MEET THE MONEY®
National Hotel Finance & Investment Conference

MEET THE EQUITY

INVESTMENT BOOT CAMP

Hyatt Regency Hotel
May 6, 2019

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INTRODUCTION

Meet The Equity: Investment Bootcamp

Preparing & Executing the Capital Raise

Most hospitality projects need some form of private equity. Raising private equity is hard for any hospitality project, and getting the right equity investor is even harder.
This workshop will explain how investors evaluate requests for capital, what makes certain deals attractive to them, and when they do not make sense.

- Mistakes to avoid when seeking private equity capital
- How equity views hotel management operations
- What makes a project most attractive to private equity
- How to get faster decisions and execution
- How you'll know if you have the "right" equity for your project
- How to minimize last-minute deal changes

This boot camp will address best practices for raising equity for hotel acquisitions and developments, key steps that cannot be missed to secure the right equity partner, deal structuring methods, and transaction closing.

WHAT SHOULD A SPONSOR HAVE BEFORE APPROACHING EQUITY?

- Control of transaction (Contract, LOI)
- Detailed and defensible pro forma and deal model
- Market study/feasibility analysis (3rd party firm or reputable experienced manager)
- Term sheet in place for Operator/Management Agreement
- Term sheet in place for Franchise Agreement (or submitted/approved application)
- Analysis of comparable sales supporting basis and exit sales price assumptions
- Indicative terms (term sheets or detailed emails) from one or more lenders
- Analysis of competitive hotels and markets, using Smith Travel data and individual research to evaluate performance against and benchmark vs. competition
- Careful, thoughtful analysis of new supply, and the impact on performance and value
- Capital improvements budget or development budget in detail, with third party validation on cash, scope, and timing

WHAT SHOULD A SPONSOR BE PREPARED FOR?

- Capital investment required
- Provision of guarantees (Completion, PIP, Environmental, Bad-Boy)
- Major Decisions
- Diligence process and timeliness
- Partner costs and expenses
- General promote terms or incentive structure
- Achievable leverage levels and cost of debt
- Unwind provisions (Buy/Sell, Forced Marketing)

KEY CONCERNS TO ADDRESS

- **Conflicts of Interest**: Other competitive investments, allocation of time and resources to the specific investment, allocations of infrastructure costs
- **Investment Horizon:** Sponsor may want to keep investments longer, especially if generating asset management or property management fees
- **Timing of Returns and Distributions:** Investor may require that the Sponsor's promote be deferred until the Investor has received some multiple on its original investment
- **Clawbacks:** Provisions ensure that the Sponsor is not overcompensated relative to the intended business arrangement
- **Initial Funding Requirements:** Critical to determine who can create capital calls and advance period of time for funding

KEY CONCERNS TO ADDRESS

Right to Remove Sponsor: Conditions which typically give rise to removal rights include:

- "Bad boy" acts (i.e., fraud, theft)
- Violations of fundamental understandings (i.e.: sponsor non-adherence to budget limitations)
- Nonfeasance (i.e., sponsor's failure to act)
- Failure to meet a standard of investment performance
    - *Particularly troublesome for the sponsor if they guarantee the loan*

Reporting Requirements and Control: Institutional investors typically require much more elaborate and frequent reporting than traditional passive investors

- Institutional investors may also require that financial reports be independently verified by third parties via an audit

Competitive Limitations: Institutional investors may impose competitive limitations on the sponsor

- One example may be that they limit the sponsor's ability to engage in competing projects within a certain radius

EQUITY INVESTOR FOCUS LIST

Sponsorship:

- Who is the sponsor, what level of experience do they have?
- What is their track record?
- What is their track record with similar investments?

Infrastructure:

- What human resources does Sponsor have on payroll?
- Can they handle this kind of investment (size, scope)?

Alignment of Interest: Level of sponsor investment (depending on size, but usually 5-10% of Equity capital invested)

Financial Returns:

- Internal Rate of Return
- Equity Multiple
- Total Profit
- Cash on Cash return
- Net Present Value

Location:

- What markets?
- What is the positioning within those markets?

EQUITY INVESTOR FOCUS LIST

Underwriting: Level of market analysis done to create achievable projections

- Reasonable leverage assumptions
- Reasonable exit assumptions for cap rates and per key analysis

Construction/Renovation Costs: Level of detail involved in construction/renovation cost estimates

- Who the general contractor is and their experience in the local market
- Fully developed budget including:
    - Soft costs
    - Pre-opening
    - Working capital
    - OS&E

PIP Management:

- Experience with small and large PIPs, and
- Renovation process management

Lender Profile:

- References
- Repeat business
- Borrowing history

PARTNERSHIP – JOINT VENTURE OPERATING AGREEMENT

- **Managing Member/General Partner:** Responsibilities for managing the joint venture
- **Major Decisions:** Will be clearly defined and usually include financings, sales, change of use
- **Exit/Unwind:**
  - Buy/Sell
  - Put Call
  - Mechanisms to exit the joint venture
- **Contributions:** Equity contributions to the partnership based on "Capital Calls"
- **Failure to Make Contributions:** If partners fail to contribute required equity there can be punitive measures including reduction of equity percentages and removal of rights
- **Preferred Returns and Promotes:** Deal sponsor can receive disproportionately higher returns as incentive compensation after partners have received certain specified "preferred returns"
- **Waterfalls:** Specify priorities and how available cash gets distributed to partners
- **Debt Guarantees:** Repayment and other guaranties provided to lenders. For non-recourse loans only recourse is directly to the asset, for a recourse loan, all assets of the guarantor may be available

PRIVATE INVESTOR DOLLARS (PREFERRED EQUITY)

