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WHAT'S THE DEAL BY DANIEL LESSER
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Lax underwriting standards

(The views and opinions expressed in this blog are strictly those of the author.)

We recently performed an appraisal for financing of an institutional-grade hotel asset that at the time of our work was under contract for purchase by a sophisticated real estate investment manager. The property, which is encumbered by a long-term brand management contract, had been widely marketed by a well-known hotel intermediary.

Our due diligence indicated the market value of the property to be roughly 15% below the contracted sale price. Much to our surprise, reconciliation of the difference in value revealed lax underwriting standards on the part of the broker and the buyer.

The economics of the existing management encumbrance are outlined as follows:

- A base fee of 3% of gross hotel revenues
- A tier 1 incentive fee equal to 20% of the amount by which operating profit exceeds owner's priority, defined as 9% of the owner's initial investment currently equal to US$58 million calculated as the sum of (i) purchase price, not to exceed US$50 million, (ii) transaction costs incurred by the owner and (iii) amount funded directly by the owner to complete renovation
- A tier 2 incentive fee equal to 50% of the remaining balance of operating profit after fixed charges, base and all incentive management fees and an allocation of 5% of gross hotel revenues for reserves for replacement

Based on information provided, over the past six years no property cash flow was available to pay the tier 2 incentive fee, and an assumption was made that this manifestation would continue. Furthermore, the sale broker presumed and the buyer agreed that the operator would amend calculation of the owner's priority by utilizing the current sale contract price of roughly US$85 million, or US$35 million more than the amount stipulated in the agreement. This major assumption, which is nothing more than a leap of faith, resulted in the broker and the buyer projecting no future tier 2 incentive fee payable to the management company. If the hypothesis of renegotiating the operator agreement proves false, the projected cash flow results in net income available to pay the tier 2 incentive fee, resulting in a market value of the property of roughly US$73 million, or US$12 million less than the contract price.

Caveat emptor; the current sellers' market is steering investors to pay up for quality hotels. While underlying

fundamentals of the sector support robust pricing, significant extraordinary assumptions to justify even higher prices are fraught with danger.

6/30/2015

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Yikes!

This case is both informative and scary!

TUESDAY, JUNE 30, 2015 | JOHN ONEILL

REPLY

Agreed John; VERY scary

TUESDAY, JUNE 30, 2015 | DANIEL LESSER

REPLY

Lax Underwriting

Dan's conclusion is dead on. Why would either the broker or the buyer assume that the management company would automatically put itself further behind the 8-ball, when, it would argue, its performance in the hotel enabled the pricing that resulted. Never assume.

TUESDAY, JUNE 30, 2015 | MICHAEL SHINDLER

REPLY

Many thanks Michael for your thoughtful contribution

TUESDAY, JUNE 30, 2015 | DANIEL LESSER

REPLY