

HOW TO BUY A HOTEL

An Overview of the
Hotel Acquisition Process



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USA LLC

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Table of Contents

Preface by Jim Butler	iii
About the authors	iv
HOW TO BUY A HOTEL, An Overview of the Hotel Acquisition Process	1
Why are we buying this property?	2
The hotel acquisition process — 10 steps	3
1. Determining acquisition criteria	3
2. Identifying potential acquisition targets	4
3. Assembling the acquisition team.....	5
4. Evaluating potential targets	6
5. Calculating your bid price	7
6. Getting the buyer and seller to a meeting of the minds.....	11
7. Agreeing on key terms of the purchase and sale	13
8. Negotiating the definitive hotel purchase and sale contract ...	20
9. Conducting due diligence	23
10. Closing the hotel purchase	26
Notes.....	27

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Preface by Jim Butler

This guide to the hotel acquisition process traces its roots back to 1994 when Bruce Baltin and I collaborated to create an educational piece to explain the complexities of buying hotels. We wanted to provide a resource with the perspectives of both the experienced hotel consultant and hotel lawyer.

In the intervening years, parts of this work (or its predecessor) were published by ULI in a Hotel Development book, released as articles, used by Bruce in some of his hotel school classes and distributed to clients.

A lot has happened to the “technology” for buying the hotel over the years, and a lot has stayed the same. We thought it was time to update this classic primer and have done so.

We hope there is something valuable here for both novices and veterans as they prepare to take advantage of the projected years of prosperity by participating in one of the most exciting events in our industry – the hotel acquisition process.

Jim Butler

January 28, 2013

About the authors



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Why are we buying this property?

A hotel is a business housed in real estate. It is dynamic. Its market is dynamic. There are no major tenant leases. Every room has to be resold every night. Guests in the hotel's dining and meeting rooms come and go on an hourly basis. Given these circumstances, it is imperative for investors deciding to include a hotel in their portfolio to understand why they are doing so, then make broad assumptions about future market conditions and devise a plan to deal with those conditions.

The first question a buyer should ask is, "Why are we buying this property?" Often, the reasons vary from the pure economics of the deal to the purely emotional. The reality is that many acquisitions are driven, at least in part, by dreams of ownership and emotional incentives, including having a place to visit and/or entertain. Here, we are not trying to imply that there is anything wrong with decisions made for reasons other than economic ones. If one can afford to own a trophy hotel like a piece of art with little or no cash flow yield on his investment, more power to him or her. However, when such a purchase is made, it is important to understand that fact so that financing is not put in place with the expectation that the property will service the debt.

There are as many strategic reasons for buying a hotel as there are willing buyers. One may see the potential for success with a specific type of property (a luxury resort, an all-suite hotel, a limited-service hotel) in a particular location (adjacent to a major demand generator like a theme park, a baseball or football stadium, a university medical center, an industrial park, or an airport). Another may find it advantageous to long-term strategy to have a property in a certain city or a certain part of town, or to be the key amenity for residential, retail and/or office components of a mixed-use project.

The acquisition process begins when investors identify an opportunity, formulate a vision for it, and then proceed to evaluate and possibly acquire the hotel. A prudent buyer requires a thorough acquisition analysis and due diligence process to validate assumptions and avoid surprises. Due diligence may suggest needed deal restructuring or termination of a proposed acquisition. But a prudent buyer will keep an open mind throughout the process.

The hotel acquisition process — 10 steps

Given the complex nature of the interrelated business and real estate components of a hotel, the analysis and process of acquisition can be as complicated or as simple as the potential buyer wants to make it, recognizing that there are practical limitations to the human and financial resources that can be applied to a field of potential purchases. Conversely, there is a real benefit to getting complete information, and the best-informed purchasers usually get the best deals.

Although there can be variations, successful purchasers will typically follow a series of steps in a logical process to acquire a hotel. The steps of this process, each of which will be covered in this article, include the following:

1. Determining acquisition criteria
2. Identifying potential acquisition targets
3. Assembling the acquisition team
4. Evaluating potential targets
5. Calculating your bid price
6. Getting to a “meeting of the minds” with the seller
7. Agreeing on key terms of the purchase and sale
8. Negotiating the definitive hotel purchase and sale contract
9. Conducting due diligence
10. Closing the hotel purchase

1. Determining acquisition criteria

From the purely business standpoint, ownership rationale can vary from active to passive involvement. Some owners position strategically for the short-term, while others take a longer view. In other instances, owners prefer to base their investment on yield or return requirements, which can vary, based on alternative investments available, strategic considerations, and other factors. Decision criteria are unique to each buyer. Among the criteria for deciding upon a hotel or group of properties to purchase are:

- Location
- Property type
- Size of property
- Cost
- Current and potential cash flow yield
- Potential appreciation in asset value
- Risk and stability of earnings
- Upside potential from repositioning, including renovation and/or management changes
- Ability for new competition to enter market
- Ability to replace management and/or franchise affiliation
- Strengths of the buyer in renovation, asset management and/or hotel management

There is no right or wrong answer for each asset or buyer. But no matter what the underlying motivation to purchase a hotel may be, a clearly defined strategy and decision process should be in place before starting the acquisition process.