- There is a structural difference between private equity and preferred equity
- Private equity is looking for highly opportunistic returns
  - Targeting 20% levered IRRs
  - Willing to accept 14-18% levered IRR’s in top markets, or more trophy-like assets
- Preferred Equity is structurally senior to Common Equity or Sponsor Equity and as such commands a lesser return
  - **Preferred Equity** functions economically similar to mezzanine loan
  - **Common Equity** gets wiped out *before* preferred equity
- Many historical private equity investors are making preferred equity and mezzanine debt investments
  - The return for preferred equity investments is more attractive to certain investors on a risk adjusted basis
- Preferred Equity is looking for opportunistic returns
  - Targeting 10-17% levered IRRs depending on the deal profile and capital structure
  - Willing to accept 10-14% levered IRRs in top markets
  - Expecting mandatory redemption
    - Usually after 3-5 years

CAPITAL CONTRIBUTIONS

- **Operating Agreement** will specify the percentages that each member is required to contribute

- Future contributions may be made on a pro-rata basis in line with the equity percentages

- If one Member does not fund when required:
  - Often times the other partners can fund the necessary amount and will dilute the equity percentage of the non-funding member
    - Dilution will usually be punitive
    - Dilution may be in the form of a loan to the joint venture which takes priority in repayment

POTENTIAL SPONSOR FEES

Fees may be earned by Sponsor for the following:

- Acquisition
- Disposition
- Development
- Financing
- Asset Management
- Management
- License / Franchise
- Technical Services
- Pre-Opening
- Purchasing
- Project Management
- Guaranty

Investors will pay a lot of attention to the types of, and magnitude of fees received by deal sponsors

IMPACT OF FEES

Depending on each member's equity investment amount, fees to the Sponsor may cause misalignment of interest.

- Equity investment of Sponsor net of fees may be minimal
- Investors will generally be comfortable with fees covering the costs, but after investor capital is returned and a preferred return is achieved, they will want sponsor profits to come in the form of promotes

Because the fees are normally paid to the Sponsor/Managing Member, for the purposes of calculating an IRR to the Members, fees are usually not considered in the cash flow calculations.

WHAT IS A WATERFALL?

A Waterfall is the order in which available cash flows are distributed to Members in the venture, and:

- Can be highly customized based on the specifics of a deal
- Can be different for operating cash flows versus capital event (sale, refinancing) cash flows

WHAT IS A PROMOTE?

Sponsors receive promotes as incentives to deliver superior financial performance.

- The concept of a promote is that, upon achieving superior returns, the interests of the Sponsors would be “promoted”
    - This puts them at a higher level than its stated nominal capital interests

- A promote is paid as excess distributions to the Sponsor at a level greater than the Sponsor’s capital contribution

WHEN IS THE PROMOTE RECEIVED?

- Usually the Promote is received when there is cash available to distribute, and the required preferred returns on and of capital have been received
- The Operating Agreement may specify when or how often distributions are to be made
- Loan documents may preclude an earned promote from being distributed to the Sponsor until achievement of certain credit statistics

PREFERRED/PROMOTE STRUCTURE

Illustration:

Preferred and Promoted returns vary given different Sponsor equity percentage investments

At a 15% Sponsor Equity Contribution, a typical promote structure is as follows:

- Pari Passu up to an annual Internal Rate of Return (IRR) hurdle rate of 10-12%
- Promote of 10 – 15% above a 10 – 12% annual IRR hurdle (optional)
- Promote of 20 – 25% above a 15 – 17% annual IRR hurdle
- Promote of 30 – 35% above a 20 – 22% annual IRR hurdle

While each deal is negotiated individually and the components are on a sliding scale, preferred return, preferred/promoted structures may look like the following:

	Hurdle			Promote		
Equity Invested	**1st Tier Pref**	**2nd Tier Pref**	**3rd Tier Pref**	**1st Tier Promote**	**2nd Tier Promote**	**3rd Tier Promote**
10%	10-12%	15-17%	20-22%	10-15%	15-20%	25-30%
15-20%	10-12%	15-17%	20-22%	10-15%	20-25%	30-35%
25%	10-12%	15-17%	20-22%	10-15%	25-30%	35-40%

PROMOTE STRUCTURE

The following illustrates the promote structure for the equity partnership (90.0% Member Equity, 10.0% Managing Member Equity)
The distributions are:

- **First**, pari passu until a 10.0% preferred return to all members, and thereafter a 15.0% promote to Managing Member
- **Second**, pari passu until a 15.0% preferred return to all members, and thereafter a 25.0% promote to Managing Member
- **Third**, pari passu until a 20.0% preferred return to all members, and thereafter a 35.0% promote to Managing Member

Member Cash Flow		2018	2019	2020	2021	2022	2023
Equity (90%)		($11,043)					
Preferred Return			($214)	$293	$1,455	$1,645	$24,350
Residual Cash Flow			0	0	0	0	0
Total Cash Flow		**($11,043)**	**($214)**	**$293**	**$1,455**	**$1,645**	**$24,350**
Cumulative Cash Flow		(11,043)	(11,257)	(10,965)	(9,510)	(7,865)	16,484
Member Returns							
Total Profit	$16,484						
IRR	20.9%						
NPV (15.0%)	$2,985						
Equity Multiple	2.49x						
Managing Member Cash Flow							
Equity (10%)		($1,227)					
Preferred Return			($24)	$33	$162	$183	$2,706
Promote			0	0	0	0	4,627
Total Cash Flow		**($1,227)**	**($24)**	**$33**	**$162**	**$183**	**$7,332**
Cumulative Cash Flow		(1,227)	(1,251)	(1,218)	(1,057)	(874)	6,458
Managing Member Returns							
Total Profit	$6,458						
IRR	45.2%						
NPV (15.0%)	$2,630						
Equity Multiple	6.26x						

CASH FLOW SPLITS

Many Operating Agreements have a cash flow distribution structure which specifies cash flow splits

