

# THE HOTEL OWNERS' JOURNAL



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## From the Director

### The knives come out



**Simon Allison**  
HOFTEL Executive Director

Downturns concentrate the mind wonderfully. Suddenly, that piecemeal growth in head office costs – whether your own or those of an operator is charging back to you – is thrown into stark relief by falling revenues. That new brand-enhancing initiative that you have been asked to fund seems rather less value for money than it did.

And that wonderful new concept that the brand manager wants you to build down the road seems perhaps a bit too much like all the others.

With everyone looking to defend their own interests, squabbles are almost inevitable. Indeed, in our own HOFTEL meetings over the last year, the emphasis has clearly moved from comparing potential deals to discussing the shortcomings of banks and (some) operators.

Against this background, we are also witnessing a couple of real corkers of legal disputes, one between Four Seasons and one of its more established property partners, Broadreach Capital; and the other is between those two branding megaliths, Hilton and Starwood. As Andrew Sangster outlines in an article herein the issues in the Broadreach case are primarily about the fiduciary duties, implied or actual, that an operator has to the underlying real estate investors and who is to blame when the property is struggling under its debt burden. In this case – between two usually highly civilized companies – the dispute has got pretty ugly, with the owners apparently physically attempting to retake possession of the asset and the operator barricading them out. Hard to avoid the suspicion that the lawyers are going to be the real winners on this one!

The second dispute concerns the furious row that has broken out between Starwood and Hilton over the launch of Hilton's new lifestyle brand, "Denizen". Basically, with several executives having gone from Starwood to Hilton in recent months, it seems that

rather a lot of files walked with them and Starwood are asserting that the Denizen concept was basically lifted from their own expertise. In a world of "me too" trendy brands, it's not surprising that concepts can be considered to overlap, but it's rare, to say the least, to have the big boys slugging it out.

What are the messages for HOFTEL members to take away from this spate of suits?

Firstly, that operators are at the end of the day running their own businesses. That means that (i) they can't be held responsible for the failures of owners to maintain a sensible capital structure that weathers the downturns and that (ii) they will defend concepts like esoteric "brand standards" which may have a dramatic and detrimental impact on their ability to cut costs. Clearly, owners have to consider the trade-offs very carefully when picking a brand, especially at the luxury end of the market where both standards and costs are less flexible and where a brand which can be a great asset in good times may prove less so when cost-cutting is a priority.

Secondly, that the battle for the "lifestyle" brands is going to be fierce as the dominant branded players continue their fightback against the likes of Kimpton, Malmaison and Amanresorts – but owners may legitimately question what benefit they will get from that. It undoubtedly distracts the major chains from focusing on their existing branded stock; it creates new competing product and it allows operators to circumvent radius restrictions for owners while still offering combined loyalty and corporate programmes to the general public.

Undoubtedly, HOFTEL members will be seeking to keep their operators and franchisors focused on the main business and a chat among "friends" in this forum can be a useful way of comparing notes on who's performing and who isn't. As HOFTEL continues to grow, we believe such chats will be more and more beneficial in the coming year.

# Norgani has change at the top

## Norgani Hotels has shuffled its top team following the departure of Roar Ingdal to Choice Hotels Scandinavia.

Existing commercial director Anders Vatne has been appointed interim CEO. Vatne joined Norgani in December last year. He was previously with Horwath Consulting for four years. Prior to that he has held positions with travel and hospitality companies including Inter Nor Hotels, Choice Hotels, and Rainbow / Thon Hotels.

The other senior members of the management team at Norgani include Eva Salvesen, CFO, who joined in January 2008, and Magne Ramlo, chief technical officer.

Meanwhile, Ingdal joined Choice on May 1 as senior vice president commercial operations. He said the position at Choice offered "unique opportunities".

Ingdal had joined Norgani in April last year from the post of CEO of Royal Caribbean Cruise Line in the Nordic and Baltic regions. From 2005 to 2007 he was CEO of Norlandia Hotels.

# Host raises cash

## Host Hotels, the world's biggest hotel real estate investment trust, has raised \$500m through a share issue to pay down debt.

