HOTELS AND REAL ESTATE INVESTMENT TRUSTS: ARE THE CONFLICTS WORTH IT?

by

R. King Burch
B.S. Zoology, University of South Florida, 1970
M.S. Oceanography, University of Miami, 1979
M.B.A., University of Hawaii, 1987

and

R. Steven Taylor
B.S. Building Construction, Texas A&M University, 1987
M.B.A., Texas A&M University, 1989

SUBMITTED TO THE DEPARTMENT OF URBAN STUDIES AND PLANNING IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF

MASTER OF SCIENCE IN REAL ESTATE DEVELOPMENT
AT THE
MASSACHUSETTS INSTITUTE OF TECHNOLOGY
SEPTEMBER 1996

© R. King Burch and R. Steven Taylor. All rights reserved.
The authors hereby grant to MIT permission to reproduce and to distribute publicly paper and electronic copies of this thesis in whole or in part.

Signature of Author:..
Department of Urban Studies and Planning
August 13, 1996

Signature of Author:..
Department of Urban Studies and Planning
August 13, 1996

Certified by:..
W. Tod McGrath
Center for Real Estate
Thesis Supervisor

Accepted by:..
William C. Wheaton
Chairman
Interdepartmental Degree Program in Real Estate Development

MASSACHUSETTS INSTITUTE OF TECHNOLOGY

SEP 1 6 1996

LIBRARIES

HOTELS AND REAL ESTATE INVESTMENT TRUSTS: ARE THE CONFLICTS WORTH IT?

by

R. King Burch

and

R. Steven Taylor

SUBMITTED TO THE DEPARTMENT OF URBAN STUDIES AND PLANNING ON JULY 31, 1996 IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE DEGREE OF MASTER OF SCIENCE IN REAL ESTATE DEVELOPMENT

Abstract

Since 1993, numerous lodging or hotel-related companies have gone public raising billions of dollars in the public equity markets. Companies going public have used primarily two organizational structures: the taxable C-corporation and the real estate investment trust (REIT). The objectives of this thesis are to: (i) evaluate the structural evolution of hotel real estate investment trusts, (ii) compare the hotel REIT structure to that of a the taxable C-corporation, (iii) compare the investment performance of hotel REITs to that of taxable public hotel corporations, and (iv) to identify those situations in which one organizational structure is preferable to the other.

Chapter 1 presents a brief discussion of the history of REITs and the statutory requirements that an entity must satisfy to maintain its preferential tax treatment. Chapter 2 compares hotel REITs to their taxable public counterparts on the basis of five specific investment and operating criteria. Chapter 3 presents examples of the costs to REIT shareholders generated by the complex structures imposed upon hotel REITs, followed by an analysis of evolutionary changes that have occurred to improve them. Finally, chapter 4 presents some considerations relating to the future of hotel REITs; in particular, under which set of conditions it is preferable for a hotel operating company to elect REIT status. Several appendices follow chapter 4. Appendices A and B provide a general overview of the hotel industry and a discussion of hotel investments in public and private markets. Appendices C, D, and E describe REIT qualification requirements; the history and evolution of REITs; and publicly-traded hotel REITs and taxable C-corporations, respectively.

Thesis Supervisor: W. Tod McGrath
Center for Real Estate

Table of Contents

ABSTRACT **2**

PREFACE **4**

CHAPTER 1: HISTORY OF HOTEL REAL ESTATE INVESTMENT TRUSTS (REITS) **6**

- Introduction 6
- Definition of REITs 8
- Hotel REIT Structures 12

CHAPTER 2: A COMPARISON OF ORGANIZATIONAL STRUCTURES OF PUBLIC HOTEL COMPANIES **24**

- Conflicts of Interest 25
- Flexibility and Growth 29
- Shareholder Control 31
- Tax Status 32
- REIT vs. Taxable Hotel Company Returns 42

CHAPTER 3: CURING THE CONFLICTS **53**

- Costs of the Conflicts 53
- Curing the Conflicts 60

CHAPTER 4: THE FUTURE OF HOTEL REITS **65**

- To REIT or Not to REIT? 66
- Investor Returns 69
- Modified Hotel REIT Structure 74
- Conclusion 78