2. Identifying potential acquisition targets

After the acquisition criteria have been decided upon, the buyer will typically get word into the market that he is interested in acquiring hotels that meet specified criteria. Brokers, asset managers, hotel companies and industry consultants are among those contacted. Often, press releases and advertisements in trade publications and the general business press are used to get the word out.

Once the request for properties has gone out, the buyer will then screen preliminary offerings submitted to him while continuing to network with industry professionals for hints of properties about to go on the market before they are shopped around. The screening process is crucial, as it allows the elimination of numerous properties early on and sets the stage for substantial effort to be expended on other properties. Too often the buyer overlooks the screening step and misses good opportunities and expends unnecessary effort in the long run.

Lacking his own screening team, the buyer will often call upon a team of outside due diligence and acquisition consultants. At this early stage in the process the buyer can “pick their brains” as to their general knowledge of potentially available properties. Using experienced consultants with local market knowledge can materially help both in the screening and in the negotiation and acquisition phases.

3. Assembling the acquisition team

Given the hotel’s dual nature as both an operating business and real estate, an investor should be sure to have the advice of those familiar with the hotel industry. Typically, an investor will assemble a team of professionals who will assist in the overall evaluation of a hotel property. Such a team would include the following:

Broker. The broker may represent either the buyer or seller of a lodging property. The broker typically helps market a property and bring the seller and buyer together. Often the broker helps negotiate and facilitate a sale. A broker’s fee is typically a percentage of the total sales price.

Appraiser. Since the experience of potential appraisers can vary widely, it is advisable to select an appraiser who has appraised either similar properties or properties in the market in question.

Accountant. An accountant’s review of the property’s books and record will determine whether funds have been properly applied and whether financial controls and reporting systems are adequate.

Market & financial consultant. A market and financial consultant is called upon to ascertain how a property might perform and what it would take to achieve desired profit or investment goals. Such consultants evaluate prevailing market conditions, prepare projections for both the market and the subject property. The market and financial consultant can also review revenues and expenses and assist in assembling the business plan.

Hotel attorney and legal consultant. Attorneys specializing in hotel work can help formulate the acquisition strategy or game plan, assist in identifying and coordinating acquisition team members, spot “show stopper” issues, advise on terms and structure of transactions, and assist in legal due diligence issues from the significance of pending or threatened litigation and regulatory matters to contracts and title issues. At a minimum, the contracts and issues will likely include hotel management and franchise agreements, labor and employment, land use, entitlement and zoning, real estate, tax, corporate, environmental, ADA, trademark and other regulatory matters. In other situations litigation, bankruptcy, timeshare and other specialties may be critical. Lawyers with hotel experience can document and close what is generally not a “vanilla” real estate deal, but the purchase and sale of a complex operating business intertwined with special purpose real estate.

Architects/Designers. If the acquisition is to involve renovation or upgrading of the property, the architect will be responsible for reviewing the specifications set forth by the owner. In addition, an architect can coordinate the activities of other members of the team who will be responsible for the physical property, such as the engineer and interior designer. The architect can review existing and potential compliance with all building codes as they apply to the existing property and as they will apply to any planned renovations.

Engineer. A qualified engineer or team of engineers should review all the physical components of the property, including mechanical, electrical, plumbing, and structural elements.

Others as needed. Managers, environmental consultants, and others may be required.

4. Evaluating potential targets

Many properties will be weeded out during the initial screening process, based primarily on review of submitted offering packages, the buyer’s or consultant’s knowledge, and the acquisition criteria itself. For those properties that pass this initial screening, the next

step is usually a site visit or a property inspection at which point another “go/no-go” decision will be made. Properties that reach the inspection stage will require a preliminary property and market analysis. The next decision, based on the analysis, will be to develop a bid price and business plan, or to eliminate the property from consideration.

5. Calculating your bid price

Perhaps the most significant element in the buyer’s calculation of a bid or purchase price is the analysis of the potential earnings to be derived from the hotel. In many purchases, it’s the only element. To develop the proposed acquisition price, the buyer must make assumptions as to future market conditions and the hotel’s performance within that market. These assumptions will be reflected in a discounted cash flow or stabilized operating projection. Thus, a preliminary business plan which reflects assumptions as to physical facilities and condition, management, affiliation and other factors must be developed in order to assess the potential acquisition realistically.

Make the business plan realistic. We have seen too many buyers fail to achieve their investment goals because they fell short in developing the business plan. Have realistic expectations as to the amount, scope and timing of renovations and their impact on short- and long-term operating results. If you plan a repositioning, lay out all the details of things you plan to do, how you are going to do them, and the time that will be required.

