TOP 10 REASONS HOTEL INVESTMENTS FAIL

And Key Strategic Insights to Keep You from Joining Their Ranks

Most people invest in hotels with the intentions of making a profit, but many intelligent people often end up failing. Strangely enough, hotel failures are nearly always preventable. In 2010 alone, U.S. hotels considered distressed by Real Capital Analytics approached 2,500 properties with total debt of $40 Billion – harshly bleeding the asset columns of "knowledgeable experts" who violated the wisdom included in this report. And of the survivors, thousands with amazing potential are barely scraping by and their owners continue to pour in money hoping that, "some day", they will actually see profit.

While the Hotel Death Toll has been harshest since 2008 when the national economy faltered, owners who knew what they were doing were able to retain their hotels and, even in some cases, were able to see increases in value. You do not hear "Hotel Profit Experts" blaming banks, Enron, the Saudis, Goldman, the Bear market or the many other issues outside their own control that the "Hotel Killers" are blaming. People who actually do know what they are doing do not need to resort to such external scapegoats. They are busy doing what you need to do to succeed in this amazing industry. That's called "knowing what others don't and building an empire where they can't."

REPEAT: Some of the worst collateral damage in our industry during the recent so-called "Great Recession" was truly avoidable if the people who "know their stuff" knew and practiced what I am here to share with you in this brief report.

After 30 years in the hotel industry and seeing success and failure, my team and I have compiled in this complimentary report the Top 10 Reasons Hotel Investors Fail. Herein, we begin to reveal what can be done to systematically mitigate your risk of loss while strategically and wisely planning to radically improve your Profit Probability.

Here below is the Top 10 Reasons Hotel Investors Fail. Any one of them can erode your profit. Two or three of them in tandem will have you practicing your "The Economy Did It" speech for your investment team – if they will still listen to you at all.

#1: NOT ALIGNED WITH THE RIGHT PEOPLE

One of the most expensive things you can do is hire an inexpensive amateur.

Aligning your hotel project with the wrong people will almost always lead to subpar results and sometimes complete disaster. Alternatively, teaming up with the right people can position a project for the highest probability of success. What is meant by "right people"? Well, they are definitely not always the cheapest or most readily available. In fact, sometimes the right people may cost the most, but if you are talking about developing or owning a hotel project that could cost $10 million or $100 million or even more, saving a dollar could result in costing you ten. Experience tells us that your hotel Management Company and team will have a direct impact on whether or not you have healthy profits, be just scraping by, or for many, painful losses.

For example, if your hotel manager is not running an efficient operation resulting in a $100,000 annual impact to the bottom line and the market for your type of property suggest a valuation based on an 8% cap rate, then this $100,000 annual impact is also costing you $1.25 million in value plus the $100,000 per year – a double hit. As you can see, relatively minor changes in operations could cost you plenty.

Taking time and completing due diligence should always be part of selecting the best team for your project. We have found that the attributes of people and companies that can insure the best success for your project include: **expertise and experience in working with similar projects; a relevant and solid track record; a "non-litigious" outlook on conflict resolution; an understanding of how hotels make profits and how they can add value to this process; a "supportive" cultural foundation when challenges arise (as they always do); deep value placed upon long-term relationships; and a genuine character based upon integrity and**

trust. The ideal partners must not only have all of these attributes, but also should be fully engaged and committed to helping you achieve your project goals.

#2: BEING BURNED BY MARKET CYCLES

Just like stocks, hotel values go up and down based on economic conditions. In the past 10 years, average values (based on hotels sold per HVS study) bottomed out in both 2002 (after falling 35% from 2001), and in 2009 (after falling 41% from their peak in 2006). The good news is that hotels have proven to rebound after falling. In fact, following the bottom in 2002, they continued a steady climb over 4 years increasing 125% by 2006. And since they bottomed out again in 2009, they are up 44% in 2010 (based on data for the first 8 months of 2010). Over this 10 year period, the average hotel sales price increased by 25%. This compares to 6% for the Dow Jones Industrial Average.[1] Even more enlightening, many hotels failed and folded during that time, while others drove strong profits. And market timing was sometimes a key contributor to their demise.

When you hit the market timing right, value fluctuations can be extremely profitable. Conversely, poor market timing can be deadly costly when you buy high and are forced to sell at the bottom of the cycle. If you are positioned with adequate working capital or the ability to work with your lender if your loan becomes due during a downturn, you can ride out the weak market conditions and likely recoup your investment and make a profit.