The move was announced at the same time as its first quarter results. Despite a 16.2% drop in revenue in these figures, Host's share price jumped to a seven-month high following the news that it was raising cash.

The first quarter figures showed revpar down 19.8% and the company reported a net loss of \$60m against the \$63m net income reported in the first quarter 2008.

A couple of weeks later, Host also raised \$400m in a private placement.

REITs in the US had raised \$10.6bn in the four months to the start of May, according to Bloomberg. This was almost as much as was raised in all of 2008. The main purpose was to cut debt and leave room to acquire competitors' assets.

# Venice venue for annual conference

## This year's HOFTEL conference is to take place in Venice on October 21st, the day before the formal start of the International Hotel Conference.

HOFTEL member Host is offering a special rate for members at its property in the Italian city. Further details have been sent directly to members and sponsors but if your email is lost contact Simon Allison directly.

Members should also start thinking about nominations for this year's OFI – the Owner-Friendly Innovation of the Year Award.

The OFI is for the operator or franchiser which has done the most to improve the life of owners over the previous 12 months. It is likely this year that the winner will be

a business that has been especially responsive to the downturn by trimming costs, cutting back on recharges, finding new sources of revenue and similar initiatives. But in the end, it is down to members to make the decision. Please nominate as soon as possible.

OFI helps HOFTEL by:

- 1) showing operators / franchisers that there is a public recognition of responsiveness to owners' needs.
- 2) Makes it clear that HOFTEL is not a blinkered "anti-operator" or "anti-brand owner" group but will rather praise the major hotel management or branding groups for a job well done.
- 3) Raises HOFTEL's profile in the hotel community.

Send nominations directly to Simon Allison at [simon.allison@hofotel.com](mailto:simon.allison@hofotel.com). You can find out more about the International Hotel Conference at [www.internationalhotelconference.com](http://www.internationalhotelconference.com).

# Foremost and CapMan sign-up

Two new members have joined HOFTEL, owner-operator Foremost Hotels and Nordic investor CapMan.

Foremost Group specialises in the development and management of bespoke and branded hotels, starting in the UK and Germany but with plans throughout Europe.

The company is currently developing a portfolio of Holiday Inn Express hotels in Germany having bought three hotels in the UK

The target is to reach 20 by 2016 under the franchise agreement struck with InterContinental Hotels Group and announced in January of this year. Already there are seven signed deals. The latest signings were both in Berlin, a 328-room property at Potsdamer Platz and a 150-room hotel in Alexanderplatz.

Berlin is already well covered thanks to the opening in April 2008 of the 158-room Holiday Inn Express Berlin City Centre West. The other open hotel is a 150-room Express at Munich airport.

According to chairman Usama Dessoky, who formed the group in 2002 on behalf of his Jersey-based family trust, the focused-service hotel business is the best investment in a downturn as they are the most resilient.

London-based Dessoky runs hotel projects and other investment businesses throughout Europe and East Asia. He said funding for his developments is now more expensive but it is still possible to obtain.

A particular success has been found with converting office buildings into hotels. Dessoky explains that these buildings are typically quicker to complete than starting from scratch on a green field site.



**Foremost's Berlin City Centre West hotel**



**CapMan's Holiday Inn at Oulu operated by Restel**

A good example is the Express in Hamburg city centre. The build started on this former office in August last year, financed by open-ended fund DEFO. The 180-room hotel is scheduled to open early next year.

Meanwhile, CapMan is similarly focused on growth having paid about €800m for a 39-strong portfolio from Northern European Properties, the business spun-off from HOFTEL member London & Regional Properties in 2006.

CapMan is one of the leading alternative asset managers in the Nordic countries and Russia. For the hotel portfolio acquisition it created a €835m fund, CapMan Hotels RE, with the capacity to grow to €1.1bn.

The largest tenant of the 39 hotels is Restel, Finland's biggest hotel and restaurant company with more than 320 establishments. Restel leases 25 properties under brands such as Crowne Plaza, Cumulus, Holiday Inn, Ramada and Rantasipi.