Because your bid or purchase price is based upon a calculation of anticipated revenues and expenses, the due diligence process is critical to validate or gain comfort with your assumptions on these cash flow analyses, and to avoid unnecessary surprises.

Understanding the market

You’ve gotta have a plan. Markets change. Change is driven by many factors within a market, including the growth or decline in the supply of hotel rooms, shifts in market segmentation, and the renovation or repositioning of competitive hotels. The prudent hotel buyer will study property and market dynamics and will not purchase a hotel property without a detailed plan to produce the expected return on investment over time. This plan will be based upon an analysis of historical market performance, expectations for the growth in the

supply of competitive hotel rooms, and the growth in demand for hotel rooms by market segment (commercial, leisure, group, etc.) by guest demand for hotel rooms at the projected rates, and guest demand as to facilities, design concepts, amenities and services.

Analyzing the potential of the target hotel and its market. The following table sets forth an example of the results of analysis of potential market performance. It presents a detailed picture of the historical and projected performance of the competitive market for our subject hotel and of the historical performance of the hotel within the market. It further provides a framework for quantifying assumptions as to the future performance of the property based on anticipated actions.

	Year	Average Daily Rooms				Occu-pancy		Average Daily Room Rate		Pene-tration	Yield
		Available		Occupied		MKT	SP	MKT	SP		
		MKT	SP	MKT	SP						
historical	2010	1,500	300	945	165	63%	55%	\$81	\$74	87.3%	79.8%
	2011	1,500	300	1,005	168	67%	56%	\$83	\$74	83.6%	74.5%
	2012	1,500	300	1,065	174	71%	58%	\$85	\$74	81.7%	71.1%
projected	2013	1,500	300	1,097	xxx	73%	xx	\$88	xx	xxx	xxx
	2014	1,650	300	1,163	xxx	71%	xx	\$88	xx	xxx	xxx
	2015	1,700	300	1,186	xxx	70%	xx	\$89	xx	xxx	xxx
	2016	1,700	300	1,210	xxx	71%	xx	\$92	xx	xxx	xxx

MKT = Market

SP = Subject Property

Penetration is defined as the share of demand received by a given property relative to its share of supply; i.e., in 2010 the subject received 17.5% of demand (165/945) relative to 20% of supply (300/1500). $17.5\%/20.0\% = 87.3\%$ penetration. A shortcut is to calculate the subject's occupancy relative to the market's ($55\%/63\% = 87.3\%$).

Yield is a property's RevPAR divided by that of the market, reflecting a property's relative position both as to occupancy

and room rate. RevPAR is derived by multiplying Average Room Rate by the Occupancy Percentage; e.g., in 2010, market RevPAR was \$51.03 ($\$81 \times .63$) and subject RevPAR was \$40.70 ($\$74 \times .55$). \$40.70 divided by \$51.03 results in a yield of 79.8%.

In this example, relatively strong growth in demand has occurred over the past several years, as is typical of a market emerging from recession. Demand is projected to grow at more modest levels over the next several years, with the exception of the year in which a new hotel is added to the market. (New hotels in a strong market often create induced demand or accommodate otherwise unsatisfied demand). Average rate has grown modestly and is projected to continue to do so, except while new supply is being absorbed.

The subject property's occupancy and rate have both grown at below-market levels, resulting in the declining penetration and yield. The challenge for the buyer's team is to determine the specific causes of the declines in yield and penetration and devise and test a plan to reverse them, if possible, so as to realistically project future penetration, yield and cash flow.

Other factors to consider. Given market dynamics, the buyer's analysis and plan will consider the quality and condition of the following, which are the basic components of any hotel performance:

Facilities

- Design concept
- Configuration
 - Mix of guest rooms and suites
 - Restaurants and lounges
 - Banquet and meeting space
 - Recreational facilities
 - Parking
 - Other facilities
- Materials used relative to maintenance and durability

- Compliance with current and proposed building and other codes

Identification

- Name
- Franchise or brand affiliation, evaluated in light of its contribution in terms of number of room nights and price/value perception

Whether retaining the current brand or changing to a new one, there are going to be costs involved including transition costs, if applicable, and costs related to a PIP (Product Improvement Program) demanded by an existing brand or new brand. To the extent that a PIP can be identified and priced out prior to the bid being made, the offer can be more realistic.

Management

Successfully matching an operator and hotel can be one of the most important factors determining your hotel's optimal value, gaining access to financing and achieving operational success. It is widely recognized that the business and legal terms of the hotel management agreement -- wholly apart from the operator's abilities -- can add or subtract 25% of the nominal value of the hotel, or more. Take a hotel nominally worth \$100 million. By this industry rule of thumb, the hotel's value could easily swing \$50 million (from \$75 million to \$125 million) depending on the operator and the management contract terms. We have seen it make even bigger differences.