APPENDIX A: OVERVIEW OF THE HOTEL INDUSTRY **80**

APPENDIX B: OVERVIEW OF HOTEL INVESTMENT **94**

APPENDIX C: REIT QUALIFICATION REQUIREMENTS **109**

APPENDIX D: THE HISTORY AND EVOLUTION OF REITS **113**

APPENDIX E: HOTEL REITS & TAXABLE HOTEL CORPORATIONS **124**

WORKS CITED **129**

Preface

Since 1993, numerous lodging or hotel-related companies have raised billions of dollars in the public equity markets. Companies going public have primarily used two basic organizational structures: taxable C-corporations and real estate investment trusts. The objectives of this thesis are to: (i) evaluate the structural evolution of hotel real estate investment trusts, (ii) compare the hotel REIT structure to that of a the taxable C-corporation, (iii) compare the investment performance of hotel REITs to that of taxable public hotel corporations, and (iv) identify those situations in which one organizational structure is preferable to the other.

Chapter 1 presents a brief discussion of the history of REITs and the statutory requirements that an entity must satisfy to maintain the preferential tax treatment afforded them under sections 856 - 860 of the Internal Revenue Code. The unique challenges that hotel companies face in qualifying for REIT status are discussed, followed by an outline of the organizational structures that have evolved to address these challenges and the function of different parties in these structures. The three structures evaluated for hotel REITs are the basic REIT, the UPREIT, and the paired-shares or stapled shares structure.

The REIT organizational structures presented in chapter 1 create certain operational challenges not faced by taxable C-corporations. Chapter 2 compares hotel REITs to their taxable public counterparts on the basis of five criteria. The first criterion is the presence and effects of conflicts of interests between management and shareholders. The second is the degree to which the organizational structure restricts or enhances the firm's flexibility to pursue growth opportunities. The third, is the degree to which shareholders can influence the actions of management and thereby, the operations of the company. The fourth, is the income tax consequences of the choice of organizational structure. And the fifth is the financial performance of their common stock.

One of the primary criticisms of the public hotel REITs organized in the last three years is the potential created by the REIT structures for the interests of REIT senior management to conflict with those of the REIT shareholders. Chapter 3 presents examples of the costs to REIT shareholders generated by these conflicts. This is followed by an analysis of evolutionary changes that have occurred to mitigate or eliminate the presence of such conflicts. These changes have been concentrated in the areas of eliminating related-party dealings, expanding the lessee market and increasing competition for leases on hotels owned by the REITs, and refining the terms of the agreements underwhich the REIT leases its hotels.

Finally, chapter 4 presents some considerations relating to the future of hotel REITs. This includes the presentation and analysis of a REIT structure currently being implemented by an institutional real estate advisor that ostensibly eliminates many of the negative characteristics of hotel REIT organizational structures. Chapter 4 also discusses the conditions under which it is preferable for a taxable hotel corporation to seek tax status as a REIT.

Appendix A, following chapter 4, provides a synopsis of the development of the U.S. lodging industry and its recent operating statistics. Appendix B presents a discussion of hotel investments in public and private markets including a review of the components of hotel value, trends in hotel real estate prices, and price changes in the Standard & Poor's Hotel-Motel stock index. Appendix

C describes the qualification requirements for REIT status, while Appendix D summarizes the legislative history and evolution of REITs. Lastly, Appendix E briefly describes those publicly-traded hotel REITs and taxable C-corporations which were included in the stock indices developed for this thesis.

Acknowledgments

The authors would like to thank David Carter and Boston Financial Group for providing financial and other support of this thesis. We are also indebted to many other individuals and organizations who provided assistance in obtaining the data and information used this study. While we would like to recognize them individually, any omission of thanks, here, is an oversight and solely the responsibility of the authors. The authors appreciate assistance received from the following: Napoleon Overton and Morgan Keegan; Stephen Rushmore and Hospitality Valuation Services; Marc Lomanno and Smith Travel Research; Robert Kline and Amber Degnan of The Yarmouth Group; Dr. Bjorn Hanson, and Christina Ampil of Coopers & Lybrand LLP; Blake Eagle and MIT's Center For Real Estate; and Roger Cline of Arthur Andersen LLP. We reserve special thanks to Tod McGrath for his enthusiastic, and trenchant, editorial direction of this thesis.

