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Slice-and-dice lodging deals in NYC — good business or bad omen?

By [Joseph Williams](#)

Lodging, like many commercial real estate sectors, feels safe for once. The recovery is closing in on the five-year mark. The drivers are well understood, and many prognosticators are calling for an elongated upcycle.

With this prevailing sense of security, investors are moving up the risk curve, and the strategies they are using seem all too familiar to some observers.

For instance, derivatives are becoming fashionable again. In October's Urban Land Institute Emerging Trends report, survey respondents said the rise of the CMBS market will be the most notable change in the capital markets. In a recent note, Ryan Meliker pointed to another recent ULI report suggesting that CMBS volumes will climb 17% in 2014. The CMBS market is still far from its peak, but cutting up loans and selling them in risk-bundled securities is again on the rise.

The same kind of slice-and-dice strategies are beginning to spread beyond securities and into the commercial property market itself.

"We're starting to see this bifurcation between land and building, and the kind of value creation that's happened as hotels have split off the fee from the building. For us, New York real estate values were already going up and going up, and higher and better uses were leading to higher land values, but there was another order of magnitude when we started seeing the slice-and-dice trade," Baird Equity Research analyst David Loeb told SNL.

Basically, the deal structure breaks off the building from the land and transacts them separately. In the simplest form, the owner of a piece of real estate that includes land and building, or a fee simple owner, may decide to sell the building but hold on to the land. In that case, they would sell a leasehold interest in the building, giving the buyer rights to use the property as if it were their own, and the buyer would pay the original owner, the seller, rent to sit on the land, usually under a very long lease, often 99 years.

This is the simplest form of such a "slice-and-dice" transaction. They can also include several contract terms that provide what the leasehold position can and cannot do with the land and certain lease payment qualifications that spread the risk out more evenly. Also, the fee simple owner may divide the building up into separate condo leases, like a retail and a hotel condo, and sell the leasehold in those parts to two separate buyers. Point being, these deals can get very complicated very quickly.

And, like all good urban real estate trends, it has taken hold in New York City first and foremost.

For example, [FelCor Lodging Trust Inc.](#) and [DiamondRock Hospitality Co.](#) each got a piece of a transaction involving the historic Knickerbocker Hotel in Times Square in early 2012. The owners, a private equity investment group, [sold](#) a 95% interest in the Knickerbocker and the land to FelCor, but the investment group held on to the retail portion of the property, which they recently sold independent of the hotel. Also, they cut off an adjacent hotel development, the Hilton Garden Inn Times Square, and [sold](#) it to DiamondRock, which effectively sliced the land under the Knickerbocker complex up.

That was one of the first of these kind of deals in a succession that Loeb said has developed into an all-out trend.

"No one was talking about this two or three years ago because they wanted middle-of-the-fairway type deals, and those are harder to come by today," Michael Bellisario, another Baird analyst, told SNL.

Another iconic slice-and-dice transaction was the sale of the Milford Plaza, also in Manhattan. The sellers in that deal split the property into three portions for the sale: the land, the retail and the hotel. As Loeb explained in an August 2013 note on the deal, the owners bought the hotel in 2010 for about \$250 million, put about \$154 million into renovations, then sold the ground at a 5.0% cap rate for about \$325 million, a portion of the hotel in a deal that valued it at about \$330 million and the retail portion for about \$65 million. The owners, another private equity partnership, ended up with 65% interest in the hotel, collections on the outstanding ground leases and an extra roughly \$316 million on their \$404 million investment, not to mention other equity stakes in various bits of the property they retained through the process.

"We're seeing, in contrast to Aristotle, the sum of the parts is worth more than the whole," Loeb said.

Indeed, for sellers, a motivating factor for these kind of highly structured deals is the extra returns and real estate value that can be gained from the extra footwork.

"There's an arbitrage play then," Bellisario said.

He explained a hypothetical situation where the market implied cap rate on a building with the land is at 6%, which really only values the cash flow and not the real estate value (a common occurrence in the public markets). The land, however, may be worth a 4% cap rate if split from the building

and leased. For simplicity's sake, say the value of the land and the building are the same, so the blended cap rate is 5%.

"So if we're valuing at 6%, but really the private market sum of the parts is a 5-cap, that's a really good game that you can play by spinning it out and potentially adding a little leverage to the remaining piece too," Bellisario said.

The seller can potentially make a significant windfall, as illustrated by the Milford deal, but they have to do a considerable amount of gymnastics to get there. As Daniel Lesser, president and CEO of LW Hospitality Advisors, put it, "Nothing for nothing in life, because the guy who has to put that thing together, it's a lot easier to sell a fee position than it is to go through the brain damage of doing that bifurcation and then selling all those pieces."

For the buyers, the motivations are more varied and possibly more compulsory.

The most obvious benefit of buying just a leasehold interest in a building is that an investor can get into a hotel property, get exposed to a hotel's operating profit for less up-front cost than buying the land and the building — the fee simple interest. However, the money the investor saves there is made up for in rent and risk.

Investors are only now willing to take on that risk, and as the hotel upcycle generates more and more demand for assets in supply-constrained New York City, it is becoming more of a requirement than a choice. As hotel returns become more and more attractive, and properties for sale in New York become fewer and fewer, buyers are willing to take on more risk to get in on the action.

"Development sites are extremely expensive and hard to find in New York," Jonathan Miller, president and CEO of real estate advisory group Miller Cicero, told SNL. "You're willing to acquire a site that has some hair on it, so to speak, and one of those would be lease land or ground lease."

Essentially, competition for New York City commercial real estate investment has gotten stiff enough that these kind of alternative transactions are becoming more commonplace. And some are saying this new willingness to take on risk is the same kind of thinking that was pervasive before the last economic crisis.

More than one of SNL's sources talked about these transactions in language evocative last decade's securities and derivatives boom.

"There's an incredible amount of liquidity in the world chasing yield," Lesser said. "By doing that slice-and-dice trade, if you think about it, you're cutting up the different tranches of risk and you can appeal to a wide variety of investors that are chasing deal opportunities in New York."

In fact, Miller explained that he saw a similar trend in New York residential real estate leading up to the last financial crisis.

"One of the signs that I saw that the market was topping out was the lack of development sites to the point where you were seeing buyers willing to develop on the site and the seller wouldn't sell the land but just lease it out, so you had high-end product being delivered subject to a ground lease," Miller said.

He explained that as supply tightened and risk aversion abated, more and more investors were taking on leverage, including ground-lease commitments. When the market went south, residential demand plummeted and housing prices tumbled about 30% in New York City, leaving many investors holding vacant apartments or sitting on unfinished development sites subject to ground leases. If a lease signed five years ago has a 3%-per-year ramp in rent, a common provision, that is a significantly impairing obligation.

Miller was quick to point out that this trend was but a snowflake in the avalanche of the last financial crisis and is not likely an omen of disaster, but it is nevertheless something to keep an eye on.

As Loeb pointed out, these kinds of deals allow companies to hide leverage where investors are not necessarily looking for it. For public REITs, he said he and his analyst colleagues do not adjust their valuations based on ground-lease risk because they are typically an insignificant fraction of the company's total obligations and are not likely to impair what are generally clean balance sheets. But in aggregate, across the commercial real estate world, they could come to represent more leverage than is healthy for the system.

As Loeb put it, "It's hidden leverage, and hidden leverage has a way of coming back to haunt people."

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