So one of the most important issues to analyze on your acquisition -- particularly if the hotel is subject to a long-term branded hotel management agreement is: Is the management company well-suited to the needs of the property vis-a-vis quality, operating culture, cost control and marketing strengths? What are your abilities to terminate the management company if it is not well-suited? How much will it cost? Can your seller terminate and deliver the property to you unencumbered by management (or franchise)? How

does this affect your business plan for the property?

Capital structure and financing costs

What does every component of your capital stack (debt and equity) require in terms of interest or return on investment? How will the investment measure up in providing the required returns?

Calculating how much you can pay for the hotel

After reviewing historical and projected market performance, along with the historical performance of the subject property relative to that market, the potential buyer will evaluate and plan for each of the foregoing issues. The result will be a set of assumptions as to future market performance, a plan of action for the property, and a set of cash flow projections resulting from that plan. The cash flow projections, including assumptions as to capital expenditures and reserves, financing costs, an exit strategy and disposition price, will then be discounted back to a present value at a discount rate that meets the buyer's return requirement. In this way, the buyer establishes the price he or she is willing to pay for the property.

Taken as a whole, the analysis outlined above, will help the buyer determine how next to proceed: whether an appropriately priced purchase represents a turnaround opportunity with great upside potential, or whether the hotel has already reached its maximum earnings level, thus posing a significant downside risk to the investment.

In determining an offering price for the property, the prudent buyer will consider the foregoing discounted cash flow analysis, the historical earnings of the property, and the sales prices per room being achieved for comparable hotel sales in the marketplace. The relationship of the offering price to the discounted cash flow analysis is often dependent upon the strength of the market, the buyer's and seller's relative positions, and other market factors. The stronger the seller's market, the higher the offer price, and vice versa.

6. Getting the buyer and seller to a meeting of the minds

Once the buyer makes the initial offer, negotiations begin. The

resulting process will either wind up with the buyer and seller coming to a meeting of the minds on the purchase price and continuing into discussions about the definitive agreement, or the negotiations will be broken off.

Once an agreement to purchase has been reached -- at least an agreement in principle as represented by a signed letter of intent or term sheet, the buyer will often summarize for internal approval or other purposes the analysis which led to the decision. The resulting investment memorandum may include the following:

- Property description
- Market summary, past and projected
- Projected profit and loss and cash flow statements for the property, with a business plan and key assumptions as to:
 - Management style
 - Affiliation
 - Marketing
 - Operating revenues and costs during the holding period
 - Capital expenditures, with schedule and major categories
 - Financing
 - Exit strategy, including timing and projected value
 - Other elements of any proposed repositioning

This document can then be updated or revised throughout the due diligence process, with the final version being used during the operations transition and beyond.

In any event, as soon as there is an agreement in principle between buyer and seller, or even as a part of the offer and negotiation process, the parties will often negotiate a letter of intent or term sheet as an interim step to negotiating the purchase and sale agreement. With or without a letter of intent or term sheet, the purchase and sale agreement process has begun.

7. Agreeing on key terms of the purchase and sale

After a tentative agreement to buy and sell has been reached, the process of negotiating the major terms of the purchase and sale agreement can begin. Successfully negotiating and preparing a contract for the purchase or sale of real estate requires a thorough understanding of the objectives of the buyer or seller, the legal and tax situation, the character of the property and the interests of third parties, including lenders, brokers, unions and others, who may require contractual provisions for their protection even though they are not parties to the contract.

Because the purchase and sale of real estate involves the investment of a substantial sum of money and the transfer of valuable assets, the parties and their professional advisors should negotiate the terms of the transaction with great care and precision.

Detailed discussion should include the following crucial business elements of the deal:

- The purchase price and any adjustments
- Third-party financing, whether existing at the time of the transaction or to be arranged by the buyer
- Purchase-money financing by the seller
- Condition of the premises
- Limitations on title and possession
- “No shop” or “stand still” provision
- Default by either party
- Indemnifications
- Items included and excluded from the purchase price
- Prorations

The business nature of hotels dictates that a great many assets other than pure real estate would be included to make it a going concern. Likewise, the negotiation of the transaction and the items included and excluded have a substantial impact on the flow and cost of transition from old owner to new owner.

Assets being purchased

As a general rule, hotel assets include the following:

Current Assets

- Cash
- Accounts receivable
- Prepaid expenses
- Securities
- Inventories of food and beverage *
- Inventories of supplies *
- Printing and stationery *
- Other current assets *

Property and Equipment

- Land *
- Building and improvements *
- Furniture, fixtures and equipment *
- Linen, china, glassware, silverware and uniforms *

Other Assets

- Organizational costs
- Pre-Opening expenses
- Other deferred charges
- Deposits *
- Licenses and permits *

The above items tagged with the “*” are those assets that a buyer would normally want included in a hotel purchase. Of these, a distinction is sometimes made between those in use and those in storage. Nevertheless, a buyer would want a sale price to be on a going concern basis, including all of the foregoing, plus assignment of leases and contracts, each at the buyer’s option, as well as all advance deposits not consumed by the date of closing.

