify competitors in the market, and present a financial proforma for the new-build hotel from which financial modeling can then begin. Such forecasts of income of expense help to determine the economic strength of the project, and are critical in establishing the appropriate method of financing for the project. Once the economic aspects and expectations of the development project are understood, various capital and ownership structures should be analyzed. Typically, third-party consultants, investment bankers, etc., will be hired to generate financial models that should cover the broad spectrum of available options to a public entity. This should include an all-encompassing presentation of financing alternatives (public, private, and public-private) accompanied by quantifiable analyses outlining the advantages and disadvantages of each. Because a large portion of the financial return from a hotel is derived from tax revenues, project tax analyses illustrating the net benefit to the city, county, and state should be built into these models. Proposed methods of capitalization must also take into

Summary

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account the appropriate sharing of risks and returns, given their capital and ownership structures. This is to ensure that all options presented to the public entity are "real world," and can be transacted if required. Should the requirements of one piece of the financial puzzle not be satisfied, the entire project may be jeopardized. As such, it is crucial that the financial modeling process be performed meticulously, while adhering specifically to the public entity's economic, political, and legal capabilities. While the studies and analyses discussed above deal mainly with the objective facets of a hotel development project, a municipality's resolution after evaluating its options may be heavily imparted with subjectivity, due to the environment in which such an entity operates. This may suggest one reason why these transactions may extend beyond the average timeframe for regular hotel development deals. Once the project economics have been thoroughly analyzed and approval is given by a public entity to move forward, the next stages include the selection of, and negotiation with a qualified developer and hotel manager. Depending upon its involvement in the project, a public entity may participate closely in these processes or rely on its financial advisor to act in its best interest. This heavy or light involvement in a hotel development project on behalf of a municipality will continue through the stabilization period of a completed project, again, based upon the public entity's elected involvement. Often at this point, specialized asset management benefits the municipal entity. Such asset management not only oversees the physical structure (ensuring that the hotel is maintained and operated at desired levels), but also closely monitors the deal's financial agreements. Public entities usually have a long-term, financial exposed position or benefit from a new hotel project. Frequently, some aspect of public debt is utilized to provide financing for a project. Alternatively, public entities may be entitled to lease income, etc. Due to this, careful monitoring and compliance with the financial aspects of these transactions, by the asset manager, is a necessity. We have explored several of the critical moving parts involved with public-private hotel development projects. By nature, these transactions tend to stretch over extended periods of time and require consulting based upon various fields of expertise. As public entities continue to seek out the required assistance from qualified experts in order to produce the most cost-efficient and financially viable hotels for their cities and counties, competition for such engagements is only strengthened in this niche business market.

About Michael T Sullivan

Michael T. Sullivan is Managing Director of HVS Capital Corp., joining HVS in June 2001. Previously, he served as Managing Director of Sonnenblick-Goldman, which he joined in 1974. During his career, he has been responsible for the financing and sale of more than 650 hospitality properties (hotels, resorts, golf courses, and shared ownership) and for completing, on average, roughly $1.0 billion per year in debt and equity transactions in hotels/resorts nationwide. In his current position, he oversees a staff of hospitality banking professionals, all of whom are involved in the origination and placement of debt and equity realty assignments, with a primary focus on the Lodging and Leisure Industry. Mr. Sullivan attended the University of Arizona, where he received a degree in accounting and marketing. He is a Certified Instructor for the National Apartment Association and a frequent speaker for the Colorado Apartment Association, BOMA, and other trade real estate groups.