Chapter 1: History of Hotel Real Estate Investment Trusts (REITs)

Introduction

Publicly-traded hotel REITs have existed for decades without much apparent interest from investors until their recent re-introduction in 1993. Therefore, hotel REITs, are *not*, an innovation of the 1990s, in fact, the first public hotel REIT (Starwood Lodging Trust, formerly Hotel Investors Trust) was formed in 1969. A second hotel REIT (Americana Hotels and Realty Corporation), was formed in 1982 by the founder of Hotel Investors Trust, and listed on the New York Stock Exchange. Prior to 1994, however, only 1.5% of all REIT assets were invested in hotels, and investment by REITs represented a far smaller percentage of the value of hotel assets in the U.S (For a more detailed description of the hotel industry and public hotel companies, please see Appendices A and B.)

Since 1993, however, investors have shown a tremendous appetite for shares in public hotel companies, and have supported the most prolific period of public offerings in the history of the hotel industry. A summary of the IPO and trading histories of selected public lodging companies is presented as figure B.1 in appendix B. In the thirty-six months preceding August 1996, approximately $1.4 billion was raised in the initial public offerings (IPOs) of 13 hotel REITs, while another $1.5 billion was raised by 12 newly-listed taxable C-corporations (Table 1.1). In addition, the follow-on debt and secondary equity offerings of these and other hotel companies have pushed the total capital raised for the hotel industry by Wall Street, to approximately $10.2 billion since 1991. Half of this amount has been raised since August 1995 alone (Ford 1996a; Ford 1996b).

Wall Street, indeed, led the recapitalization of the hotel industry with the re-introduction of the hotel REIT. RFS Hotel Investors, led the way with its successful debut in 1993. The volume and

size of IPOs by hotel companies increased steadily and, at least through 1995, hotel REIT IPOs outnumbered those of taxable C-corporations. However, a trend towards more IPOs from hotel companies organized as taxable C-corporations, rather than REITs, has become apparent since mid-1995.

Table 1.1. Hotel Company Initial Public Offerings, 1993-1996

	1993	1994	1995	1996
Equity REITs Number of IPOs	1	6	4	2
Equity REITs IPO Volume ($)	$40,000,000	$293,000,000	$885,000,000	$155,000,000
C-Corporation Number of IPOs	0	2	5	5
C-Corporation IPO Volume ($)	$0	$130,000,000	$475,000,000	$880,000,000
Total IPOs (REITs + C-Corp)	1	8	9	7
*Total Volume ($) (REITs + C-Corp)	$40,000,000	$423,000,000	$1,360,000,000	$980,000,000

*excluding secondary offerings (source: compiled from various trade and business periodicals; for example, see Pacelle, 1996; and Sandler and Pacelle, 1996).

Whether this trend with respect to organizational structure is important, and whether it reflects any consensus by investors about the relative investment prospects of hotel REITs versus taxable C-corporations, recent IPO activity illustrates that hotel investors face a fundamental choice between, (i) broadly participating in the business of hotel ownership and operations through shares of taxable C-corporations, and (ii) participating only in the ownership of the physical hotel assets through shares in tax-advantaged REITs.

In order to understand hotel REITs and the investment opportunities they represent, it is instructive to review the history of REITs and the purpose which they were intended to serve.

Definition of REITs

The real estate investment trust (REIT) vehicle was created to afford small, individual investors access to professionally managed real estate investments, with preferential tax treatment similar in many respects to traditional limited partnership investments (Lynn and Bloomfield 1995, p1-2). The modern REIT is a descendant of the turn-of-the-century Massachusetts business trusts. In the early part of this century such trusts were utilized for the pooling of funds to invest in real estate. The trusts afforded investors many of the benefits associated with corporate structures such as limited liability and transferable ownership shares, but were treated as trusts for tax purposes and thus not subject to income taxes at the entity level. Beginning in 1909, the preferential tax status of business trusts was subjected to several legislative and judicial challenges, culminating in the loss of their entity level tax exemption in the 1935 U.S. Supreme Court case of *Morrissey v. Commissioner* (296 US 344 (1935)). In that case, the Court held that an entity engaged in an active trade or business and possessing a majority of corporate-like characteristics (such as continuity of life, transferable ownership, centralized management and limited liability) would be taxed as a corporation.