The language in the Distributions section of the Operating Agreement will specify the splits:

- *Example*: Distributable cash flow is split 90/10% until the achievement of a certain IRR or a certain return threshold

- After a certain IRR threshold, the cash flow will be split 70/30%

- Capital event proceeds may be split the same way or a different way than operating cash distributions

RISK ALLOCATIONS

There are numerous ways to allocate risk within a JV:

- Pursuit costs or pre-development costs may be provided for with the Sponsor bearing a greater share than their Equity Percentage
- Funding cost overruns for a development or a Property Improvement Plan (PIP) may be allocated disproportionately to the Sponsor overseeing the work
- Certain fees to sponsors that provide services may be subordinated to a certain level of performance return
- Sponsor representations in the Operating Agreement

GUARANTEES

Guarantees required may include:

- Completion
- PIP Completion
- Debt repayment
- Carry (Interest, Taxes, Insurance)
- Non-recourse carve-out (“Bad-Boy”)
- Environmental
- Franchise

- Guarantees are recourse and are often provided by the Sponsor, though sometimes the Sponsor may not be willing to provide all necessary guarantees nor does it have sufficient net worth or liquidity

- Certain guarantees may be provided by the JV, depending on the amount of Equity Value in the property owner entity

- If the Limited Partners are providing guarantees, they may then be indemnified by the Sponsor, or may receive a fee for providing such guarantees

GMP VS. COMPLETION GUARANTY

GMP

- Hard Costs, including: materials, general conditions, general contractor fees
- Builders Risk Insurance
- Contractor Identified Contingency

Completion Guaranty

- Hard Costs, including: materials, general conditions, general contractor fees
- Builders Risk Insurance
- Contractor identified contingency
- Land costs
- Legal costs: Buyer, Lender, zoning, liquor, other
- Development fee and development overhead
- Financing costs: origination, placement fees, Lender, and due diligence
- Capitalized Interest: funded interest during construction period
- Funded reserves: Debt service, insurance, taxes
- Franchise fees: Pre-opening services fee
- Furniture, fixtures, and equipment
- Operating supplies and equipment
- Pre-opening expenses: payroll, marketing, recruiting
- Working capital
- Leasing commissions and tenant improvements
- Contingency
- Change orders beyond GMP score

MAJOR DECISIONS

- Pursuant to an approved operating and capital budget, day to day management of the hotel is generally handled by the Sponsor

- The Operating Agreement will spell out in detail a number of decisions referred to as Major Decisions

- Generally, Major Decisions need to be unanimous, or sometimes a supermajority

Major Decisions will often include:

- Sale of hotel
- Refinancing of hotel
- Change in management company
- Change in brand/franchise
- Approval of General Contractor
- Bankruptcy
- Approval of GMP contract
- Admission of additional partners
- Consent to guarantees (debt, franchise, other)
- Entering into material leases
- Labor neutrality agreement

UNWIND PROVISIONS

It is critical to determine how the partners in a joint venture can exit their investment:

- There are a number of ways to create unwind provisions for a JV
- Often, there is an asymmetry in the desired holding period between the partners

The most common unwind provisions are:

- Buy/Sell
- Put/Call
- Forced Marketing
- Drag Along/Tag Along Rights

Operating Agreements may not address all of the ancillary issues involved with an unwind or transfer of interests:

- Replacement guarantees (financing, franchise, lease)
- Unfunded obligations
- Impact of service contracts (if a Member is also the operator)
- Transfer provisions under franchise agreements, lease agreements, loan agreements
- Liquor license transfers

Underwriting

WHAT MATTERS TO HOTEL INVESTORS

- Historical and projected operating performance
- Penetration analysis (Occupancy, ADR, RevPAR)
- Cap Rate (NOI *after* FF&E reserves)
- EBITDA Multiple
- IRR: *Internal Rate of Return*
- NPV: *Net Present Value*
- Cash on Cash return
- Debt yield (using NOI after FF&E reserve)
- Loan to Cost
- Loan to Value
- Tax considerations

UNDERWRITING ISSUES

The following is a list of commonly seen underwriting and deal presentation errors:

- **Understated Debt Assumptions**: Including too much debt, too low an interest rate, interest-only assumptions, credit statistics that won't satisfy the lender
- **Unrealistic Exit Assumptions**: Residual Cap rates not supported by historical market transactions, implied exit prices-per-key in excess of historical transaction comparables
- **Unrealistic Occupancy & ADR**: Occupancy and ADR projections well in excess of local submarket performance
- **Missing Development Costs**: Missing costs for pre-opening expense, working capital, unrealistically low capitalized interest, lender legal title, and closing costs
- **Timing Issues**: For development deals, Pro Formas that have no construction period thereby overstating the IRR calculations, assumptions that capital expenditures are spent immediately, and year 1 pro forma projections fully reflect this
- **Debt Modeling Errors**: Failure to repay mortgage debt on assumed hotel sale, failure to repay mezzanine debt on assumed hotel sale
- **Immediate Revenue Ramp-up**: Assumed accelerated ramp-up in occupancy, ADR, F&B Revenue to stabilized levels without factoring in calendar timing, timing of attracting and securing group rooms, negotiated corporate accounts, social catering events
- **Immediate Margin Ramp-up**: Assumed stabilized margins in Year 1/ Year 2 prior to actual stabilization

WHAT ARE THE POTENTIAL FLAWS WHEN COMPARING TO A "COMP SET"?