Non-financial assets are also a consideration in a hotel acquisition. Accounting books and records, operating statistics, employee records, sales and marketing files, licenses and permits and numerous other items are required to keep a hotel going. The hotel buyer should be certain to have his attorney and operational advisors assist in making sure that the purchase terms will ensure a smooth transition of operations from seller to buyer.

Price

The final sales price is often affected by negotiations involving other terms in the purchase and sale contract. For example, the purchaser will at times pay a higher price if the seller is willing to provide purchase-money financing. Other factors that can influence final sales price are the amount of the earnest money deposit, the amount of time over which cash payments can be spread, and whether or not an existing mortgage can be assumed. Other considerations that may affect final sales price include the track record and financial strength of the purchaser, the speed with which the transaction can be completed, and what is being purchased (e.g., receivables, claims, other intangibles). The price may also be affected by the results of buyer's due diligence, and adjustments required as a result.

Existing management or franchise affiliation

When a hotel is subject to a hotel management contract, the contract should be examined by counsel to determine ability to assign, terminate or otherwise deal with it. When the purchaser desires a new operator, the parties must resolve the ability to terminate and address related issues of canceling the management contract. In some instances, the contract can be terminated by paying a cancellation fee. Generally, when a hotel is sold without the requirement that the existing management be retained, the sale price will be higher than it would be if the operator were to remain.

Similar considerations apply to a hotel franchise or license agreement.

Contingencies

In situations where the seller is the present management company operating the property, and the purchaser wants the management company to remain in place, the seller may offer cash flow guarantees

or take back purchase-money financing, which essentially pays out the purchase price over time. Such arrangements generally create a higher selling price and make it easier for the purchaser to put together the overall financing.

When a buyer enters into a purchase and sale contract, a sizable money deposit is usually made to demonstrate the purchaser's commitment to closing the transaction. If the deal is not completed, the buyer may forfeit all or a portion of the deposit. To reduce the risk of losing the deposit, the purchaser usually negotiates a set of key terms involving various contingencies that allow the purchaser to back out of the transaction with the return of all or a portion of the deposit.

Some of the more frequently used contingencies include any inability of the purchaser to:

- Obtain specified financing
- Transfer or obtain a specified franchise affiliation
- Obtain specified licenses or permits (particularly a liquor license)
- Approve results of complete due diligence within a specified period of time
- Obtain clear legal title to the hotel's real property

In a seller's market (where the seller has a choice among many competing buyers), the seller usually agrees to encumber a transaction with one or more of these contingencies only when offered inducements such as a larger and/or nonrefundable deposit, a higher price or other more favorable terms.

Use a letter of intent (LOI), or go straight to definitive binding agreement?

The LOI advocates. One school of thought holds that a letter of intent is the best way to get agreement for the purchase and sale of a hotel property. These advocates believe that the letter of intent's more streamlined focus on only the key deal terms (without the distraction of other details) will flush out whether or not a deal can be done. And once the basics are agreed to, the letter of intent provides a good outline for the first draft of the definitive agreement of the purchase and sale agreement (sometimes just called a PSA).

They argue: Why get bogged down in a long agreement with all the details of secondary issues if there is no agreement on price and critical closing contingencies? Why even start on the seller's representations and warranties (and limitations on such representations and warranties) if you can't agree on fundamental deal terms?

Most parties do not intend their letter of intent to be a binding contract. Nevertheless, the letter of intent can be a binding contract if that intention is indicated and sufficient terms are specified. It lays out the basic terms of the agreement. It also serves as an obligation on the part of both the buyer and seller to work in good faith to complete the transaction. After the letter of intent has been accepted by both parties, the buyer must perform tasks of due diligence and must obtain financing. Negotiations regarding the final form of the purchase and sale contract should be ongoing throughout the entire process. When the content, structure and schedule of the transition are agreed upon, the closing takes place at the specified time.

Representative items covered in an LOI. The following is a list of representative deal points that might be included in a letter of intent.

Property description. A description of the property being sold or leased. This is not a legal description, but is sufficiently detailed so that both parties understand the nature of the transaction.

Selling price. A description of the price and terms of the transaction and the financing structure.

Due diligence. The purchaser is allowed to perform a certain amount of review, documentation, and analysis of the property. The seller will give the purchaser access to its property for such matters. If any of the diligence is invasive (such as an environmental phase 1), the buyer generally will be obligated to repair any damage to the property.

Contingencies. Specific circumstances that allow one or both of the parties to void the deal.

Seller's representations. Representations that are made regarding the owner's legal ability to complete the

transaction.

Dates for certain performance. Dates or time periods may be specified for executing a binding purchase contract, making deposits, having deposits go “hard” (nonrefundable), and closing dates.

What protection does a non-binding LOI offer a buyer? Unless the letter of intent provides otherwise (and the provision is stated to be binding), even when the letter of intent is executed, the seller is generally free to continue marketing the property and negotiate with other interested investors. The would-be seller and buyer must make both make a good faith effort to conclude the transaction. Ethically, this restricts the seller only to a limited extent.

