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Platform Private Equity For Private Hotel Operating Companies - A Good Or Bad Idea?

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Mr. Bill Boyar

You're a relatively small, privately-owned, well-managed hotel operating company. You manage for institutional owners, and have solidly built a core business. But you have limited distribution and don't control the assets you manage. You might even be concentrated geographically. You're concerned that if you don't gain control of the assets you manage and grow your portfolio, you'll have difficulty keeping your key management team. Worse yet, you're concerned that you'll lose market share, your revenues will decline and your profitability will be reduced. You risk watching the enterprise value that you worked so hard to build deteriorate. Not a pretty picture.

What are your options? Should you:

- Focus on adding more third-party management contracts?
- Merge into or sell to a larger competitor?
- Raise capital and acquire assets to gain long-term control over your
- destiny and build enterprise value?

Let's take a quick look at the options.

Grow Third Party Management Contract Business. If you make a decision to grow the third-party management business and not pursue a capital strategy, you'll not likely escape the vagaries of short-term contracts, pressure on base fees and termination of your contracts upon sale of the assets you manage. You might build brand distribution, but you live at risk under tight performance criteria, sometimes unreasonable budget expectations, and unpredictable owner exit strategies.

Merge or Sell. With a good portfolio, unique brand or attractive niche product, if the timing is right, you might have the opportunity to combine with a large public or private competitor. Unfortunately, while giving up control, you're unlikely to receive cash. And, you will likely exchange that control for an investment in the acquiring company. You're ability to exit your position will be restricted for some period of time. You will not have achieved any liquidity, and you'll be at risk for market shifts, while having ceded control of your exit. In fact, you will have exited.

Au contraire, if you catch the cycle just right, it can potentially be the simplest, most profitable way for you to access capital to grow your brand and ultimately achieve liquidity.

Raise Capital and Grow Asset Base. If, after you do your research, you chose to raise capital, you will have options, but they will be limited. The most accessible route will be private equity, but fasten your seatbelt; it can be a wild ride!

Build Enterprise Value. Since the lodging industry is so highly capital intensive, your access will be to institutional private equity or very substantial high net worth private investors. You will initially have to go through the "gatekeepers" - the pension fund advisors and opportunity funds. They amass capital through discretionary investment funds and play the real estate cycles. If you hit the cycle at the right time, capital will be available to finance the right platform, strategy, management team and/or asset play. High net worth investors will have similar appetites and employ similar investment strategies (but might be a little more patient). They too have gatekeepers, although they're often more difficult to identify. Either way, the issues you will confront will be similar. We'll focus on the opportunities and risks associated with institutional private equity.

Platform Versus Asset Investors.

You've made the decision to pursue a private equity raise. Now what? Your first question is clear: “Is this a platform investment or an asset play?” With a platform investment approach, attracting private equity for hospitality investment requires (1) a brand or niche play, (2) a strong management team, (3) a sound growth strategy and (4) a viable exit strategy for the investor. Investors who pursue platform investments are company builders; not opportunistic "deal guys." They typically invest in the management team and brand and look to create value by combining control of assets with distribution and operating synergies. Proceeding cautiously, this is the place for you to build long-term enterprise value.

Asset investors are more opportunistic. They play real estate cycles, look for opportunities to buy right, make value-added improvements and sell when the asset achieves its value high point regardless of the impact on the enterprise value of the management company. They make their money on the assets. When it's time to sell, it's time to sell. The most important ingredients to the asset investor are (1) your transaction pipeline and (2) your ability to demonstrate that you can manage the assets to achieve underwritten returns. These investments are typically structured as separate partnerships and you will probably be expected to make a modest co-investment. The investors are entitled to achieve their threshold returns first (which enables them to achieve the investment returns promised to their fund investors and make an initial level of profit for the fund sponsors), and then upside is shared with you. Asset-based opportunity investors might make an investment and take a minority position in your operating company in order to "align interests," but in reality interests are not really aligned. This is a place for you to potentially make some money and build a capital base, but building enterprise value is a secondary purpose.

What Makes a Successful Platform Investment? The key ingredients for a successful platform investment are:

- A strong company culture
- Strong leadership and vision
- An experienced management team
- Alignment of interests among all stakeholders - management, investors, employees and customers
- A well-defined strategic plan
- A functional governance model
- A working communications model that fosters fact-based, authentic conversation
- A shared view of the outcome that all of the stakeholders are committed to achieving.

Opportunities and Risks in Pursuing a Platform Investment Strategy

If you pursue a platform strategy, you have potentially significant opportunities to grow your business and build value. You can build asset mass (and hence your balance sheet), increase your brand distribution, expand your geographic position, build your management team, invest in technology, develop your people, and, if it all works according to plan— build value and wealth. You can also blow a gasket! It takes the right partner/investor, with aligned strategic purpose to make a platform investment work in the long run. Along the way, you deal with risks and issues involving:

- Control and governance
- Potential dilution of your ownership and influence
- Availability of product to allow you to put the capital by your investor to work
- Economic factors, market conditions and cyclicality impacting supply and demand
- World events impacting travel and lodging
- Availability and pricing of debt financing to fund acquisition and development according to your

strategic plan

- Overall blended cost of capital.

Purpose <-> Method <-> Outcome: Tools for Assessing Opportunities and Designing Strategy

To effectively address all of these critical issues, develop a coherent strategy and create a successful company, you need tools - tools to evaluate, tools to communicate, tools to negotiate, tools to govern and tools to cause change if circumstances demand change. The best plan in the world is useless without tools to assess opportunity. Borrowing a chapter from my good friends Mickey Connolly and Richard Rianoshek in their book The Communication Catalyst, let me suggest a starting point for your search to find the right capital investor.

Focus on two questions —

First, what is the fundamental or "senior" purpose that you have in seeking capital for your company? Is it to build a brand and grow your company, or is it to accumulate assets and make money from opportunistic investment? Do you want to build a sustaining organization, or is the purpose of the management organization to service the assets in which you want to invest?

Second, what outcome are you trying to achieve? What does the company look like to you in one year, three years and five years? What is the role of your existing management team at each of these stages? What changes will you have to make to achieve the outcome and are you prepared to make them? How much ownership and influence dilution are you willing to accept in order to achieve the desired outcome?

The answers to these critical questions will provide direction for your capital search. The clarity of a defined purpose and desired outcome will guide you to the right partner for your business. Nothing is more important than aligning on these two critical things - purpose and outcome. You will have the necessary foundation for designing a relationship that provides possibility for success. You will have a basis for raising and addressing the complex issues that must be addressed. Once you have critical alignment on purpose and outcome, along with the other ingredients outlined in this article, the design of the relationship- the method of implementation - follows. Between purpose and outcome lies "method."

Platform private equity can be not only a good idea but a great idea. It can also be a very bad idea. Many platform deals have failed over the last 10 years. That need not have been the case. Many failed because of the lack of alignment - the lack of an agreed upon fundamental purpose and a failure to identify and agree upon a mutually desired outcome. Some failed because of the absence of tools; tools to facilitate valuable conversation, tolls to support effective governance, tools to align the interests of investors, management, employees and customers. It's definitely possible to create a successful and valuable platform relationship. It takes commitment, alignment on purpose and outcome, and a structure that connects the two. The result for you is value creation. If that's your senior purpose, this can be a valuable path to travel . . .with your seatbelt fastened.

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