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MCC INTERVIEW: David Stone Phelps / Akin Gump Strauss Hauer & Feld LLP

Hospitality Investors Adjust to Shifting Realities

As ownership and operations diverge and hard assets are privatized, millennials drive growth

The hospitality industry is undergoing profound transformation. The big brands no longer own their properties, global money is chasing safety in the U.S., Airbnb continues to disrupt, and the massive millennial cohort is shunning white glove amenities for smaller rooms and better WiFi. ***Akin Gump*** *partner* ***David Stone Phelps****, an industry veteran, says all of that and more presents an array of challenges to investors – from private equity and sovereign wealth funds to entrepreneurs hoping to capitalize on the millennials' hunger for new experiences. His remarks have been edited for length and style.*

MCC: Please tell us about your background as it relates to your focus on private equity funds and other institutional investors in the hospitality industry.

Phelps: I've been a real estate lawyer for 30 years. I represent private equity funds and their managers, private REITs, and private and public companies in purchasing, developing, financing, and selling commercial real estate, hotels, and multifamily residential properties throughout the U.S. and, as it relates to hospitality, abroad as well. Over the last 10 years, my practice has focused on the hospitality sector. We historically have not represented brands in our transactional hotel practice, only the owners. That gives our group an understanding of the broader market and a unique perspective on the issues embedded in documents and deals across all the brands.

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The end result of the separation between ownership and the operation of hotels is privatization of the hard assets.

MCC: When you joined Akin Gump 18 months ago, you expressed great optimism about the real estate market. Has anything happened since then to change or temper that outlook?

Phelps: I'm still bullish on real estate generally and hospitality specifically, though I do think we're starting to see some new trends. For example, the revenue per average room, or RevPAR curve, which over the last three to four years was trending up, now appears to be flattening, while cost structures are rising modestly. Acquisitions in the hospitality sector are becoming more difficult with the possible exception of the limited service sector, where there is more availability, a lower capital cost to entry and lower operational costs, and where it's easier to manage. In certain sectors where the cost to acquire exceeds the cost to build, especially in gateway cities, like New York and San Francisco, where there's also limited and highly priced supply, we're starting to see the construction pipeline increase. The corollary to that, however, is that private equity funds have begun to curtail their construction funding out of a belief that they're overweighted in this sector.

Where we are seeing growth is in the branded and unbranded focus on millennials. Products like Starwood's Aloft, Moxy by Marriott, Canopy by Hilton and Radisson Red are all examples of brands looking to capture millennial demand. In addition, we're seeing new nonbranded entries, like Bunkhouse and Basecamp, which are kind of the youth hostel approach to hospitality. Overall, millennials are attracted to lower priced hotels that are cool and communal, or are in cool and different neighborhoods, the kind of neighborhoods where you would not have thought to put a hotel in the past, such as the Meatpacking District in New York and South of Market in San Francisco.

Finally, Airbnb continues to expand. I think it is working on a more sophisticated business model in which the ADA, fire safety and local transient occupancy taxes are being addressed. This is a potential major threat to the brands, just as Uber was to the conventional taxi industry.

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MCC: EY, in its annual outlook report on real estate private equity trends, says there's tremendous activity and opportunity across all fund types "from core opportunity and value-added to separate accounts and direct investments and sovereign wealth intention funds." They also noted a significant upswing of activity in the secondary funds market. Please tell us what you're seeing in your practice.

Phelps: I think that is true to a degree. As we discussed, certain property types in certain locations, for example, in particular gateway cities are harder and harder to find, and they carry some of the highest per-room costs in the country, so value-added opportunities are more important. For funds to deliver double-digit yields, they have to focus on properties where significant value can be added. As a result, we're seeing a lot of apartments, condos and even office spaces, through renovation or ground-up construction, being repositioned for hotel use in urban areas, often in secondary and tertiary markets. We have a particular hotel client, for example, whose main focus is repositioning historic downtown buildings into hotels, and many fund managers whom I have spoken to talk about a similar focus. The lack of product and the need to see higher returns drives this.

Sovereign wealth funds and pension funds can have different underwriting criteria from the typical private equity fund. In general, they are willing to take longer possession of the assets as opposed to the four- to seven-year view of private equity funds. Additionally, the sovereign wealth funds seem to look more at trophy assets. They are moving money into gateway cities, which drives up prices. Also, they see the U.S. as a safe place to park capital in a growing, unsteady global economy.

Generally, my practice and experience are consistent with EY's view. There is still a lot of money out there to invest.

MCC: Tax considerations are central to most major real estate transactions, particularly those with international players involved. Given the Organisation for Economic Co-operation and Development's focus on reducing tax avoidance by multinationals, what do your clients need to be thinking about to ensure that they do not get blindsided by the shifting tax environment?

Phelps: I know enough to understand that the U.S. tax laws can be relatively unfavorable to non-U.S. investors in real estate. I also know enough to recognize the limits of my expertise in tax and the absolute need to always consult with my tax partners. Generally, though, the Foreign Investment in Real Property Tax Act (FIRPTA) rules, with certain exceptions, seek to impose at least a single level of U.S. federal income tax on a non-U.S. investor's U.S. real estate. Accordingly, much of the planning associated with foreigners' investment in U.S. real estate–related assets centers around attempting to mitigate the impact of the FIRPTA rules, which often entails complicated structuring and may raise other international tax issues.