Nevertheless, even when non-binding (as most LOIs are), letters of intent may serve a number of important and legitimate purposes:

1. The letter of intent permits the parties to focus on the most important terms to see if they have agreement on these before getting bogged down in detail.
2. If one of the parties is an institution or investment group, a policy may require a letter of intent before negotiations can proceed (in order to minimize legal and other expenses or to minimize the risk of undue publicity if the transaction fails to close).
3. If the transaction is to be financed by the public issuance of securities, the underwriting concern may require a letter of intent as a “comfort document” to justify the time and expense in a due diligence investigation.
4. In a complex negotiation that may take many months to complete, a letter of intent may prevent misunderstandings by identifying the purposes of the parties at the inception of the negotiation.

Should the LOI be binding or non-binding? Depending upon the language used and legal doctrines that may apply, the letter of intent can be (1) binding, (2) non-binding, or (3) partly binding and partly non-binding. The typical letter of intent attempts to detail only the most important deal points to be sure the parties have fundamental agreement of the big issues before they proceed with due diligence and definitive contract negotiation.

When a letter of intent is intended to be non-binding in its entirety, it is usually just a preliminary step used to confirm a meeting of the minds on key terms before expending more time and money on due diligence and documentation. A binding letter of intent can be dangerous, because any party may be able to compel the other party to perform without agreement on the details that are usually worked out in the final definitive agreement. However, a letter of intent is often intended to be binding only in certain regards and otherwise non-binding.

This is the case where the parties want to postpone negotiations of the details to the definitive agreement stage (after they have agreed on price, timing and other key terms), but want certain provisions to be binding, such as a forfeitable deposit by buyer, confidentiality provisions, or a “no shop” provision (preventing the seller from negotiating with others while the buyer completes due diligence, and the parties negotiate the definitive agreement). For example, sometimes a buyer will get the seller’s binding agreement to “stand still” (and not sell to anyone else) during a limited period of time (say 30 days) while the buyer conducts due diligence. If due diligence is satisfactorily concluded, the letter of intent may provide some additional period within which the parties must negotiate and execute a definitive purchase and sale agreement.

The language of the letter of intent is very important in determining what provisions, if any, are binding and what provisions are non-binding. Parties should be advised by counsel whether they want a letter of intent to be binding in whole or in part, or to be non-binding in whole or in part. For a letter of intent to form a binding contract, it should expressly state that intention and it must also specify sufficiently the material terms of agreement such as parties, subject matter, price, and terms. If the parties want a letter of intent to be non-binding, that intention should also be clear. But in many states, the law will imply conditions on the parties that they may not have intended or understood.

For example, a buyer or seller may believe a letter of intent is non-binding, but may not be free to walk away from the deal without negotiating in good faith with the other party to consummate the transaction. If the parties want to be able to terminate at any time without damages, then a clause should be added to that specific

effect. Similarly, since a buyer may expend substantial money in due diligence, he should understand what rights, if any, he has to force the seller to proceed with the sale.

The definitive agreement advocates (anti-LOI). In contrast to the advocates for using LOIs, another school of thought holds that a letter of intent just wastes time that could be better spent in negotiating a binding definitive purchase and sale agreement (or PSA) with appropriate “outs” or conditions such as satisfactory due diligence, obtaining financing, obtaining necessary regulatory approvals, and other such matters.

Under this approach, the parties execute a binding agreement of purchase and sale and simply provide that the agreement may be terminated (with or without payment of certain sums) in specified events prior to the expiration of the due diligence period. Once under binding contract, a buyer may have greater comfort in spending the money required to complete due diligence, obtain financing, and take the other steps necessary to buy the property. The downside of this approach is the time and money required to negotiate the agreement without the certainty that the diligence results will be satisfactory or that other conditions will be satisfied.

There can be merit to both schools of thought, depending on the circumstances.

8. Negotiating the definitive hotel purchase and sale contract

The final purchase and sale contract negotiations should lead to a document with all the terms and conditions of the transaction. The issues covered in the purchase and sale contract include all those in the letter of intent and many other details that are typically not included in a letter of intent, particularly representations and warranties, indemnifications, and closing conditions.

Hotels are complex operating businesses, integrally intertwined with special-purpose real estate. Parties to a purchase and sale agreement should be advised by experienced hotel lawyers who have a long track record of getting deals done.

Typical provisions in a purchase and sale contract deal with the

following matters:

Purchase price. The purchase price and its composition (relative to equity and debt), and when and how it will be paid (i.e. upon closing, in installments, etc.)

Earnest money or deposit. The amount of the deposit and circumstances under which it would be defaulted or returned. Sometimes there is an initial deposit on signing the PSA (or opening an escrow) and additional deposits as conditions are waived or approved (such as due diligence approval).

