



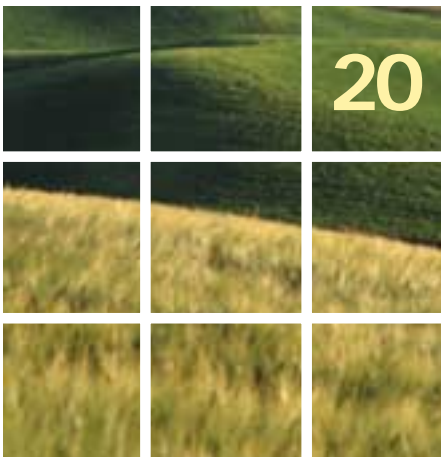
With all of the focus in the media over the last four or five years on public capital markets, there has been a tendency to ignore the role of private capital. In the middle of 1998, we were all looking forward to a quiet summer not realizing that by August, the capital markets would be in turmoil and by the fall, the landscape for REITs and the Commercial Mortgage Backed Securities or CMBS business would be completely altered.

property to compete against. But it wasn't to last and the much vaunted securitization of US real estate took a breather as Wall Street cooled on the industry's fundamentals. As stock prices swooned, portfolios were rationalized and the focus switched to "same store" growth.

Over the past year, property cap rates have probably declined some 200 basis points and transaction volumes have

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## Private Capital Looking for returns in hospitality



Spreads widened and literally engulfed a whole group of investors who have since disappeared from the scene. Meanwhile, the momentum investors who had bought into the real estate and hospitality industry story departed as returns from internet stocks and technology companies were going through the roof. Clearly it has been hard for hospitality and real estate businesses to compete with the returns available elsewhere.

But stepping into the breach it seems has been a variety of private sources of capital—private funds, opportunity funds call them what you will, pension funds and even some life insurance companies, all looking to acquire property or take positions in one way or another in the hospitality sector. They are approaching the market a lot differently than the REITs were back in the "old days"—just a couple of years ago. They use leverage differently and expect higher returns. For the REITs of yore it wasn't rocket science—buying property at say nine percent cap rates and paying dividends out at say five percent—a formulae that was hard for others trying to acquire hotel

declined along with them. In the last half of 1998, the hotel property transaction market was off approximately 70 percent and in the first half of this year it has been more of the same.

For buyers who previously had to compete with the currency of public REITs, the passport these days is cash. Once again, cash is King and the focus has switched to private capital.

But while there is plenty of cash in private hands looking for a suitable home, it is apparent that bid/ask spreads between buyers and sellers in the property market remain wide, forestalling any quick return to a fast-moving transactions environment. And with occupancy softening and average room rate growth slowing, values (at least as perceived by buyers) are in decline. But for the trophy property end of the market, where the strategic play will frequently outweigh some of the economic considerations, there has been some activity.

### Private capital

So what is private capital? Well it embraces a variety of sources ranging



from corporate, union and governmental pension funds, to endowments, financial institutions, life companies and high net-worth individuals.

And for many of these sources of capital, there are market players who organize around their needs and form funds of one kind or another to troll the market for attractive investment opportunity. But they can be sensitive about their names. And so while in the really tough times (such as the very early 1990s),

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some were labeled as “Vulture Funds”, taking advantage of the unfortunate predicament of property “owners” (frequently institutions who never intended to end up owning property), they have since tried to gain mainstream respectability. This has largely been accomplished by migrating to such appellations as “Opportunity Fund” or “Private Capital Fund” to be seen as more appropriately positioned for a variety of constituencies. Despite the labels, however, the objectives are generally the same—taking advantage of weakness, arbitraging market dysfunctionalities and generating high returns.

#### Private investment funds

For private investment funds, the pension community is by far the largest source of capital. Pension funds represent huge pools of capital that need to be placed in a balanced portfolio of investments ranging from equities, to fixed income securities and in many instances real

estate. One of the most significant challenges facing pension funds today is actually becoming “fully invested”—that is to say, satisfactorily placing all of their capital in investment vehicles of choice. But pension funds, at least as they relate to real estate investments, generally do not see the deal flow that would provide them with sufficient exposure to a variety of opportunities. They also generally do not have the depth of experience to underwrite deals (especially in specialty

products such as hotels) or have the ability to execute transactions with the speed required in a fast moving market. As a result while they want to participate in the property market, they generally prefer not to lead an investment strategy, particularly one that is counter-cyclical or contrarian in nature.

