

**28th
Annual**



MEET THE MONEY[®]

National Hotel Finance &
Investment Conference

PRIVATE EQUITY STRATEGIES WORKSHOP

**Hyatt Regency Hotel
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CAPITAL ADVISORS

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, in line with market assumptions
- Analysis of competitive hotels and markets, using Smith Travel data and individual research to evaluate performance against and benchmark vs competition
- Careful and 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 Sponsor's promote be deferred until the Investor has received some multiple on its original investment.
- **Clawbacks:** Provisions ensure that the Sponsor is not over compensated relative to the intended business arrangement.
- **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 not adhering to budget limitations), nonfeasance (i.e., sponsor’s failure to act), or failure to meet a standard of investment performance. This is particularly troublesome for the sponsor if the sponsor guarantees 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 this kind of investment?
- **Infrastructure:** What resources does the Sponsor have on payroll? Can they handle this kind of investment?
- **Alignment of interest:** Level of sponsor investment (depending on size but usually 5-10% of Equity invested)
- **Financial returns:** Internal Rate of Return, Equity Multiple, Total Profit, Cash on Cash return, Net Present Value
- **Location:** What markets, where positioned in the 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
- **PIP Management:** Experience with small and large PIPs and renovation process management
- **Lender Profile:** References from lenders, repeat business, good borrowing history

PARTNERSHIP – JOINT VENTURE

- **Managing Member / General Partner:** Responsibilities
- **Major Decisions:** Will be clearly defined; 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:** Specifies 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 IRR's
 - Willing to accept 15-18% levered IRR's in top markets or more trophy-like assets
- Preferred equity is structurally senior to common equity or sponsor and as such commands a lesser return; 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 is more attractive to certain investors on a risk adjusted basis
- Preferred Equity is looking for opportunistic returns
 - Targeting 10-17% levered IRR's
 - Willing to accept 12-14% levered IRRs in top markets
 - Expecting mandatory redemption usually after 3-5 years

CAPITAL CONTRIBUTIONS

- Partnership Agreement will specify the percentages that each partner is required to contribute
- Future contributions may be made on a pro rata basis in line with the equity percentages
- If one partner does not fund when required, the other partners can often times fund the necessary amount and will dilute the equity percentage of the non-funding partner
 - Usually dilution will be punitive
 - Dilution may be in the form of a loan to the partnership which takes priority in repayment

POTENTIAL SPONSOR FEES

Fees may be earned by Sponsors for the following:

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

IMPACT OF FEES

- Fees to the Sponsor may cause misalignment of interest depending on each partner's Equity Investment amount
 - Equity investment of Sponsor net of fees may be minimal
- Fees are usually not considered in the cash flow calculation for purposes of calculating an IRR to the Limited Partner as the fees are normally paid to the Sponsor / Managing Partner

WHAT IS A WATERFALL?

A Waterfall is the order in which available cash flows are distributed to partners in the venture

- 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” and 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 JV 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

What is the current range of preferred and promoted returns 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, you might see different preferred/promoted structures that look like the following:

Equity Invested	Hurdle			Promote		
	1 st Tier Pref	2 nd Tier Pref	3 rd Tier Pref	1 st Tier Promote	2 nd Tier Promote	3 rd 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

Promote Structure

- The following illustrates the promote structure for the equity partnership (90.0% LP Partner Equity, 10.0% GP Equity)

The distributions are:

- First, pari passu until the achievement of an 10.0% preferred return to the GP Investor and LP Investor, and thereafter a 15.0% promote to GP Investor
- Second, pari passu until the achievement of an 15.0% preferred return to the GP Investor and LP Investor, and thereafter a 25.0% promote to GP Investor
- Third, pari passu until the achievement of an 20.0% preferred return to the GP Investor and LP Investor, and thereafter a 35.0% promote to GP Investor

	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>
LP Cash Flow						
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
LP Returns						
Total Profit	\$16,484					
IRR	20.9%					
NPV (15.0%)	\$2,985					
Equity Multiple	2.49x					
GP 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
GP Returns						
Total Profit	\$6,458					
IRR	45.2%					
NPV (15.0%)	\$2,630					
Equity Multiple	6.26x					



CASH FLOW SPLITS

Many joint ventures have a cash flow distribution structure which specifies cash flow splits

The language in the Distributions section of the JV 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 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 Joint Venture Agreement

GUARANTEES

Guarantees required may include:

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

GUARANTEES - continued

- 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

MAJOR DECISIONS

- Day to day management of the hotel is generally handled by the Sponsor pursuant to an approved operating and capital budget
- The JV 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
- There is often times 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

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

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