The other main tenants are Sokotel, with nine hotels, and Scandic, with three hotels. At the time of the deal, CapMan also signed a letter of intent to develop four spa projects with Holiday Club Resorts Oy.

# Debating debt

## The lack of debt finance dominated discussion at HOFTEL's seminar at the Berlin investment conference, reports Andrew Sangster

Debt was the inevitable focus for the private meeting of HOFTEL members and sponsors at the International Hotel Investment Forum held in Berlin.

The debate started by examining how much the slide in share prices of hotel companies would be followed by a slide in asset values.

Russell Kett from HVS International said that the stock market had already largely priced in the recession as far as hotel companies were concerned. "But it will be adversely affected if there is a spectacular bankruptcy," he warned.

Public markets were very different to the asset markets that HOFTEL members were primarily in, he added. However, asset values were down and those markets not yet showing a decline in asset values would do so in the rest of this year.

It was nevertheless possible for some individual assets not to show decline. The general, aggregate picture would be of decline continuing in 2009 and into 2010, he forecast.

Although base rates have fallen, the effective real interest rates paid by borrowers were unchanged

Although base rates had fallen, the effective real interest rates paid by borrowers were unchanged. Amortisation was now higher and spreads had widened, negating any impact of base rate declines.

Local banks were still a possible source of small scale finance but with banks that have a more international profile, things were still jittery, said Kett.

A key task for owners was to challenge the budgets currently being put forward by operators, said Kett. "Unless challenged, operators only produce what owners want to hear. Delivering bad news is not in their psyche."

Owners had a key role to play in budget setting and disaster planning, said Kett. Operators were poor asset managers, he warned. Tough decisions like shutting floors to obtain a more economic business model might be necessary.

A key problem was management agreements which were not written by people with an understanding of asset management.

Daniel Poser from London & Regional Properties remarked that the share prices of some hotel companies were "eye catching" [he was speaking at the low point, prior to the recent run-up]. "I wonder what Blackstone would be showing without the Hilton debt," he asked.

The stock market valuations for hotel companies was showing just what the equity piece of financing is worth and reflected the current state of financing fundamentals.

Poser pointed to Orient Express where even with all the takeover uncertainty it was still valued [in early March] at just \$1 per share.

Simon Allison, HOFTEL's director, said that it "must be a profitable time to lend". Deals prior to the crash had seen debt financiers lend after five years of growth and they have now suffered, added Allison.

Alex Schoenich, head of hotel lending at KfW, said his bank's decision to enter the hotel market was driven by a wish to diversify rather than to take advantage of the timing of the cycle.

The debt structure for Foremost's Express in Hamburg was discussed. This €10m advance was struck at a loan to value of 72% and 130 basis points above base with a five year bullet repayment.

Schoenich said that while deals like this were possible it was a problem when you looked for a loan above €20m.

The discussion concluded with Kett pointing out that in the long term the hotel business has proved resilient. "Business will come back," he said.

\*The HOFTEL seminar, Risks and opportunities for hotel real estate investors in 2009, took place on Tuesday March 10.

# Leases or management agreements?

Until as recently as ten years ago, most branded hotels operated under full repairing and insuring leases, for terms of between 15 and 25 years, and otherwise with similar obligations to those contained in an office lease. The lessee/operator normally paid a full rack rent, and was responsible for all repairs and maintenance. In return, the operator received all of the profits.

Variations were introduced in “hybrid” leases, where the operator paid a base rent, coupled with a turnover rent or a rent linked to EBITDA.

In the last decade very few leases of hotels have been granted, and market practice is now to operate through a Management Agreement. These typically contain the following elements:-

- A base fee of perhaps 3% of Gross Revenues.
- An incentive fee, traditionally in the region of 10% of Gross Operating Profits.
- A term of between 30 and 50 years.
- Full responsibility on the owner for all maintenance costs, employee costs, and capital expenditure.

The distinctions can be clearly seen in the table below.

