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To Make Deals in Hospitality Today, You Need to Be Creative

As the challenges mount, lawyers need to adapt

Given the complications that the hospitality sector faces these days, from cross-border deals to mega-mergers to disrupters crashing the business, the environment can appear at times almost inhospitable. But ***John Allen Bain*** *and his firm,* ***Akin Gump Strauss Hauer & Feld LLP****, fresh from their recent work on 7-Eleven's $3.3 billion deal to acquire 1,108 Sunoco convenience stores, are nothing if not bullish. The industry "is, of course, facing a lot of dynamic variables," Bain allows. But "we feel really good about the industry at large." The interview has been edited for style and length.*

Given changing customer demographics, technological advancements and disruptive competition, companies have to adapt and respond to survive.

The hospitality and leisure sectors have been thriving for some years now, even as they face disruptive competition from private accommodations aggregators such as Airbnb and rapidly changing customer expectations. Where do you see the sector going, given the substantial changes it continues to face?

John Allen Bain: I don't think the hospitality sector is unique in this. A lot of sectors are facing changing customer demographics, technological advancement and similar variables. These variables create opportunities for disruptive competition and newcomers. The existing players have to adapt and respond in order to survive.

In the hospitality sector specifically, online travel agencies, aggregators and millennial travelers are forcing brands to adapt their existing product lines and bring new products to market. This has resulted in some markets being overbuilt, as sub-brands slice the markets into thinner segments. Owners in these markets are concerned about this for several reasons. They're facing competition from their own franchisors, and the overall addition of available rooms in the market has a flattening effect on daily rates.

That's just one example of how the traditional industry players' responses to disruptive activity can have a ripple effect throughout the industry. Other adaptive responses include seeking out strategic partnerships with newcomers or purchasing them outright – and, of course, consolidation that creates operational efficiencies and broader customer loyalty programs.

My view on where things are going is that this process will continue to shape the industry.

Many of the deals you've worked on involved private investment funds. How does the involvement of private equity, sovereign wealth, family office and other funds alter your approach to these transactions?

Bain: The 2008 downturn created a lot of opportunities in the real estate space. One of the sub-sectors it created an opportunity in is hospitality. That type of opportunity fits the private equity model, which is basically to enter into a deal or purchase an asset, hold it for a defined hold period and exit prior to the end of that period. These entities have a responsibility to their investors to create a high return. These returns are typically higher than what other players in the market have to create. This model creates different motivations than the ones that spur other players within the market.

Private equity generally pursues deals that have a value-added component and the upfront prospect for a clean exit. By way of example, we have a client that is a joint venture with a private equity fund as the equity source and an experienced hospitality asset manager as the sponsor. This is a common private equity structure in the hospitality space. This joint venture solely focuses on limited-service hotels that are underperforming. This allows them to buy the hotel at what's effectively a discounted price, put an easily definable amount of capital investment into the hotel to either reposition or improve it, and in either case to improve the performance of the property, then take

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it back to market relatively quickly and exit. That business model requires a completely different approach to seeking out deals, entering and exiting deals, than a REIT (real estate investment trust) or a sovereign wealth fund. For instance, sovereign wealth funds often seek out trophy properties in high-barrier-to-entry markets. Those are typically very expensive full-cost assets intended to be held on a long-term basis. That type of asset doesn't fit the private equity approach to investing in the hospitality sector. Contrasting approaches, interests and goals like those reflected in the examples above end up driving many components of a transaction. As outside counsel, understanding your client's business model helps to inform your approach through the life cycle of each deal.

The hospitality market has seen players and money from China, the Middle East and across the world chasing deals and returns. What are the challenges in working with financing sources from overseas in what are increasingly cross-border deals?

Bain: I think the challenge that's discussed most now is capital controls. This is the common term used to describe regulatory schemes that governments put in place to control the outflow of capital from their country. There are specific regulatory agencies within these countries that have to review each proposed investment and approve it. As a practical matter, that means it's very hard to get additional money down the road for an investment that hasn't already been approved by the regulators and hasn't already exited the country and entered the U.S. or wherever the investment is being made. This has to be accounted for when structuring the investment. The other big-ticket item is tax structuring. That requires tax counsel experienced in creating structures that account for the specific tax challenges presented by the source of the funds.

Here at Akin Gump, luckily we have tax counsel that are very experienced with these matters. So when we are presented with this challenge, we have the right people in place to provide the solutions.

Transactions involving foreign investments also present practical challenges that you wouldn't necessarily expect. It's often hard to get everyone on the phone at the same time because there can be significant time zone differences. Language and cultural differences can pose some challenges. For instance, in different countries the roles of legal counsel can differ, which may cause misunderstandings. Even something as simple as getting documents signed and effectively notarized and delivered creates both timing and logistical obstacles that need to be accounted for whenever you're in time-sensitive situations.

A recent survey asked industry players to predict the shape of the hospitality industry in 2030. One finding was that there will be a shift in market power that could either drive further consolidation or accelerate fragmentation in the industry. Give us your perspective on how the industry will evolve, and what that might mean for how you advise your clients at Akin Gump.

Bain: Here in the Akin Gump hospitality section, we feel really good about the industry generally. It is, of course, facing a lot of dynamic variables. Millennials and younger generations are becoming a part of their target customer demographic. Technology is affecting the demand for business travel.

Online travel agencies are competing with brands for customer loyalty. This competition has created opportunities for independent hotel owners who are able to generate positive ratings that are accessible to retail customers. Generally all of this drives opportunity, and opportunity drives transaction activity. As outside counsel, my view on it is that we need to be prepared to be responsive and creative as our clients look for and take advantage of opportunities presented by the shifts within the industry.

The Akin Gump team worked for 7-Eleven, the top chain in the convenience retailing industry, which announced in April – in one of the largest deals ever – the $3.3 billion acquisition of 1,108 Sunoco convenience stores across 18 states. Tell us what a sprawling multi-jurisdictional deal such as this looks like from the real estate perspective.

Bain: It can become a bit of a people and project management exercise. First, as outside counsel you have to establish your role versus the role of the client's in-house legal team. It's important to continuously revisit this as the demands of the transaction evolve, so that there are no responsibility gaps. You also have to establish the individual work streams within the teams created here at the firm. The fact that this is a multi-jurisdictional deal drives the need for local counsel, which is yet another team that must be managed and whose scope of responsibility must be established and monitored.

Deals like this have some unique features. Obviously individual state laws can have an effect on structuring the transaction. If there's a severe transfer tax imposed by a particular state in which there are a lot of properties, the parties may structure around that tax, if there is an option to do so. Similarly, if there is acquisition financing and any applicable states have a high mortgage tax, the buyer will want to mitigate this tax as much as possible. This often requires assignments of mortgages and related documents, which needs to be contemplated in the primary transaction documents. In either case, you have to understand the potential impact of individual state taxes at the deal negotiation phase and plan ahead for the challenges they present. This drives the need for the seller and the buyer to be more cooperative than they would be in simpler transactions.

Another similar issue is that liquor laws from individual states can create timing and process issues.

Portfolio deals in general have a number of other unique challenges that you don't find in single-asset deals. For example, you need to create a mechanism for removing individual properties from the deal that have diligence or title issues or are affected by a casualty; define materiality thresholds within representations applicable to both individual properties and the portfolio as a whole; identify individual properties or a set number of properties, that, if dropped, would entitle either party to terminate the transaction; and solve for transition challenges presented by multi-property service contracts that cover properties that aren't part of the transaction.

Generally the range of issues that you face with a deal like this can be broad and complex. The key is staying proactive and communicating early and often.