HVS CAPITAL CORP

HVS CAPITAL CORPORATION

Full-Service Investment Banking for the Hospitality Industry

HVS CAPITAL CORP

Hospitality Financial Structures Presentation

"The Investment Decision"

September 26, 2012
Hospitality Business Real Estate Investment and Development Class
William G. Sipple

HVS CAPITAL CORP

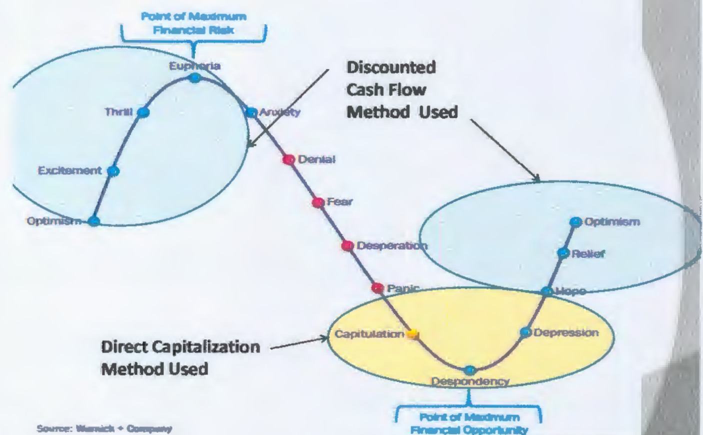
Agenda

- ✓ Asset Valuation
- ✓ Real Estate Cycles
- ✓ Capitalization of Hotel Assets
- ✓ Loan Types
- ✓ Restructuring versus Refinance
- ✓ Equity Sources, Costs and Structures

HVS CAPITAL CORP

Approaches to Valuation

- **The Income Approach (whether Cap Rate or DCF)** is the preferred approach to valuation as it most closely reflects the economic analysis employed by typical buyers and sellers. There are various weaknesses associated with the other two approaches.
- **Sales Comparison Approach** – no sale is the same and too many adjustments to variables (property condition, time of sale, financing conditions at time of sale, location, market orientation, etc.) need to be made to make the approach reliable.
- **Cost Approach** – Knowledgeable buyers of hotels generally base decisions on economic factors. Cost Approach does not consider such factors and requires numerous adjustments for subjective depreciation estimates.



HVS CAPITAL CORP

Direct Capitalization Rate

- **Capitalization Rate ("Cap Rate")** – percentage rate used to convert NOI into an indication of asset value (NOI/Cap Rate = Estimated Value). The Cap Rate is a way to assess risk and is reflective of physical condition, location, asset type, and/or operational performance.
- **Useage:**
  - In last cycle, the Cap Rate may have been calculated on Proforma NOI.
  - Today, the Cap Rate is almost exclusively calculated on a T-12 NOI.
  - Selecting a Cap Rate from Comp Sales is difficult due to myriad of conditions affecting NOI and transaction prices. Therefore, a Band of Investment Technique is used which is a calculation of the WACC.

Band of Investment Technique to Cap Rates				
Financing Component	Percent of Value		Rate of Return	WACC
Mortgage	60%	x	5.5%	3.30%
Equity	40%	x	18.0%	7.20%
			Overall Cap Rate:	10.50%

  - Cap Rate comparison between asset classes.

Discounted Cash Flow Approach

- **Discounted Cash Flow Approach** – whereby the forecasted NOI (5 or 10 years), plus the net sale proceeds at the end are discounted back to the date of value using an appropriate Discount Rate to arrive at an estimate of asset value.

Mortgage Debt & Mezzanine Debt

Typical Mortgage Debt Terms				
Terms	**CMBS Lender**	**On-Book Lender with Recourse**	**High Cost Bridge Loan**	**Typical Mezz Debt Terms**
Interest Rate	5.00% - 6.00%	4.00% - 5.50%	8.00% - 12.00%	10% - 16%
Term	5 to 10 years	3 to 5 years	1 to 3 years	Coterminus with Senior
Amortization	25 years	25 years	Interest Only	
Maximum LTV	65%	60%	65%	Up to 85%
DSCR	1.35x	1.40x	.90 - 1.10x	Can be less than 1.0X
Minimum Debt Yield	11.50%	11.00%	8.0-10.0%	with structured pay rate
Advantages	Inexpensive Asset-Based Underwriting	Least Expensive Short Term	Leverage for transition Flexible Structure	Fills Financing Gap of Capital Stack
Disadvantages	Stringent Reporting Standards	Personal Guarantees	Most Expensive	Expensive Pledge of Ownership
Changes over recent business cycles:	• CMBS rapidly emerged in the early to mid-2000s, spurring hotel construction and lending activity. Provides highest proceeds and lowest	• Interest rates have dropped 150bps. • Amortization dropped to 25, from 30 years. • Max LTV decreased from 70% to 75% to current terms. • Debt Yield and T-12 results have become the standard.	• Increased use of this type of financing, as there have been more properties in transition. Must have clear repositioning and exit scenarios.	• Interest rates have dropped from the mid-teen range. • agreements have become increasingly complex, deterring usage in favor of preferred equity.

Relevant Loan Sizing Terms

- **Loan-to-Value** ("LTV") – Loan amount divided by property value or cost - helps prevent lender from becoming overexposed on property's overall capitalization.
- **Debt Service Coverage Ratio** ("DSCR") – NOI divided by debt service payment - ensures that the income generated by property covers the debt service a multiple number of times (or does not cover).
- **Debt Yield** – NOI divided by Loan Amount. Provides metric for gauging how many times property's NOI is needed to payoff loan amount.