Real and personal property being sold. A description of what the buyer is getting -- the real and personal property being transferred.

Business assets being sold. A listing of the various licenses, contracts, franchises, and other miscellaneous and intangible personal property that are being transferred with the real property.

Due diligence. The review of the property and other aspects of the transaction made by the purchaser and the conditions and limits imposed upon the transaction. The contract should detail the period of time during which this should occur and the rights and obligations of each party.

Terms of purchase financing. The terms of the mortgage involved in transactions in which the seller takes back purchase-money.

Title commitment and survey/search. The specifications for the type and quality of title the purchaser is willing to accept.

Seller's deliveries. The data and information that must be given to the purchaser by the seller and the time by which it must be provided.

Employee issues. Potential liability for past employment

practices for the seller and/or future employment practices of the buyer usually motivate both parties to formally terminate all employees at the closing, with the buyer interviewing and rehiring (often on a probationary basis) most of the hotel's staff.¹

Seller's representation, warranties and covenants. The statements and promises made by the seller to induce the purchaser to buy the property. From the buyer's perspective, the purpose of the seller's representations and warranties is to cause the seller to disclose those facts that, together with ordinary due diligence, are sufficient to allow the buyer to make an informed purchasing decision. Representations and warranties in purchase agreements typically cover 3 general areas: (a) the seller, (b) the purchase agreement and (c) the status and condition of the property and the business being sold.

Representations and warranties of purchaser. The statements and promises made by the purchaser to induce the seller to sell the property.

Indemnifications. If any party breaches the representations and warranties of the agreement, what are the indemnification obligations and limits? Is there a minimum amount of claims in certain categories (or "buckets") before indemnification becomes effective? Is there a maximum or cap on the amount of indemnifications? Must claims be made within a year or some other time period proscribed by the agreement? Are consequential damages waived?

Prorations and adjustments. The specific prorations of the current revenues and expenses between the purchaser and seller.

Closing. The date, time and place of closing.

Closing documents and procedures. The various documents needed to close the transaction as agreed to by both parties. The closing procedure must also be approved

by both parties.

Closing expense. The agreement reached on the allocation of closing expenses between the purchaser and seller.

Eminent domain and risk of loss. The details of what occurs if the property is taken by eminent domain (condemnation) or a casualty loss while the hotel is under contract.

General clauses. General housekeeping contract clauses, usually including matters such as the selection of the law that governs interpretation and enforcement of the contract.

9. Conducting due diligence

Particularly in the context of a hotel acquisition, “due diligence” generally refers to the investigation conducted by a potential buyer of the hotel that is the target of the acquisition. The investigation covers both the physical asset (i.e. the hotel structures, parking, systems, equipment, inventories) as well as the operating business conducted at the hotel facility, and the relevant markets and environment.

The purpose of the investor’s due diligence is to understand and evaluate the potential investment in the hotel. It is the analytic review of the real and personal property, the business operations and potential of the specific hotel. This effort all seeks to validate the investor’s reasons for buying the hotel and to avoid surprises after the purchase has closed.

Perhaps the most significant element in the buyer’s calculation of a bid or purchase price is the analysis of the potential earnings to be derived from the hotel. To develop the proposed acquisition price, the buyer must make assumptions as to future market conditions and the hotel’s performance within that market. These assumptions will be reflected in a discounted cash flow on stabilized operating projections. Thus, a preliminary business plan which reflects assumptions as to physical facilities and condition, management, affiliation and other factors must be developed in order to assess the potential acquisition realistically.

Because the buyer’s bid or purchase price is based upon a calculation of anticipated revenues and expenses, the due diligence process is

critical to validate or gain comfort with your assumptions on these cash flow analyses, and to avoid unnecessary surprises. Unforeseen expenditures to replace leaking window systems, replace boilers or cooling towers, demolish a portion of the hotel which encroaches on adjoining property, or meet a new property improvement program from the brand -- these can all play havoc with the purchaser's expectations if they weren't anticipated.

Any letter of intent or purchase and sale agreement should provide that the purchaser's obligations are subject to buyer approving satisfactory results from the due diligence investigation. A due diligence review would typically deal with the following items:

- Audited balance sheet (for last 5 years).
- Annual audited profit and loss statements, with full supporting schedules (for last 5 years).
- Current year-to-date profit and loss statement with comparison to previous year.
- Monthly profit and loss statements, with full supporting schedules (for last 3 years).
- Occupancy and average daily rate (for last 3 years).
- Capital expenditures for the last 5 years, with current projections for expenditures.
- All architectural & engineering plans and specifications.
- All inspection reports, including health, fire, building and elevator.
- Copies of all studies, including all recent appraisals, market studies, environmental, engineering reports and marketing plans.
- List of all tenants, rent rolls, deposits and term of lease.
- Inventory of FF&E, supplies, consumables and inventories.
- Real and personal property tax bills for the last 3 years.
- Schedule of all insurance coverage, including cost and expiration.
- The legal property description.
- Copies of all material contacts, particularly including

hotel management agreements, hotel franchise or license agreements, employment agreements, union agreements (collective bargaining agreements or CBAs), leases, service contracts, licenses, permits, and any documents evidencing obligations that the purchaser is expected to assume.