Finally, pension funds need diversification and so they are typically confronted with two choices when it comes to real estate—either to invest in public REITs or in private funds. As to the former, the pension fund community has undoubtedly not appreciated the volatility of REIT pricing on Wall Street over the last year and so we have seen an increased focus on private funds, where the investment agendas and objectives can be more closely aligned.

While pension funds have dominated the scene, there is still a home in the private fund market for wealthy individuals, but they are few in number. Funds of any significance generally require large minimum investments which for many

individuals represent hurdles that are tough to meet, especially when coping with the balance among investments that most individuals seek. There are signs however, that funds are being organized that will address this issue, and if they are successful one wonders whether this might take us eventually back around to the glory days of property syndications. And with the frothiness in the current stock market, such an outcome is certainly a possibility.

#### Fund management

For today’s managers of investment funds, the environment is quite different than heretofore when management fees were driven solely by how much capital was being managed. But as in the hotel management field, capital providers have become wizened to the ways of the market and have long since ensured an alignment between their own interests (generating satisfactory returns) and those of the manager. As a consequence, today’s fund managers will frequently have equity stakes in the funds they manage and their fees are more tied to returns generated rather than capital managed.

For fund managers, the environment in theory could not be better. Interest rates are low and debt capital is widely available. But the property market is not cooperating. With comparatively high going-in return requirements, property asking prices will need to moderate if the economics are to work on the private side. Fortunately, most private players (at least those organized in disciplined funds) tend to be unemotional about their investments. They typically are in for a short to medium term hold and need to be opportunistic in their approach. They look for a current yield and a clear exit strategy. It is in many respects a return to “core value” investing—a focus on the fundamentals, plain and simple.



### Private capital deals

For the private funds, we find deals occurring with higher end properties and resorts, typically where the barriers to entry remain high. In the limited service sector, while individual or even moderate sized portfolios are less interesting for the private funds, we might see some consolidation plays. This as some organizations that have concentrated portfolios have difficulty coping with the large increases in competitive supply.

### Private investment fund yields

In terms of yields, most funds are still looking for equity yields of 20 percent and higher. And with lower earnings growth expectations, there has been a switch in assumptions and pricing. Whereas say an eight percent going in cap rate coupled with a five percent income growth projection would produce the requisite say 13 percent unleveraged return, the earnings growth assumptions have moderated. With such growth expectations at say three percent (instead of say five), the going in cap rates have had to escalate causing the problems on the buy-side. Quite naturally, many sellers evidently remain unconvinced that their future growth expectations need revising downward.

### Managing the business

In the business-intensive hospitality sector, private capital is consistently looking for strong management. Some private players may in fact prefer to “control” management and will either buy the management entity or find ways to so tightly align the interests as to essentially merge the otherwise conflicting agendas between owner and manager. Most funds like to see “skin in the game” but for those with an exit strategy in mind, too much management company involvement may lead to complication upon an exit that requires property delivered “vacant possession” or without any management contract “encumbrance”.

There is of course much to be said in favor of the benefits that such management brings but these benefits will need to outweigh the financial impacts that can raise cap rates 100—200 basis points leading to downward adjustments in property pricing when selling property subject to a management contract.

### Exit strategies

The exit strategy is important especially to those investors who are holding for the

private capital has exhibited strong interest, it has been largely overshadowed of late by public hotel companies such as Accor, Bass and Canadian Pacific.

### Private capital outlook

In terms of the outlook for private capital investing, our current take on attitudes to the hotel sector is bullish. Most players continue to like what they see in this industry even though their brethren on

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short to medium term. With the public capital market window now effectively closed for probably as long as 12 to 24 months, the holding period for today's private investors may be longer than anticipated unless an exit back into the private capital market is feasible. This of course will be the case for many, providing private investor sentiment holds up. Given the continuing solid profits being generated in the industry, this seems like a reasonable bet. If the public markets do open earlier than expected, this of course would represent an additional upside.

### Foreign capital

While most private investors have focused on the domestic scene, there is a growing play in cross-border capital movements. For some private US investors, Europe has been beckoning particularly in the UK and France and especially in London and Paris. Canada has also produced some interesting opportunities. For foreign investors by contrast, the US market continues to hold strong interest, less so from Asia, where domestic difficulties have kept investors close to home but particularly from Europe and of late from Canada. While

the public side are much more ambivalent. We should therefore expect the volume of private capital investment to increase over the next year as sellers finally settle down and mark to market. And for those within the industry seeking private capital for their growth and development plans, revisiting their capital strategies to include the private capital community should be the first order of business.



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