Discounted Cash Flow Approach

INCOME CAPITALIZATION APPROACH TO VALUATION

	LTV	Expected Yield	Discount Rate	
Equity Component	50.0%	20.00%	10.00%	12.75%
Debt Component	50.0%	5.50%	2.75%	

DISCOUNTED CASH FLOW

	2012/13	2013/14	2014/15	2015/16	2016/17
Net Operating Income	$ 2,713,610	$ 3,271,608	$ 3,628,024	$ 3,842,127	$ 3,992,687
Terminal Value					46,033,330
Total Proceeds	2,713,610	3,271,608	3,628,024	3,842,127	50,026,017
Discount Factor @ 12.75%	0.88692	0.78652	0.69767	0.61878	0.54880
Discounted Proceeds	$ 2,406,750	$ 2,573,524	$ 2,531,168	$ 2,377,418	$ 27,454,477

VALUATION MATRIX

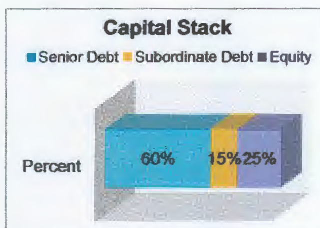
Discount Rate		Terminal Capitalization Rate 7.50%	8.50%	9.50%
12.00%	Value	$42,000,000	$38,400,000	$35,700,000
	Per Room	293,706	268,531	249,650
12.75%	Value	$40,700,000	$36,600,000	$34,700,000
	Per Room	284,615	255,944	242,657
13.50%	Value	$39,600,000	$36,300,000	$33,700,000
	Per Room	276,923	253,846	235,664

Capitalization of Hotel Assets

What is a "Capital Stack"

Components of the Capital Stack

Sources of Capital / Cost of Capital



Restructuring vs. Refinancing

- **Restructuring** – when the project's overall capitalization is rebalanced to reflect current market debt levels using an infusion of equity from a new investor.
  - Example:
    - Hotel is considered overleveraged due to declining market values and decrease in operating performance.
    - Debt is restructured through the use of a "rescue" investor, who comes into the deal via a JV and pays down the debt to a more appropriate level.
    - In return, new investor gets a Preferred Return.
- **Refinancing** – project is not necessarily rebalanced. If it is rebalanced, the infusion of equity comes from existing (Legacy) investor/owner.
  - Generally results from a loan maturity or strategic decision to take advantage of improved metrics in the capital markets.

Preferred Equity

- New investor puts equity into a deal (usually "rescue" equity), in return gets a priority return of cash flow.
- The priority return generally consists of one of two structures:
  1) **Preferred Return Rate**: a TBD rate (say 15%) wherein investor gets all cash-flow after debt service until rate is achieved, then may get a split of remaining cash flow and split of sale proceeds.
  2) **Current Pay Rate**: an initial TBD rate (similar to a mortgage rate, say 6%) wherein investor gets all cash-flow until initial rate is achieved, cash flow is then split until investor gets an overall return IRR (of say 15%).
- Similar to mezzanine debt:
  - Subordinates common equity.
  - High cost of capital.
  - Legacy investor (original owner) gets a "hope" certificate.
  - Is not a debt position secured against the asset or ownership interest.

Equity Sources: Preferred/ Opportunistic / Core

Core Equity Investments:

Who: Institutional Investors – REITS, Equity Funds
Why: Easier to access low cost capital, lower risk profile
What: Typically larger hotels in top 10 markets, brand managed under major brand – Marriott, Starwood, Hilton

Opportunistic Equity Investments:

Who: Individual owners, opportunity funds, hedge funds
Why: Less competition, higher equity yields
What: Smaller branded (or higher quality independents) in top 100 markets. Many times looking for value-add opportunities

JV Structures, Operating Partnerships, and Promotes

- **Joint Venture** - when two entities come together to work on a particular project. The parties establish a goal at the beginning of the venture, work together to achieve the goal, then dissolve the JV once the goal is reached.
- **Parties form a JV to:**
  - Access the expertise of others;
  - Access the capital of others;
  - Gain access to a project or asset that they would not otherwise have access to;
  - Share the risk of a project or asset with others;
  - JV structures may be used to accomplish complex financings and/or increase the leverage on a particular project.

JV's are typically structured with the asset being held in a Single Purpose Entity (LLC or LP). This limits liability and eliminates double taxation. Major considerations are initial capitalization amounts, ownership split, economics split, and control provisions.

Contact

William G. Sipple
Managing Director
HVS Capital Corp

8055 East Tufts Avenue, Suite 530
Denver, CO 80237

(303) 512-1226
wsipple@hvs.com

www.hvscapital.com

JV Structures, Operating Partnerships, and Promotes

- **Operating Partner** – serves as the managing entity of the JV, operating the day-to-day tasks of the business, subject to major decision controls:
  - Annual Budget
  - Expenditures exceeding X percent
  - Sale or refinancing
  - Execution of material contracts
- **Promote Structure** – profits participation over and above a baseline return on financial capital. Typical institutional structure is two tiered:
  1) **15% over a 15% IRR to Capital Partner**
  2) **20% over a 20% IRR to Capital Partner**
- **Advantages/Disadvantages**
  - Provides the capital source with operating expertise on an "as used" basis. OP's generally provide deal flow to the capital partner.
  - Operating partner can have limited capital invested, but still have a material profits participation.