- A hotel in any given area will not necessarily compete with all hotels in that area for the same sources of demand
- For a market study or diligence, it is important to determine which hotels compete with the subject hotel and to what degree
  - Those hotels that do not should be eliminated
- The process of selecting the hotels to be included in a comp set is, in itself, subjective, and the biases of the person making the selection can influence what hotels are included and excluded
- Other potential issues that could distort a comp set include:
  - A lack of supply within the market
  - Oversaturation of hotel supply within the market
  - Failing to acknowledge new hotels
  - Grandfathering a comp set during conversion
  - STR sufficiency guidelines
  - Substantial property uniqueness

Agreements

Management Agreements:

- **Term:** Management agreement terms usually vary from 1 year to 50 years, and often have automatic extensions; independent management companies usually have much shorter term and greater flexibility than branded managers
- **Base Fee:** Base fees are typically structured as a percentage of total revenue, usually 3-4% of gross revenue for full-service and 4% of gross revenue for limited service properties
- **Incentive Fee:** Incentive fees are usually structured as a percent of income in excess of a certain GOP (*Gross Operating Profit*), or as a percent of NOI in excess of a preferred return on capital invested by owners
- **Termination Fees:** Brand managed hotels usually have substantially greater termination fees than independent management contracts
    - Termination fees can range from the remaining term of the contract down to no fees; independent management contracts usually have a sliding scale starting at 3x prior year fees and reducing to 1x, and sometimes burning off entirely
- **Change of Control:** Most management agreements are not assumable, so new owners have to work through similar economics with an existing or new manager
    - Often, the ability to acquire a hotel unencumbered by management significantly increases the value and the pool of potential investors, and reduces the cap rate by 50 to 100 bps

KEY BUSINESS TERMS / CONCEPTS IN AGREEMENTS – MANAGEMENT AGREEMENTS

Management Agreements *continued***:**

- **Working Capital:** Specified amounts are required to fund working capital needs of the hotel
- **Employee Liability Issues**: Employees are almost always employees of the manager, not the owner
    - Owner is responsible for employee costs, including payroll and benefits
- **Performance Test**: Hotel owner may terminate the Management Agreement if various performance test measures are not met for a period of time, usually two consecutive fiscal years
- **Financial Reporting**: The manager is responsible to submit full financial reporting for the hotel on a monthly, quarterly, and annual basis, while keeping a full set of books and records
- **Pre-Opening Fees**: Fees charged to the Owner by the Manager for providing services that are necessary to prepare the hotel for operation before the opening date of the hotel
- **The FF&E Reserve (Furniture, Fixtures, & Equipment):** Usually 4-5% of gross revenue is set aside in order to have a pool of capital for replacements and upgrades of the FF&E in a hotel

KEY BUSINESS TERMS / CONCEPTS IN AGREEMENTS – FRANCHISE AGREEMENTS

Franchise Agreements:

- **Term:** Typically 20 years, but sometimes 10 years
- **Royalty Fee:** Ranges from 4.0% to 6.5% of Gross Rooms Revenue and, for some Franchisors, also from 0 to 3% of Food and Beverage Revenue, a significant profit center for the Franchisor
- **Marketing/System Fee**: Usually about 4% of gross rooms revenue, and not a profit center for the Franchisor
- **Other Fees** *Including***:**
  - Reservations, technology, loyalty program, training, etc.
- **Fee Ramp-Up**: For new investors/buyers making significant capital improvements
  - It is common to see some reduction in earlier year royalty fees
  - Royalty fees may by reduced by 1, 2, or 3 percentage points during the early years
- **PIP**: Property Improvement Plan capital expenditures; required by a Franchisor on change of ownership of an asset, and is designed to bring the hotel up to current brand standards
  - PIP is attached as an exhibit to the Franchise Agreement
  - PIP is created based on scope of the required work, and does not have a defined dollar amount

KEY BUSINESS TERMS / CONCEPTS IN AGREEMENTS – FRANCHISE AGREEMENTS

Franchise Agreements *continued:*

- **Termination Fees:** Payment of liquidity damages required to prematurely exit a Franchise Agreement
- **Guarantees:** Franchisee guarantees its obligations under the Franchise Agreement including payment of fees and completion of the PIP
- **Liquidated Damages:** If Franchise is terminated prior to term, there is a liquidated damages calculation
- **Radius Restrictions:** Limitations on where and when the Franchisor can grant another Franchisee
    - Also known as an AOP (*Area of Protection*)
    - Usually burns off after a few years and is very specifically defined
- **Key Money**: Unsecured, forgivable loan that self-amortizes over the life of the underlying franchise agreement; key money is very valuable to owners as it reduces equity
    - If a Franchise Agreement is terminated early, repayment of unamortized key money is required
    - Is generally funded to the Franchisee shortly after the hotel opens
- **Technical Services Fee:** Fee for technical advisory services provided to Owner, and is related to hotel design, area requirements for reach hotel function, food and beverage concepts, the facilities program and criteria for hotel systems

KEY BUSINESS TERMS / CONCEPTS IN AGREEMENTS – FRANCHISE AGREEMENTS

Franchise Agreements *continued***:**

- **Debt Restrictions**: Some stronger Franchisors impose certain covenants or LTV limitations on debt financing
    - Debt restrictions becomes a major negotiating point for heavily leveraged, opportunistic buyers
- **Change of Control**: Franchise Agreements are generally not assumable so a new asset buyer must negotiate a new franchise agreement, which may be on better or worse terms than the existing agreement
- **Approved Operator**: Franchisors require that the Management Company selected be an approved operator, creating limitations on who may manage the property

F&B Leases / Operating Agreements:

- **Term**: Term varies based on strength, popularity, and cachet of the operator
- **Base Fee**: If structured as an operating agreement, usually a fee of 4-5% of total F&B Revenue
    - For celebrity chefs it may be as much as 6% of F&B revenue
- **Incentive Fee**: Various structures, usually a significant percentage of profit
- **Termination Fees**: Usually insignificant, but may be higher in the case of a celebrity chef
- **Other Key Issues:** Branding, financial reporting, adherence to hotel brand standards, etc.