MCC: Are you seeing more take-private transactions in the hospitality sector? What's driving this activity?

Phelps: There have been obvious and noteworthy taking-private transactions in the lodging sector, most notably Blackstone's acquisition of Hilton. Less obvious I think is the spinning off of hard assets by the brands over time to private equity buyers, sovereign wealth funds and other private buyers. There has been this separation occurring between ownership and operation of hotels for some time. The end result is the privatization of the hard hotel assets. What we have been seeing and will continue to see is a systematic long-term effort by the brands to sell off their own hotels while maintaining their long-term management and franchise and licensing agreements in order to restructure their balance sheets to be more asset light and less capital-intensive.

The public hotel companies have excellent access to capital, but in some cases, the market is just not providing the valuations that they believe reflect their true value. Why bear the risk of real estate and the valuation swing, and why bear the capital cost associated with hotels when you can sit back and enjoy fees paid over a very long period of time with less real estate risk?

On the vacation ownership side of the hospitality industry, we are seeing a similar trend, as hotel brands spin off their vacation ownership units into divisions. Marriott, Hyatt and Starwood all have done so in the last few years, and I believe there's talk of Hilton doing the same. The motivation is to convert these units into a franchise and away from the capital-intensive units owned by the hotel brands. The belief in all of this is that it's better to leave the ownership and capital upkeep to private parties.

MCC: What are the latest trends you're seeing in financing of hospitality and gaming projects?

Phelps: As we discussed, construction lending is slowing down on the private equity front. With more traditional banks, we are seeing an increased need for high equity levels to obtain financing. Where you could finance projects for a higher loan-to-value of say 70 to 75 percent, we are now seeing loan-to-value requirements in the 50 percent range. There is this need for more equity or a mezzanine piece to make up the difference.

The gaming companies in the Las Vegas market are encountering decreases in gaming revenue as a percentage of total revenue, currently estimated to have dropped to around 30 percent of total revenue. Owners are turning their focus away from gaming and toward restaurants, clubs and retail to boost revenue and to better underwrite debt service coverage requirements and concerns. In addition, as the power of the casino diminishes, fewer and fewer rooms will be sold at subsidized rates. Again, to boost revenue, this trend is likely to continue.

MCC: The influx of foreign investors is having a profound impact on the hospitality market. For example, commentators say the continued increased in cross-border capital flows is intensifying competition in gateway markets among traditional financial investors. With China slowing, what do you see on the horizon as far as cross-border investment goes?

Phelps: Anbang Insurance Group of China has been a major player of late. Its acquisition of the Waldorf Astoria from Hilton for a very significant sum shows a concentration on trophy properties. In addition, it's been reported that Anbang made an unsolicited offer to buy Starwood after Marriott already appeared to have the deal locked. In the end, Marriott succeeded but at a higher price. We are likely to see more of these cross-border deals even if China and the world's economy weaken because the U.S. remains one of the safest currency havens in the world. Relatively safe investment is essential to foreign nations as their economies slow down. Having said that, the Chinese, Indian and other Asian hotel sectors are seeing cross-border investments from the U.S., Europe and other Far East players as their regions represent one of the largest potential markets in the world for lodging growth.

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MCC: We touched on millennials earlier. A generational shift is driving major changes in the hospitality space as millennials enter their prime earning years with a love of travel and customized travel experiences. How is this shift manifesting itself across the industry and your practice?

Phelps: The millennials are seeing active brand development from all the major hotel companies, as well as private companies, like Ron Burkle's Yucaipa Group. To put it in perspective, the millennials as a group are 50 percent larger than the baby boomers, but they are not looking for all the bells and whistles of a full-service four- or five-star hotel. The branded versions are trimmed down in room size, and social media is wrapped in a cool atmosphere. This trend is likely to continue for the foreseeable future. Airbnb is also likely to expand substantially because the millennials are looking for a less expensive and social media–centered supply that Airbnb will provide. My clients are part of the trend as they focus more of their time and capital on building and renovating millennial-friendly hotels.

MCC: What are the opportunities for investment in hospitality in Cuba, and what process must U.S. companies go t hrough to get a foothold in the market?

Phelps: What is important for any U.S. investor to understand is that the long-standing sanctions are still in place. It will take an act of Congress to overturn the restrictions. That said, various restrictions have loosened, so it's easier to go to the island to assess commercial opportunities, and U.S. banks can finance transactions. Investors that have legitimate interest in assessing the opportunities can now go with greater ease.

Once they get there, it immediately becomes apparent that a major capital infusion is required to restore Havana to its potential. That's where the opportunity lies. The Cuban government is open to bringing in investors in the hospitality sector because capacity is quite low, especially in Havana, to handle even current tourist numbers, not to mention future numbers. Investors should be prepared for joint venture arrangements, and due diligence on property claims is important. Cuba is working to address historical claims, so it is possible to get transparency on these matters.

Where an interested investor starts is to go to Cuba on an exploratory visit to meet with government officials, scout out potential properties and meet potential partners. Once some of the groundwork is done, serious conversations need to begin with the government on what is possible. Then there is a need to get approval from the U.S. Department of Treasury, which means preparing and submitting a license application. This is where we come in. Our Cuba practice can assist clients with a whole host of services – from helping interested investors navigate the island to working with U.S. officials to ensure transparency and compliance with U.S. laws and regulations.