In today’s difficult environment, new operating contracts are only going to work where there is a greater alignment of risk, and this has meant that owners,

and some operators, are again considering returning to the hybrid lease format. This would involve:

- A basic rent designed to achieve some return for the owner e.g. 7%.
- A turnover or EBITDA rent, but with a threshold set at a level so as not to make the deal too risky for the tenant. Otherwise, in a downturn, there would be a risk that the operator would make nothing.
- Management Agreement type protection including restrictions on an owner selling to a competitor, and obligations to maintain brand standards and to maximise EBITDA.

There is no doubt that the majority of operators still prefer Management Agreements because they have no investment risk. Where there is a lease, the interests of the owner and the operator are more aligned as the risk is shared, whereas there is a clear misalignment of interests under a Management Agreement. For example, capital expenditure is likely to improve revenue and gross operating profits, but although the operator will derive part of the benefit from these via both the base fee and the incentive fee, the owner pays for the lot!

In response to this misalignment, owners are seeking more favourable terms in Management Agreements, and are pressing for lower base fees, together with an incentive fee which is paid on a slice system against performance hurdles, and which may be subordinated either to debt coverage or owner’s return. In the immediate future this is the direction that most operating contracts will be going, but, for the reasons set out above, we do see a return to the lease format in some areas where the owner’s negotiating position is strongest.

**Maxwell Winward LLP**  
 April 2009  
[www.maxwellwinward.com](http://www.maxwellwinward.com)

Operating lease	Management agreement
All maintenance costs, capital expenditure and employee costs are the responsibility of the lessee/operator	All maintenance costs, capital expenditure and employee costs are the responsibility of the owner
All of the profits belong to the lessee/operator	All of the profits belong to the owner
The owner receives a fixed rent, or possibly a combination of a fixed rent and a turnover or EBITDA rent	The operator receives a base fee being a percentage of gross revenues, and an incentive fee being a percentage of gross operating profit
Terms range between 15 and 25 years	Terms range between 30 and 50 years

## Management contracts under pressure

### Broadreach battle foretaste of management contract fight ahead, reports Andrew Sangster

The economic crisis is putting management contracts under huge pressure. This is not surprising if we are indeed in the grip of the worst downturn since the 1930s.

Previous recessions have exposed problems and the depth the current downturn has already reached makes it highly likely we will see owners and managers fighting it out publicly in the courts.

The first battles are already taking place in the US. This is not surprising for a number of reasons. Firstly, the US was the first of the major economies to drop into recession and thus stress has been felt here the longest. Secondly, the country has pioneered the use of management contracts. And finally, the business culture is one where litigation is comparatively commonplace.

It is the US then, where we can expect to see how management contracts will be reshaped. And already we have some spectacular rows hitting the courts.

The highest profile to date involves Four Seasons, often hailed as the most successful hotel management company, and Broadreach Capital, an established and experienced owner.

The row is a result of failing to agree on this year's operating budget and has so far resulted in Broadreach suffering a humiliating rebuff in the courts.

The hotel in question, the Aviara resort in San Diego, California, has been operated by Four Seasons since 1995 when it signed a 30-year contract with three 20-year options, giving it control of the hotel until 2087.

Another legal battle in the US that hotel investors ought to keep an eye on is the suit filed by mezzanine debt investors in the \$8bn acquisition of Extended Stay Hotels.

The filing alleges that the banks and the buyer, Lightstone Group, hatched a "scheme to wipe out" mezzanine investors.

The deal was struck at the height of the boom in April 2007 with just \$600m of equity. The debt to earnings multiple was almost 13 times.

When the economy turned sour, Lightstone entered talks about restructuring its debt, which comprises \$3.3bn of mezz structured in various classes and \$4.1bn of senior debt which was securitised.

Lightstone filed for bankruptcy in June stating putting a \$3.3bn value on the chain. It is expected that the mezz holders and even some of the senior debt holders will be wiped out. Among the debt holders is the Federal Reserve thanks to its assumption of the assets of Bear Stearns.



**Uncertain outlook for the Four Seasons Aviara**

## Management contracts under pressure continued

To really classify this as a peak-of-the-market deal, it has emerged that Lightstone put in just \$200m of equity and even some of this was borrowed.