Operating Agreements:

- **Equity Contribution**: Majority partner will want sponsors to have "skin in the game" in order to align interests
    - This is a big concern if sponsors have reduced their basis through the receipt of Development Fees, Acquisition Fees, Asset Management Fees, and/or Property Management Fees
- **Asset Management Fees**: Sometimes structured as a percent of revenue and is sometimes structured as percent of asset value and is used to offset the costs of overseeing the assets and the venture
    - The trend has been to move away from formulaic asset management fees and towards a true cost reimbursement so that asset management fees are *NOT* a profit center to the sponsor
- **Preferred Returns**: Most JV agreements with private equity sources have preferred returns to capital invested, before the sponsors receive promoted interest
    - Preferred returns are generally measured as the leveraged IRR to the equity invested
- **Major Decisions:** Clause in the JV agreement which governs the partners' ability to come to an agreement on items such as capital expenditures, sale of the asset, refinancing, ability to enter into operating agreements, franchise agreements, etc.

Operating Agreements *continued***:**

- **Promotes**: Promote structures take many forms, but are utilized to provide outsized incentive compensation to deal sponsors for strong returns and performance
  - Promotes are sometimes referred to as extra splits or Carried Interests
    - Carried interest is an equity interest granted to an investor or participant in a deal, which gets that participant an equity interest different than its actual percentage equity contribution
      - Carried interest may result from a sponsor's effort in putting a deal together, securing certain entitlements or approvals or in executing a deal
- **Splits**: Some deals are structured with splits in lieu of promotes
  - The splits simply govern how net cash flows are allocated to the Members and do not contemplate a preferred return
- **Financing/Refinancing**: Decisions on financings are critical and drive the financial return to Members and potential promotes

KEY BUSINESS TERMS / CONCEPTS IN AGREEMENTS – JV EQUITY AGREEMENTS

Exit Mechanisms:

- **Buy/Sell Agreement:** An agreement made between the JV partners whereby either member can set a price at which it will either sell its interest or buy the other member's interest
- **Put/Call Agreement:** In some JV's, one partner may want to hold the asset long-term and the other want to liquidate earlier
  - The JV can provide for a sale of the seller's interest under certain circumstances
  - The advantage of this approach is that the JV partner that wants to buy knows it will be the buyer and the JV partner that wants to sell knows it will be the seller
- **Right of First Offer (ROFO):** a contractual obligation by the owner of an asset to negotiate the sale of an asset with the rights holder before offering the asset for sale to third parties
- **Right of First Refusal (ROFR):** a contractual right that gives its holder the option to enter a business transaction with the owner of an asset, according to specified terms, before the owner is entitled to enter into that transaction with a third party

Loan Agreements:

- **Rate**: Can be fixed or floating
- **Amortization**: Typical to see 25 year amortization for hotel loans
  - Some have 30 year, and for lower leverage loans, some may have no amortization and are interest only
- **Term**: In CMBS, 10 years is most common term for fixed rate loans, followed by 5 year loans
  - 5 year loans are most common for floating rate CMBS, and they are usually structured as 2 year loans with 3 one year extension options
- **Points/Fees**: Fixed rate loans typically have no origination fees, whereas floating rate loans will usually have 1 point origination fees
- **Prepayment**: Floating rate loans will typically have some lockout period during which the loan may not be prepaid, followed by yield maintenance for a portion of the term

KEY BUSINESS TERMS / CONCEPTS IN AGREEMENTS – LOAN AGREEMENTS

Loan Agreements *continued***:**

- **Recourse**: For a recourse loan, a lender can look to all other Borrower assets as collateral
  - Most CMBS loans are non-recourse except for "Bad Boy" carve-outs
- **Covenants**: Minimum required credit statistics such as Debt Service Coverage Ratio (DSCR) or Debt Yield
- **Guaranties**: May require personal recourse guaranties of repayment, debt service, and performance of obligations
- **Cash Traps**: Many loans incorporate a feature that traps cash and precludes it from being distributed to owners if certain credit statistics and operating cash flows are not achieved
- **Reserves**: May be required for property taxes, insurance, ground rent payments, FF&E replacement, seasonality, debt service shortfalls
- **Defeasance**: Substitution of U.S. government securities as collateral for a property removed from a loan
  - Fixed rate CMBS loans will typically require defeasance to exit the loan
- **Yield Maintenance**: Designed to keep a lender indifferent between maintaining an outstanding loan vs. paying it off;
  - Calculated as the present value (usually using the Treasury rate as the discount rate) of all of the future debt secure payments, less the outstanding balance

What is the FF&E Reserve? How does it work?

- The FF&E Reserve (*Furniture, Fixtures, & Equipment*) is usually 4-5% of gross revenue and is set aside in order to have a pool of capital for replacements and upgrades of the FF&E in a hotel
- Lenders underwrite and require the reserve
- Franchise agreements require FF&E reserves
  - Lender and Franchisor FF&E Reserve requirements are not duplicative and are generally 4-5% of gross revenue

What are Bad Boy Acts and Non-Recourse Carve-outs?

- Bad Boy Acts are a series of specifically defined actions that trigger personal recourse liability for the sponsor of the borrower
- Bad Boy Acts include: Voluntarily filing for bankruptcy, fraudulently stealing or diverting funds, causing environmental damage to the building or land
- The concept of the "carve-outs" is that the commission of any of the enumerated "Bad Boy" Acts is carved out of the non-recourse nature of the loan, converting it to recourse

Glossary

GLOSSARY

- **ADR (average daily rate)** - The average rate paid for rooms occupied, calculated by dividing room revenue by rooms occupied. (ADR = room revenue / rooms)

- **ADR (rate) index** - ADR index measures a hotel's ADR performance relative to a competitive set. An ADR Index of 100 equals fair share of ADR, compared to the competitive set of hotels. To calculate an ADR index: (Hotel ADR / competitive set of hotels' ADR) x 100 = ADR index For example, if the subject hotel's ADR is US$50 and the ADR of its competitive set is US$50, the subject hotel's index would total 100. If the subject hotel's ADR totaled US$60, its index would be 120, indicating the hotel has captured more than its fair share. If the subject hotel's ADR totaled US$40, its index would be 80, indicating the hotel has captured less than its fair share.