So how does one know what part of the cycle they are in and whether now is the time to buy, hold, or sell? As most investors know, picking bottoms and peaks can almost be impossible to predict in advance, however there are usually clues that can be helpful in determining what part of the cycle you might be in and what action to take. When year-over-year increases in U.S. Revenue Per Available Room (RevPAR) are getting smaller, hotels are selling at prices that don't seem to make rational sense, and as this happens, new players enter the market with easy money and build hotels with projected growth rates substantially above historical averages - the

[1] Information on hotel values is based data for hotel sales over $3 million provided by HVS, the world's leading consulting and services organization focused on the hotel, restaurant, shared ownership, gaming, and leisure industries. DJIA info is based on the change in the average index pricing using the beginning and end of year value.

indications are good that you may be getting close to the top of the market. On the other hand, when new construction is frozen, financing is very hard to come by, and year-over-year declines in RevPAR are starting to get smaller, this may be an indication that you are nearing the bottom.

All of us know it would be ideal to buy at the exact bottom and sell at the exact top. However, attractive returns can also be generated if you can buy at the bottom half of the cycle and sell during the top half of the cycle. **The key is having the financial flexibility with your capital resources and financing to be able to properly manage the timing of your disposition or refinance.** It can be extremely valuable to have either limited pre-payment penalties in your loan documents, have the ability to extend your loan, or have the resources to refinance with alternative sources under a distressed environment. Maximizing leverage may limit your options to refinance when the market turns down and may result in foreclosure or bankruptcy. Thus the higher leverage you have, generally, the fewer options you will have if your loan matures in a downturn environment. If you have questions about any of this and you are looking at hotel investing, yet uncertain of market timing signals, you need solid advice.

#3: NOT UNDERSTANDING YOUR LOCATION OR THE TRENDS THAT COULD CAUSE IT TO WEAKEN OVER TIME

Another factor that may cause your hotel investment to fail can be attributed to either being in a weak location or having a location that is weakening over time. Visibility, easy access and parking, being close to retail, dining, and entertainment venues, and being near corporate or leisure demand generators are all factors that contribute to being in a strong location. Other factors that can affect a location's Location Strength or Weakness include crime rates and local government tax policies and business regulations.

In business, everything happens at the margin. If your hotel's location positions you to achieve a lower occupancy and rate than a similar but better located hotel, your profit, value and viability will be significantly impacted. An inferior location can thereby result in a lower valuation in the magnitude of millions of dollars. When an existing hotel is purchased, the value of the location can be quantified by reviewing the track record for the hotel and the many varied external factors that could cause those trends to shift upward or downward. However, for a new hotel, the lack of historical performance makes an accurate valuation much more difficult to determine. Usually, a very strong location is very clear and can be easily understood, however a marginal location is often rationalized to work based on numerous variables – and failure in proper assumptions in those variables can prove to be the project's downfall in the end. As we all know, real property is a fixed asset, and once a location is built upon, it's not going anywhere and thus becomes a permanent factor in the property's value.

It also very important to understand the changing dynamics of both market conditions and location…. If the crime rate near your hotel is on the rise, this trend will likely negatively impact the value over time. On the other hand, if the area by your hotel is attracting new employment or entertainment venues such as a new football stadium, than not only will your revenue likely rise, you may be able to sell your property at a lower cap rate which can significantly impact your price.

Another key location factor to consider in valuing a property's potential is known as "barriers to entry." Barriers include, but are definitely not limited to: lack of undeveloped land zoned for hospitality, lack of reasonably priced land, and lengthy approval processes. Another related and critical barrier is known as "general development feasibility." If for example, a market has a low ADR and Occupancy, then you aren't likely to see new competition as the numbers will not encourage development. Your partners and your team should know not only all of these factors but the dozens of others not addressed in this report but available to the discerning investor.

BOTTOM LINE: When investing in hotels, it is vital to remember that good locations drive revenue, impacting cash flow, exit values and therefore return on investment (ROI) – and many locations that seem "good" could become your worst nightmare unless you truly know what you are doing.

#4: POOR UNDERWRTING ASSUMPTIONS

Unsound underwriting assumptions may seem like an obvious factor that could lead to making bad investment decisions and ultimately a cause of failure; however, it is surprising how many investors make decisions based on poor or incomplete information and upon seriously flawed assumptions. Every assumption you make in developing an intelligent business plan for your hotel will propel your forward momentum. Bad assumptions drive you in the opposite direction of profit. Terrible, fatal assumptions lead you to hand your hotel over to the bank and walk away.