Yet another twist in the who-can-sue-who game, is the lawsuit between the developer of a 1,000 room Marriott property in San Antonio and the operator. Miller Global Properties is suing Marriott for changing the original development plans and missing key items out of the original estimates.

The JW Marriott branded hotel, which is due to open early next year, was estimated to cost \$415m to build

back in 2005. But this had risen to \$565m by last autumn. The law firm representing Miller Global is Bickel & Brewer, the same one as in the Aviara case.

Another manager currently in arbitration with its owner is Fairmont thanks to its alleged shortcomings in marketing the Turnberry Isle Resort in Aventura, Florida. A suit was filed back in April but the dispute has not reached the point of the Aviara where the owner wants to oust the manager. Rather the owner is trying to reclaim \$1.3m in what it calls unjustified fees given that the hotel has underperformed its competitive set.

### The Aviara story

At the start of April, Broadreach Capital Partners and Maritz, Wolff & Co launched a lawsuit against Four Seasons to throw it out of the Aviara resort in San Diego without arbitration.

In May, Broadreach issued a press release announcing that Dolce, the management company it owns, had been installed as the new manager. This release said that the management agreement had been terminated "amid allegations that Four Seasons breached its fiduciary duties in connection with the 329-room luxury property".

The release went on: "The case will be closely watched in the hotel and investment community, as hotel owners seek greater transparency and financial responsibility from the management companies with whom they associate."

Bill Brewer, partner at Bickel & Brewer and the lead counsel for the resort's owning-group, said in the release: "The owners terminated Four Seasons because they lost trust and confidence in its management of their resort."

The management agreement was formally terminated on March 29 but Four Seasons refused to acknowledge the termination or to relinquish control of the hotel. This led to a legal action being filed by the owner on April 1 seeking an injunction prohibiting Four Seasons from continuing to manage the hotel. The owner also started arbitration proceedings against Four Seasons, seeking "tens of millions of dollars in financial damages".

Four Seasons responded with its own press release on May 14, refuting "the false and inflammatory rhetoric being disseminated by lawyers for the owners in conjunction with their improper attempt to take control of the resort from its contractual managers".

It went on: "The owners and their counsel have been engaging in a misleading media campaign to defame Four Seasons while simultaneously attempting to circumvent the legal system and usurp the arbitration process agreed upon by both parties."

The owners rejected the proposed operating budget put forward by Four Seasons for 2009 and now Four Seasons are operating with the 2008 budget.

Four Seasons claims that the hotel is profitable at the operating level but a refinancing of the asset in 2006 has left the business unable to service its debt in the current economic downturn.

The owners "are unwilling to take the necessary steps to meet their financial obligations and Four Seasons will do everything possible to ensure that the owners live up to these obligations".

A particularly lively part of Four Seasons' response related to the owners claims that the manager threatened a breach of the peace. Four Seasons said: "In response to the owners' widely published threats to storm the hotel and forcefully take over control of operations, Four Seasons enhanced check-in procedures and security to ensure the guest experience would not be interrupted."

Four Seasons added: "On March 28 at 1 in the morning, owners' representatives, accompanied by a cadre of security, conducted a physical invasion at the resort, changing locks of private management offices and intimidating resort employees."

For the owners, Brewer said that Four Seasons had subsequently "erected barricades and checkpoints" at the hotel's entrance.

Brewer also claimed that Four Seasons "demonstrated a complete lack of concern for the people who own the property and pay the bills". Among frustrations are the refusal by Four Seasons to hand over financial records and the alleged wasting of many millions of dollars.

The wrangling led to Four Seasons seeking a temporary restraining order in San Diego Federal Court. A hearing held last week slapped down the owners and told them to follow the arbitration procedure set out in the management agreement.

The arbitration was set to take place in the middle of June as we went to press.

**\*This is an extract from a story that first appeared in Hotel Analyst**

# HOFTEL's sponsors

The sponsors are prepared to assist HOFTEL members with enquiries related to their area of expertise. Please feel free to contact them.

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