- **Amortization period** - The timeframe during which the loan amount will be fully paid down to a 0 balance; most hotel loans have a 25-30 year amortization period. If the amortization period is longer than the loan term, then at loan maturity there will still be an outstanding loan balance.

- **Bad Boy Carve-Out** - A risk or source of liability for which a borrower's principals may assume personal liability under a Carve-out guaranty for the commission of "Bad Acts".

- **Base Management Fee** - A percentage of "gross revenue" (sometimes referred to as "total revenue") which rewards the management company's revenue generating capability (but not efficiency). 3.0% - 4.0% of "gross revenue" is a typical base fee.

- **Basis point** - A unit equal to 1/100th of 1% and used to denote the change in a financial instrument. The relationship between percentage changes and basis points can be summarized as follows: 1 percent change equals 100 basis points, and 0.01 percent equals 1 basis point or "bp".

- **Bullet Loan** - A loan with no amortization, in which borrower agrees to repay principal in a lump sum at maturity. Interest is generally payable monthly.

- **Capital expenditure** - Also known as CapEx. Cash spent by a business to invest or maintain fixed assets such as land, buildings and equipment. These amounts are capitalized on the balance sheet rather than run through the income statement as an expense.

GLOSSARY

- **Cap** - A hedge to protect the borrower from the risk that a floating interest rate will rise above a certain level, much like an insurance policy against higher interest rates. Requires a one time payment but imposes no other obligations to the beneficiary.

- **Capitalization rate** - The capitalization rate (or cap rate) is the NOI divided by the hotel's total value. This represents the unleveraged yield on investment.

- **Carve-Out Guaranty** - A guaranty of certain risks for which a lender refuses to look solely to the collateral. Also sometimes a contingent full guaranty of the loan, to discourage the borrower from doing certain bad things (like a voluntary bankruptcy). These matters are all "carved-out" from the otherwise nonrecourse nature of the loan, giving the lender access to the other assets of the guarantor.

- **Cash-on-Cash Return** - The amount of cash flow (NOI after debt service) divided by total cash invested.

- **Commercial Mortgage Backed Securities (CMBS)** - fixed rate bonds collateralized by diversified pools of first mortgages on commercial properties located throughout the United States. A simple bond structure is used to create individual bond classes, called tranches, which each carry a distinct rating and risk/return profile.

- **Competitive set** - A competitive set or "comp set" consists of a group of hotels by which an individual property can compare its own performance to the group's composite performance.

- **Contract rooms** - Contract rooms are occupied at rates stipulated by contracts – such as for airline crews and permanent guests.

- **Credit agreement** - A legal contract in which a bank arranges to loan a customer a certain amount of money for a specified amount of time. The credit agreement outlines all the rules and regulations associated with the contract. A credit agreement can be a lengthy and detailed document that explains all the terms of the contract.

- **Deposit Account Control Agreement (DACA)** - A deposit account control agreement is a document in which a debtor, secured party and bank maintaining a deposit account agree to the handling of funds in that account. The document "perfects" a security interest in the debtor's deposit account in favor of a secured party under the UCC. Because security interests in deposit accounts can only be perfected under the UCC by control, control under the DACA is established when the depository bank agrees to comply with instructions from the secured party directing the disposition of funds from the account without needing any further consent from the borrower.

GLOSSARY

- **Debt service** - Payment of interest and principal on a loan. May be paid monthly, quarterly or annually.
- **Debt yield** - The annual return a lender gets on its loan to a borrower, calculated as NOI divided by the outstanding debt balance; essentially measures the cap rate to the lender.
- **Debt Covenant** - Is a promise that certain activities will or will not be carried out.
- **Defeasance** - A process to substitute collateral when looking to sell or refinance an existing property
- **Deferred maintenance** - Delayed required maintenance items on a property.
- **Discount rate** - The interest rate used in discounted cash flow (DCF) analysis to determine the present value of future cash flows. The discount rate in DCF analysis takes into account not just the time value of money, but also the risk or uncertainty of future cash flows; the greater the uncertainty of future cash flows, the higher the discount rate. The discount rate is essentially a measure of the riskiness of the cash flows.
- **Draw** - A disbursement from a construction loan to pay for construction and other costs incurred to date on a job.
- **Dry Closing** - A closing in which everything is finished except the funding.
- **DSCR** (**Debt Service Coverage Ratio)** - NOI divided by annual debt service payments, where the debt service includes interest and principal amortization.
- **EBITDA** - Earnings Before Interest, Taxes, Depreciation, and Amortization, NOI, but without an deduction for reserve for replacement.
- **EB-5** - An immigration program that provides a method of obtaining United States visas and green cards by investing in the U.S. and creating new jobs within specified Regional Centers defined by the government.
- **Equity** - The property value attributed to the owner; often this is the cash invested in the property; Calculated as Value – Debt