Many investors mistakenly rely on rosy and grossly optimistic broker proforma numbers that are used to stretch the value for the seller. Think: *Caveat emptor*. Just as a used car salesman diverts your attention from dings, rust, a previous accident and a transmission on the fritz, so, too, does the seller's broker focus on the positives. Failing to ask critical and strategic questions designed to reveal the unspoken negatives can leave one of those horribly Assumption Errors hidden until it's way too late to ask.

Some rookie hotel investors also blindly fail to factor in changes that are expected with new competition or economic variables impacting the local economy. A seasoned investor either had a good mentor and never made such mistakes – or they already made that mistake and learned every little nuance of how to avoid them in the future at the expense of their own profit on previous projects. In either case, that wisdom is available. A truly wise person learns from the mistakes of others and thus avoids "learning" lessons already known.

In order to minimize investment risk, comprehensive due diligence should be completed with all major assumptions being supported and understood. Due diligence review should include, but not be limited to a detailed review of the market, understanding the potential for new competition and its impact to the subject property, research and understanding of the demand drivers for your hotel and anticipated future changes, detailed study of the improvements including having an engineering report completed and reviewed, study of environmental status, detailed bidding and budgeting for construction or renovation that reconciles to franchisor required property improvement plan (PIP), detailed review of historical operating statements and completion of a detailed operating budget, review of all in-place service contracts, and review of title report with underlying documents.

#5: OVER-LEVERAGED WITH "EXPENSIVE" CAPITAL

It is very tempting to borrow as much as possible for a hotel investment, often justified by lack of sufficient equity, appraisals, eager bankers or the motivation to **maximize returns on paper.** However, higher leverage typically results in a higher interest rate, which translates into higher cost of capital and higher risk to the equity investment meaning a higher risk of investment failure. **When cash flow goes negative, and you don't have money to put in, either from reserves or other liquid assets, then you will lose the property – it's that simple.** Avoiding the temptation to over-leverage will require a disciplined investment approach which will often lead to lower investment returns on paper and may require you to seek additional outside investment partners, but when times get rocky, will better position you to avoid a complete loss of capital. As we have witnessed over and over in the last few years, those that did over-leverage often ended up getting wiped out. Translation, a lower return is always better than no return.

#6: GETTING HAMMERED BY COST OVERRUNS

The risk of cost overruns is directly tied to the caliber of the team members and the amount of planning and preparation completed prior to starting any construction or renovation project. The caliber of team members can be a function of how much experience they have with similar type of projects and the results they have achieved. You're planning and preparations directly tie into the wisdom your team has accrued and the wisdom of outsiders you bring in to help assure the success of the project.

Planning and preparation includes detailed review and understanding of the drawings and specifications by the team members, including the owner and contractor, in advance of starting construction. This can be critical in avoiding unplanned changes that may end up costing double in the end. For example, if a product such as door hardware is not previewed by the owner prior to ordering and is installed by the contractor and during a periodic inspection the owner sees them for the first time and decides they don't meet his liking, then the owner will have a very costly change order for not only buying a second set of hardware, but also have the expense of removing the old hardware. There are a lot of details on any construction or renovation project, yet it is extremely important to commit the time to review everything in exhausting detail in advance – challenging each assumption all along the way. In addition to having team members review the plans and specifications, the city and hotel franchisor should also have the opportunity to review prior to finalizing the budget and starting the construction or renovation project. **Project timelines should allow for drawings and specifications that are 100% complete and approved by all parties prior to project construction in order to avoid unbudgeted change orders.**

It is further recommended that all plans be bid out by a qualified contractor and subcontractors on a fixed price or guaranteed maximum basis with an appropriate project timeline. Contractors should have the financial strength to backstop the price guarantees included in a fixed price or guaranteed maximum contract. Contractors should also have the systems in place to diligently review all sub-contractor bids and be able to determine if the bids are complete and consistent with the timeline and specifications needed. Further, provisions relating to project completion dates with incentives for early completion and penalties for delays should be incorporated into the contracts. This is important, as delays can cost significantly in the areas of interest cost, pre-opening costs, and lost income to the ownership, not to mention higher project overhead to the general contractor.

Although proper planning can minimize the risks of change orders, there will typically always be some unanticipated changes on a project and therefore the project budget should include sufficient contingencies. The more the planning timeline is compressed or shortcuts are made, the higher the contingency amount needs to be considered. The less experience your team has with similar projects, the higher the contingency. Often, a dollar saved on the front end will cost you two dollars in the long run.