- Copies of all trademarks, trade names and copyrights.
- Copies of all notes and mortgages currently encumbering the property.
- Details of any administrative action or litigation threatened or pending against the hotel.
- Estoppel letters from any mortgagors (lenders) and tenants.
- A list of employees, including name, position, salary, benefits, together with the employee's employment file.
- A list of future reservations and bookings, including name of party, deposit received, rate guaranteed, dates and status.
- List of all purveyors and sources of supplies and services.

Tasks performed during the due diligence process include:

In-depth market demand analysis. Validating or refining the assumptions used in the business plan.

Legal analysis. An investigation by an experienced hotel lawyer of all the property's contracts, licenses, permits, franchises and other documents to determine any potential adverse provisions and whether they can be transferred from the seller to the buyer. In addition, a legal review would typically analyze issues such as ADA, environmental, land use, entitlement and zoning, labor and employment, employee benefits and liabilities (such as unfunded pension plan liabilities), title, intellectual property and other such matters.

Financial audit. An independent audit performed by an accountant or firm with experience in the hospitality industry.

Engineering inspection. A detailed study of all physical

components of the property, including mechanical, electrical, plumbing, structural elements, telephone systems, computer systems and items of decor.

Environmental inspection. A detailed inspection made by a qualified environmental engineer to disclose any potential environmental hazards that may exist on or within the property site.

Title search. A review of the various factors that could affect the title to a property. The title search should be performed by either an attorney or title company. The results of the title search should be reviewed and evaluated by an attorney.

Property tax verification. A search into the current status of the tax assessment imposed on the property. When a hotel property is sold, the local taxing jurisdiction is likely to investigate the terms of the sale and possibly adjust the property's assessed value upward to reflect the sale price. A new assessed value could adversely affect the property's future cash flow. A property tax verification performed by a knowledgeable property tax consultant will provide an accurate estimate of future tax liabilities. The property tax consultant can also assist in minimizing an upward adjustment made by the assessor.

10. Closing the hotel purchase

The closing of a hotel transaction involves the actual transfer of title of the hotel from the seller to the buyer. Generally, when the buyer will either manage the hotel itself or bring in a new hotel operator, the closing coincides with the takeover of operations by the new operator. The parties likely to be present at a closing include:

- Seller and seller's attorney
- Buyer and buyer's attorney
- Lender and lender's attorney
- Title company
- Real estate broker

The activities that take place at a closing include (1) accounting to

allocate and prorate the property's revenues and expenses and (2) a physical inventory of all the assets included in the purchase price. Any items to be transferred that are not included in the purchase price must be inventoried and valued in accordance with the terms of the purchase and sale contract.

After the necessary allocations and prorations are calculated, the mortgages and notes are signed and the requisite moneys are transferred among the parties. Once this process is concluded, the buyer holds title to the hotel.

Notes

¹It is usually preferable for the seller to officially terminate all employees on the day of takeover and for the buyer's new entity to interview and hire them on a probationary basis. At the same time, an analysis can be made of medical and health benefits, pension and retirement plans, vacation and sick day entitlements. If appropriate, the buyer may choose to allow all employees to carry their benefits forward as if no sale had taken place, with an accounting between buyer and seller for the accrued liabilities for vacation, sick days and retirement assumed by the buyer. Legal counsel can help a buyer avoid unintended "successor liability" for employment practices of the seller or its predecessors. Legal guidance is particularly important where a hotel is the subject of union contracts, union organization activity or some unique plant closing laws (such as can be found in Hawaii). These matters can also be affected by the hotel management agreement.

\$35.00

HOW TO BUY A HOTEL

In *How To Buy A Hotel, An Overview of the Hotel Acquisition Process*, Jim Butler and Bruce Baltin use their decades of practical experience in advising hotel buyers and sellers to offer a comprehensive overview of the hotel acquisition process.

For professionals who are involved in only certain aspects of hotel acquisitions, this booklet provides a perspective-broadening narrative exposing the entire process of buying a hotel – from identifying the opportunity to calculating the price, and from due diligence to closing the deal. Veteran hotel buyers will want to share this perspective with new team members. It will be a great starting place for them to move into real deals. It has been used for more than 15 years to prepare hotel school students to deal with this important aspect of the hotel industry in the real world.

Hotel lawyer Jim Butler and hospitality consultant Bruce Baltin provide a straightforward, comprehensible account of a complex process that often includes high stakes for all involved. The authors' objective is not to provide a deep exploration of the many issues that arise when buying a hotel, but to broadly educate members of the hospitality industry – whatever their level of experience – who keep hotel deals moving.

For more information, visit Hotellawyer.com or pkfc.com

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