Many of the real estate business trusts in existence in 1935 were then liquidated, but around 1950 those that remained organized a lobbying effort appealing to Congress to pass legislation granting preferential tax treatment to real estate business trusts. In response to their efforts, the Real Estate Investment Trust Act was passed in 1960, creating the REIT substantially as it exists today (The New York Times, Sept. 5, 1960). REITs were granted preferential tax treatment by allowing them to deduct from their taxable income dividends paid to their shareholders. This tax treatment effectively enables REITs to avoid taxation at the entity level. A more detailed discussion of the judicial and legislative history of REITs is presented in Appendix D.

In creating REITs, Congress intended that they would remain primarily passive investment vehicles for the benefit of small investors. Congress was particularly concerned that REITs not engage in an active trade or business and enjoy an unfair competitive advantage over their taxable competitors by virtue of their preferential tax treatment. Therefore, Congress imposed upon REITs certain strict organizational and operating requirements which must be continually satisfied to maintain their preferential tax status. These requirements can be grouped into four categories: organizational requirements, asset requirements, income source requirements, and income distribution requirements.

The organizational requirements stipulate that a REIT must be organized as a corporation, trust or association and structured such that it would be taxable as a corporation in the absence of its REIT tax status. To insure diverse ownership, a REIT's shares must be held by at least 100 individual investors for at least 335 days in each tax year. Lastly, to guard against concentration in ownership, no more than 50 percent of a REIT's outstanding voting shares can be held by 5 or fewer investors (Internal Revenue Code (IRC) § 856(a)(1)).

The asset requirements are designed to insure that REITs invest primarily in real estate and real estate related investments, and that REITs maintain a prudent level of diversification in their non-real estate investments. There are two asset requirements. First, the 75-percent test requires that at the end of each quarter at least 75 percent of the assets held by a REIT consist only of real estate, cash, ordinarily occurring receivables, and government securities (IRC § 856(c)(5)(A)). Real estate is defined to include direct and partnership investments in real property, loans secured by mortgages on real property, interests in real estate mortgage investment conduits, ownership shares in other qualifying REITs, and assets attributable to temporary investments of new capital such as from an initial or secondary public equity offering.

The asset requirement related to diversification has three components. First, not more than 25 percent of a REIT's assets may consist of non-REIT, non-government securities. Second, not more than 5 percent of a REIT's non-real estate, non-government assets may be from a single issuer. Third, a REIT may not hold more than 10 percent of the outstanding voting securities of a corporation that is either not a REIT or not a qualifying subsidiary of the subject REIT (IRC § 856(c)(5)(B)). A qualifying subsidiary of a REIT is defined to be a subsidiary that has been wholly owned by the REIT throughout the subsidiary's existence (IRC § 856(i)).

There are three requirements a REIT must satisfy related to the sources of its income. These requirements are commonly known as the 95-percent test, the 75-percent test, and the 30-percent test. Under the 95-percent test, at least 95 percent of the gross income received by a REIT for a taxable year must be derived from the following: dividends, interest, rents from real property, gain from the sale of real property not held primarily for sale to customers in the ordinary course of business, income and gain from foreclosure property, property tax refunds, and loan or contract commitment fees (IRC § 856(c)(2)).

The 75-percent income test is designed to ensure that REITs derive most of their income from real estate and real estate related assets. This test requires that at least 75 percent of a REIT's gross income be derived from the following: rents from real property, interest on loans secured by mortgages on real property, gain from the sale of real property other than prohibited transactions, dividends and other distributions from interests in other REITs, refunds of taxes on real property, income and gain from foreclosure property, loan and contract commitment fees, and qualified temporary investment income (IRC § 856(c)(3)). A prohibited transaction is defined to be the sale or other disposition of property, other than foreclosure property, that is held by the taxpayer primarily for sale to customers in the ordinary course of a trade or business (IRC § 857(b)(6)(B)).

Finally, the 30-percent test limits the portion of REIT income that may be derived from short-term investments and is intended to prevent REITs from acting as brokers or dealers of securities and real estate assets. Specifically, the 30-percent test stipulates that no more than 30-percent of a REIT's income during a tax year may be derived from the following: sales of stock or securities held for less than one year, sales of real property held for less than four years other than property acquired involuntarily such as through foreclosure, and gain from sales qualifying as prohibited transactions (IRC § 856(4)).