#7: SLAMMED BY NEW COMPETITION CAUSING AN OVERBUILT MARKET ENVIRONMENT

Development in the hotel industry seems to happen in waves. The waves start with improving market conditions that drive higher occupancy and revenue followed by loosening of capital markets causing new development to be feasible. Many developers jump in at the same time, causing a surge in new hotel inventory. Then when the economy starts to slow down, the wave crashes with hotel income declining due to demand and supply imbalance -- and values take a sharp downturn. The size of the wave and the timing of and strength of future demand growth will determine how long it will take to recover from the impacts of the wave.

Thus, the key to survival is to recognize the magnitude of the wave of new properties being developed and be prepared for its impact – or, alternatively, when you see the wave coming, sell. The good news is, once the wave hits, it is usually followed by limited or no new product for some time. Another key is to invest in markets where demand growth is relatively stronger over time so the recovery period will be shorter. Focusing in markets where there are higher barriers to entry is also wise. Wise investors also recognize that if you are planning a project and it is feasible, others are likely looking at the same market and coming to the same conclusion and will likely not be deterred by your plans.

#8: INADEQUATE WORKING CAPITAL RESERVES REDUCE PRODUCT QUALITY, VALUE, PROFIT AND LIFESPAN

As was unfortunately witnessed by many in 2009 and 2010, if you run out of working capital when cash flow goes negative, your property will likely go into default with your lender. When that happens, unless things turn around, you will lose your property. Managing adequate working capital can either be done at the property level or with the owners having sufficient liquidity. In any case, plans should be strategically stress tested to accommodate potential downturn scenarios resulting from market cycles as well seasonality impacts on cash flow. **As a rule of thumb, it is advisable to carry a working capital balance equal to six to 12 months of debt service for operating requirements.**

In addition to working capital reserves for operating needs, hotel properties should carry capital improvement reserves for ongoing property upgrades that may be required by your franchisor or may be needed to maintain the product. This is essential to assuring that your property can remain competitive and not lose market share. Typically, lenders will require a set-aside equal to 4% of revenue for capital improvement reserve, which may not be enough to fully fund your capital improvement needs. It is recommended that long-term capital improvement budgets be completed for a minimum of the next five years and a plan is put in place for funding the budgeted improvements. **If you short change your capital improvement plan and don't adequately reinvest in your product, you will lose market share, and when you lose market share, you lose value – like clockwork.**

#9: INFLEXIBLE MANAGEMENT

As change is inevitable, in order to avoid failure, management must have a culture that stays in front of change by continually being educated on new technologies, products, and market trends and implementing business practices and systems that lead to higher productivity and effectiveness. Failure to heed this warning is going to cost you money – maybe a whole bunch of money. Those that embrace technological changes are often rewarded with a happier more efficient workforce. A small example of this is often seen in hotels where their front desk systems and/or team members are using old computer equipment with outdated software. It literally takes twice as long for the front desk associate to check in a customer, or an associate to complete a simple computer task costing the owner more in labor and leaving the customers getting agitated.

#10: POOR MANAGEMENT, SERVICE, AND PROPERTY MAINTENANCE

Management companies that do not have a "people culture" will always produce lower profits. You simply MUST understand the importance of having the right people on the team. You MUST educate those individuals effectively, and you must train them to have a keen eye for detail. These are a do or die requirement to reap your fullest rewards.

Inexperienced hotel investors sometimes fail to remember that hospitality is a *service* industry. When poor service occurs, it can often end up on the internet, negatively impacting hundreds if not thousands of potential prospective guests, not to mention the potential to lose existing customers for life. Unhappy consumers hold grudges. And the internet now helps them sign total strangers up for their grudge-fests. One must be at the heart of service to this industry, or go do something else.

Poor property maintenance impacts customers' experiences while staying at your hotel, also potentially catalyzing negative reviews on the internet. Poor property maintenance can also impact repeat business, drive by business, and therefore impact revenue. Additionally, poor property maintenance can impact your need to attract the right type of personnel, employee retention, and employee attitudes towards their workplace -- all of which can have a negative impact on the bottom line.

Unlike other classes of real estate, hotels are management intensive business and simply must be actively managed on a daily basis -- with systems, procedures and policies that provide ongoing feedback on performance relative to targeted goals.

This report on "Top Reasons Hotel Investments Fail" was made available based on years of experience by the Executive Management Team of Vesta Hospitality, LLC. Questions, please contact Rick Takach, President and CEO of Vesta Hospitality, LLC or Rob Gartner, Vice President of Business Development. If you have a hotel investment project and are interested in significantly improving the soundness of your buying and management decisions, let's discuss it and see how we can help you.