HVS

Anatomy of a Hotel Investment Fund

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HEI Hospitality Fund Seeks to Acquire $800 Million in Hotels It seems like every week that a new hotel investment fund is announced to buy hotels. While the timing to buy hotels is favorable, and will likely remain so for at least the next 18 months, according to recent industry forecasts, what is attracting them to the industry and what are these new groups looking for? HVS thought it would be interesting to look at the anatomy of a recently announced fund that already has made a number of acquisitions and is looking to do more: HEI Hospitality Fund. The fund was announced in June. As is typical of many of these funds, Wall Street played a role in its formation, with Morgan Stanley acting as placement agent. HVS spoke with Gary Mendell, HEI chairman and CEO, to gain some insights into the fund's philosophy and goals: **HVS:** Why form your own fund, since you already had acquired a number of hotels through partnering with a number of funds? **Mendell:** We were quite satisfied with our joint-venture partners, but felt the timing was right for a fund that had a slightly different vision. We were one of the first groups to actively seek properties. In fact, the recovery had not yet begun when we formed the company in the fall of 2002. That head start helped us acquire more than $500 million in hotels in 20 months. We formed HEI Hospitality Fund with institutional investors and a significant investment from the principals and employees of HEI. The funds philosophy is somewhat contrary to many of the funds who have a built-in exit strategy. Our goal is hold the real estate for a longer term, which means we are buying a slightly different kind of asset. **HVS:** How does it differ? **Mendell:** We're looking for a lot of the same type of first-class, full-service hotels that other funds are looking for. However, we are more deliberate in our acquisition criteria and are focusing on assets that still have significant productive lives ahead of them. We seek institutional grade properties that are well located, in markets with barriers to entry and can operate well through all phases of the real estate cycle. While we don't have a specific deadline, 5- 10 years would be a reasonable target. Our target size property is 200 to 500 rooms in the top 50 U.S. markets with an emphasis on internationally recognized premium brands. Because of our extended hold period, we will look at new construction on a very selective basis. That doesn't mean that we won't occasionally prune our portfolio, but our intent is to hold considerably longer than most funds out there today, which typically are in the three- to five year range. **HVS:** How much do you intend to invest? **Mendell:** Our fund has $275 million of discretionary equity. What is interesting is that our initial goal was $250 million. It was quite gratifying to be oversubscribed at a time when there were numerous other opportunities for investors. We believe that, with prudent leverage, we have the financial strength and flexibility to acquire up to approximately $800 million in hotels over the next 24 to 36 months. **HVS:** How has the fund done so far and how do you view pricing? **Mendell:** We've closed on five properties, or about one a month so far. We have a very active pipeline. Since the fund began, we've looked at more than 100 properties and have about 20 transactions that we are looking at right now. Prices have been rising, which is a natural after-effect of the rebound in the hotel industry. I don't think any buyer is every happy with prices; they are always going to be too high. Nonetheless, if you look hard enough and you have the expertise to operate the hotels efficiently and the funds to keep them in top competitive position, there are still a reasonable number of properties to choose from. Prices aren't anywhere near the early '90s, when you could buy for 40 to 50 cents on the dollar, but for the most part, it is still less expensive to buy than it is to build and will likely remain that way for the next few years. **HVS:** Why is so much money chasing hotel deals? **Mendell:** The real estate industry is cyclical and the various classes all have different cycles that don't run on the same track. Savvy investors look at the returns available from bonds and the stock market and don't see a lot of upside today. They then turn to real estate and look at the various different sectors. Right now, we're just entering the up phase of the hotel cycle, whereas the other real estate classes are either at peak or in decline. Simply put, most investors believe that compared to other assets, hotels will generate much better returns over the next few years. **HVS:** What do you expect from 2005? **Mendell:** Barring any unforeseen catastrophe, 2005 and 2006 should be good years for the

Summary

An inside look at one of the nation's top hotel acquisition funds. Find out what they are looking for and what are they buying.

industry, a trend that likely will continue after that for at least a few more years if we remain true to historic patterns of the last 75 years. The keys will be the strength of the economy and the extent of overbuilding. Right now, it looks like the supply/demand equation will remain in good shape for at least the next couple of years. From an acquisition viewpoint, there currently is a lot of competition to acquire real estate, which will continue to put pressure on cap rates. The key is relationships and being able to creatively structure transactions that are win-win for the buyer and seller. So far, we've been fortunate, and we look forward to building on past successes. We've acquired about 30 percent of our goal and remain quite optimistic that our $800 million target is still achievable, through a combination of individual assets and portfolios.