GLOSSARY

- **Extended Stay** - Hotel guests stay for extended periods of time, typically more than 5 consecutive nights.
- **Extension Test** - In order to qualify for an extension beyond the initial maturity date for a loan, several requirements or covenants must be met such as DSCR ratios, debt yield, etc.
- **Equity Kicker** - A lender's right to receive a percentage of appreciation or ownership of the collateral.
- **FF&E Reserve** - Refers to Furniture, Fixtures and Equipment, that have no permanent connection to the structure of a building or utilities. Hotel owners set aside an annual reserve for replacement for FF&E, typically 3-5% of Total Revenues.
- **Flow-through** - A measure of marginal profitability/loss on each incremental increase in top-line revenue
- **Food & Beverage (F&B) revenue** - Revenues derived from the sale of food, beverages, banquet beverages and other F&B sources. Other F&B sources include meeting room rentals, audio-visual equipment rentals, cover or service charges or other revenues within the food-and-beverage department.
- **Franchisor** - A company that sells franchises license agreements. Sometimes referred to as a licensor.
- **Franchisee** - An individual or company buying a franchise. Sometimes referred to as a licensee.
- **Full-service hotel** - Full-service hotels have a restaurant, lounge facilities and meeting space as well as minimum service levels.
- **FF&E** - Furniture, fixtures and equipment.
- **FF&E Reserve** - Refers to Furniture, Fixtures and Equipment, that have no permanent connection to the structure of a building or utilities. Hotel owners set aside an annual reserve for replacement for FF&E, typically 3-5% of Total Revenues.
- **FFO (Funds From Operation)** - Used by REITs to define cash flow from overall operations; FFO includes deductions for depreciation and amortization expense.
- **GOPPAR** - Gross operating profit per available room.

GLOSSARY

- **GOP (Gross Operating Profit)** - Measures the operational profitability of a hotel after subtracting all Departmental Expenses and Undistributed Expenses.

- **Group rooms** - Group rooms are sold simultaneously in blocks of a minimum of ten rooms or more (e.g. group tours, domestic and international groups, association, convention and corporate groups).

- **Guest Satisfaction Score (GSS)** - A customer metric related to satisfaction and willingness to recommend through a blind feedback mechanism. GSS scores are often an important metric in calculating incentive management fees for the franchisee / manager.

- **Hard Lockbox** - A lockbox that the lender fully establishes at Closing, with tenants being immediately directed to pay all rent to the Lockbox. Any disbursements from the Hard Lockbox require lender approval.

- **Hedge** - Any transaction to shift to a third party a risk of market fluctuations. In real estate, typically refers to mitigating the borrower's exposure to interest rate fluctuations by purchasing a Cap or entering into a Swap. Borrowers cannot yet enter into Hedge transactions to cover fluctuations in real estate values, but these may be around the corner, assuming continued development of the derivatives market.

- **Hold period** - The timeframe that an investor owns or intends to own a hotel; usually a 5-year or 10-year hold period.

- **HOST Study** - The HOST Study contains information on hotel revenues and expenses broken down by departments including rooms, food and beverage, marketing, utility costs and maintenance. This report is published annually by STR and the results are based on the operating statements of over 5,000 U.S. hotels.

- **Interest only (I/O)** - A loan that has no required principal amortization during the loan term. A loan may be interest only for a defined number of years, and then has a principal amortization schedule.

- **Interest rate** - The rate of return paid to the lender; the interest rate on a Fixed Rate loan remains the same throughout the lifetime of the loan; the interest rate for a Floating Rate loan varies based on an index.

- **Incentive Management Fee** - A fee that is a percentage of some level of operating income. A typical incentive fee will be in the range of 10%-15% of operating profit above a return on invested capital which rewards the management company for profitability.

GLOSSARY

- **Intercreditor Agreement** - An agreement among lenders that sets forth the various lien positions and the rights and liabilities of each creditor and its impact on the other creditors.

- **Internal rate of return (IRR)** - The discount rate that makes the net present value of all cash flows from a project equal to zero. Generally the higher a project's internal rate of return, the more desirable it is to undertake the project. IRR can be used to rank several prospective projects under consideration. Assuming all other factors are equal among the various projects, the project with the highest IRR would probably be considered the best and undertaken first.

- **Limited-service hotel** - Rooms-only operations, (i.e. without food-and-beverage service) or offer a bedroom and bathroom for the night, but very few other services and amenities.

- **Loan Servicing** - The administration aspect of a loan from the time the proceeds are dispersed until the loan is paid off. This includes sending monthly payment statements and collecting monthly payments, maintaining records of payments and balances, collecting and paying taxes and insurance (and managing escrow and reserve funds), remitting funds to the note holder, and following up on delinquencies.

- **Loan Term** - The timeframe during which the loan will be paid off.

- **Loan to Cost (LTC)** - Metric used in hotel construction used to compare the financing of a project as offered by a loan to the cost of building the project. The LTC ratio allows commercial real estate lenders to determine the risk of offering a construction loan.

- **London Interbank Offered Rate (LIBOR)** - The interest rate for lending among banks is typically the base rate for floating rate commercial real estate loans.

- **Lockbox** - An arrangement by which property income goes directly to a particular bank account (subject to lender security interest) to be applied in accordance with a Waterfall. Formally called cash management. Subspecies include Hard Lockbox, Soft Lockbox, and Springing Lockbox, whose definitions can vary.

- **Loyalty Program Threshold** - When a given hotel's occupancy goes above the Loyalty Program Threshold (ie: 95%), all loyalty redemption nights are charged to the brand at the ADR currently on the books. If it is below this threshold, they will be charged at some fraction of the ADR on the books.

GLOSSARY

- **LTV (Loan-to-Value)** - The percentage of loan amount to the overall property value.
- **Manchised** - Hotel properties that are managed and franchised by the same company.
- **Mezzanine debt** - A subordinated debt instrument secured by a pledge of equity in the borrower.
- **Mezzanine Financing** - A hybrid of debt and equity financing typically used to finance the expansion of existing companies. Mezzanine financing is debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan isn't paid back in time and in full. It's generally subordinated to debt provided by senior lenders such as banks and venture capital companies.
- **Monetary Default** - The failure to pay interest, principal, or other financial obligations promptly when due.
- **Net Operating Income (NOI)** - A company's operating income after operating expenses are deducted but before income taxes and interest expense are deducted. It is usually calculated as EBITDA less an FF&E reserve.
- **No-Cut Management Agreement:** A management agreement that a hotel owner has virtually no hope of ever terminating before its schedule expiration.
- **Non-Recourse** – a provision in a loan that prohibits the lender from seeking debt repayments from the owner of the property, and the lender can seek recovery only from the property itself.
- **Occupancy** - Occupancy is the percentage of available rooms that were sold during a specified period of time. Occupancy is calculated by dividing the number of rooms sold by rooms available. Occupancy = Rooms Sold / Rooms Available.
- **Occupancy (Penetration) Index** - An index designed to measure a hotel's share of the segment's (Hotel Occupancy / Competitive Set Occupancy).
- **Online travel agency (OTA)** - An Internet-based hotel and travel reservations system. (Expedia, Booking.com, Priceline.com)
- **Quality Assurance** - A test provided by a hotel franchisor in order to ensure that a given hotel franchisee is meeting brand standards and operating procedures.

GLOSSARY

- **Pipeline** - Pipeline data details existing hotel supply and projected growth.
- **Portfolio lender** - A lender that originates mortgage loans and holds them on its balance sheet.
- **Property Improvement Plan (PIP)** - A requirement by hotel brands that owners undertake renovations and upgrades to meet current brand standards. PIPs are generally required when a hotel joins a brand system or when a branded hotel is sold.
- **REIT (Real Estate Investment Trust)** - Entity that invests in real estate and does not pay corporate level income taxes.
- **Real-estate owned (REO)** - Property owned by a lender, usually a bank, after an unsuccessful sale at a foreclosure auction.
- **Recourse** - A provision in a loan that allows the lender to pursue the personal assets of the borrower if a loan is in default.
- **Return On Investment (ROI)** - The % return on an investment; calculated as the actual or projected return ÷ investment capital required.
- **Right of First Offer** - Is a contractual obligation by the owner of an asset to a rights holder to negotiate the sale of an asset with the rights holder before offering the asset for sale to third parties.
- **Right of First Refusal** - Is a contractual right that gives its holder the option to enter a business transaction with the owner of something, according to specified terms, before the owner is entitled to enter into that transaction with a third party
- **RevPAR (revenue per available room)** - Revenue per available room (RevPAR) is the total guest room revenue divided by the total number of available rooms. RevPAR differs from ADR because RevPAR is affected by the amount of unoccupied available rooms, while ADR shows only the average rate of rooms actually sold. Occupancy x ADR = RevPAR.
- **RevPAR (yield) index** - A RevPAR (yield) index measures a hotel's fair market RevPAR versus the competitive set.
- **Room Revenue** - Total room revenue generated from the rental of rooms.

GLOSSARY

- **RRM (Room Revenue Multiplier)** - The ratio of value to room revenue; calculated as the value ÷ room revenue rooms available.
- **Securitization** - The process of combining mortgage loans and then marketing different tiers of the repackaged instruments to investors. Mortgage-backed securities combine mortgages into one large pool, the issuer can divide the large pool into smaller pieces based on each individual mortgage's inherent risk of default and then sell those smaller pieces to investors. The process creates liquidity by enabling smaller investors to purchase shares in a larger asset pool.
- **Segmentation** - Rooms nights and revenue broken down by type of business (transient, group, contract).
- **Single Purpose Entity** - A newly formed entity whose sole purpose in life is to own and operate particular collateral. The rating agencies established elaborate rules for these entities (e.g., cannot share letterhead or telephone number with another entity).
- **SMERF** - An acronym for the Social, Military, Educational, Religious and Fraternal segment of the group travel market; usually has high level of guests per room and achieves a low ADR.
- **Smith Travel Research (STR)** - Smith Travel Research or STR is a global provider of benchmarking, analytics and marketplace supply and demand data for the hotel industry.
- **Soft Lockbox** - A Lockbox that the parties establish at Closing, initially allowing the borrower to withdraw funds without lender permission or control. The lender can block those withdrawals if the property later fails certain financial tests.
- **Springing Lockbox** - A lockbox to be established or activated in the future if certain events occur.
- **Subordinate** - Refers to the fact that one entity's position is inferior to another; for example, the mezzanine lender is subordinate to the primary lender, meaning that the primary lender is paid first and the mezz lender is paid next; thus, the mezz lender is in a riskier position if there is not enough NOI to pay them.
- **Sweat Equity** - The equity value in a property that is earned by a developer who increases its worth through the developer's intangible efforts, such as by obtaining zoning or planning consent, negotiating option rights, producing schematic drawings for a potential form of development, or negotiating terms for a pre-leasing. The developer may covert its Sweat Equity into a share in the future value of the completed development.

GLOSSARY

- **Total revenue** - Revenue from all hotel operations, including rooms sold, F&B, parking, spa, laundry, phone, miscellaneous.
- **Trailing 12** – The past 12-month period.
- **Transient rooms** - Include rooms occupied by those with reservations at rack, corporate, corporate negotiated, package, government, or foreign traveler rates. Also includes occupied rooms booked via third party web sites.
- **Underwriting** - The process of evaluating an investment, including its potential value, risk, future cash flow, probable return, and ability to fund debt; performed by investors and lenders.
- **Warm Body** - A creditworthy individual, as opposed to a borrower-related entity that might sign a guaranty but has no real assets.
- **Waterfall** - The priorities for application of cash, such as in a Lockbox.
- **Wet Closing** - A closing where the parties not only sign documents but also fund the capital.
- **Yield Maintenance** - a prepayment penalty that, in the event the borrower pays off a loan before maturity, allows the lender to attain the same yield as if the borrower had made all scheduled mortgage payments until maturity.