The final and perhaps most commonly recognized operational requirement for electing and preserving tax status as a REIT is the required distribution of taxable income. Under the current tax code, REITs are required to distribute to shareholders 95 percent of their taxable income each year (IRC § 857(a)(1)). Taxable income for a REIT is defined by the tax code as regular corporate taxable income adjusted by disallowing the standard corporate dividends received deduction and excluding any REIT income that is taxed under other provisions of the tax code (IRC § 857(b)(2). Income, after these adjustments, is what a REIT would otherwise be taxed on; however, if a REIT distributes at least 95% of this amount of taxable income to its shareholders in the form of cash dividends, it is entitled to claim a deduction for such dividends paid, which effectively results in eliminating any entity-level tax liability.

Failure to meet any of the aforementioned requirements will result in a REIT losing its preferential tax status (ability to claim a deduction for dividends paid) and being subject to income taxes at the entity level. However, the REIT statutes and tax code do provide opportunities to cure certain violations that are deemed to be unintentional. A more detailed discussion of the REIT requirements is provided in Appendix C.

Hotel REIT Structures

Although the REIT format has been used for virtually every property type over the previous thirty years, it was not until recently that it has been used to any great extent for the ownership of hotels. The primary reason for the historical lack of hotel REITs has been that the level of services provided hotel guests causes hotel room revenues not to qualify as rent from real property as required under the 95-percent and 75-percent income source tests mentioned above. The REIT statutes and tax code define rents from real property as:

> *(1) rents from interests in real property; (2) charges for services customarily furnished or rendered in connection with the rental of property; and (3) rent attributable to personal property leased in connection with a lease of real property, if such rent does not exceed 15 percent of the total rent received under the lease* (IRC § 856(d)(1)(A-C)).

The statutes and tax code further require that services provided in (2) above be usually or customarily furnished (by property owners) in connection with the mere rental of real property. Unfortunately for hotels, services such as room service, telephone service, and maid service do not fall within this definition. Therefore, most revenues received by a hotel in its normal course of business do not satisfy either the 95-percent income source test or the 75-percent income source test for REIT qualification.

Additionally, though to a lesser extent, hotels typically maintain a larger investment in personal property, or furniture, fixtures and equipment (FF&E), than do other types of real estate. Therefore, a hotel renting a room to a guest for the evening is not only renting a certain quantity space to the guest, but is also renting the use of furniture, a television, linens, etc. A portion of the room charge paid by the guest must be attributed to the value of the furnishings. Depending upon

how well a hotel furnishes its facilities and guest rooms, a hotel may also violate the 15 percent restriction related to FF&E in the definition of rents from real property.

The challenge, therefore, in employing the REIT format in financing hotel companies has been converting the typically non-qualifying income stream of hotel room and service revenues into a stream of cash flows that will satisfy the income source requirements for REITs. The solution for this problem has been for a hotel owner/operator wishing to qualify for REIT status to separate the hotel ownership from the hotel operations. This is done by creating one entity which will own the hotels, and qualify as a REIT, and a separate and independent entity charged with operating the hotels. The ownership entity then leases the hotels to the operating entity, and receives in return a stream of rental payments that qualify as rent from real property under the REIT income source tests (Clifton, 1994-1995, p. 4)

This structure was first employed in August of 1993 when the investment banking firm of Morgan Keegan & Company led the initial public offering of RFS Hotel Investors, Inc. (RFSHI), the first of the 1990's hotel REITs. Prior to its initial public offering, RFS was a privately held hotel owner\operator. To accomplish its public offering as a REIT, RFS created RFSHI to be the hotel owner (the REIT) and created RFS, Inc., to be the independent operator of the hotels.

The Basic Hotel REIT Structure

There are several parties/entities involved in the formation and operation of a hotel REIT and its properties. These generally include the REIT sponsor, the shareholders of the REIT, the real estate investment trust itself, the lessee, the management company, and the franchisor. The structure may also include an external advisor to the REIT. Depending upon the specific hotel REIT, some of

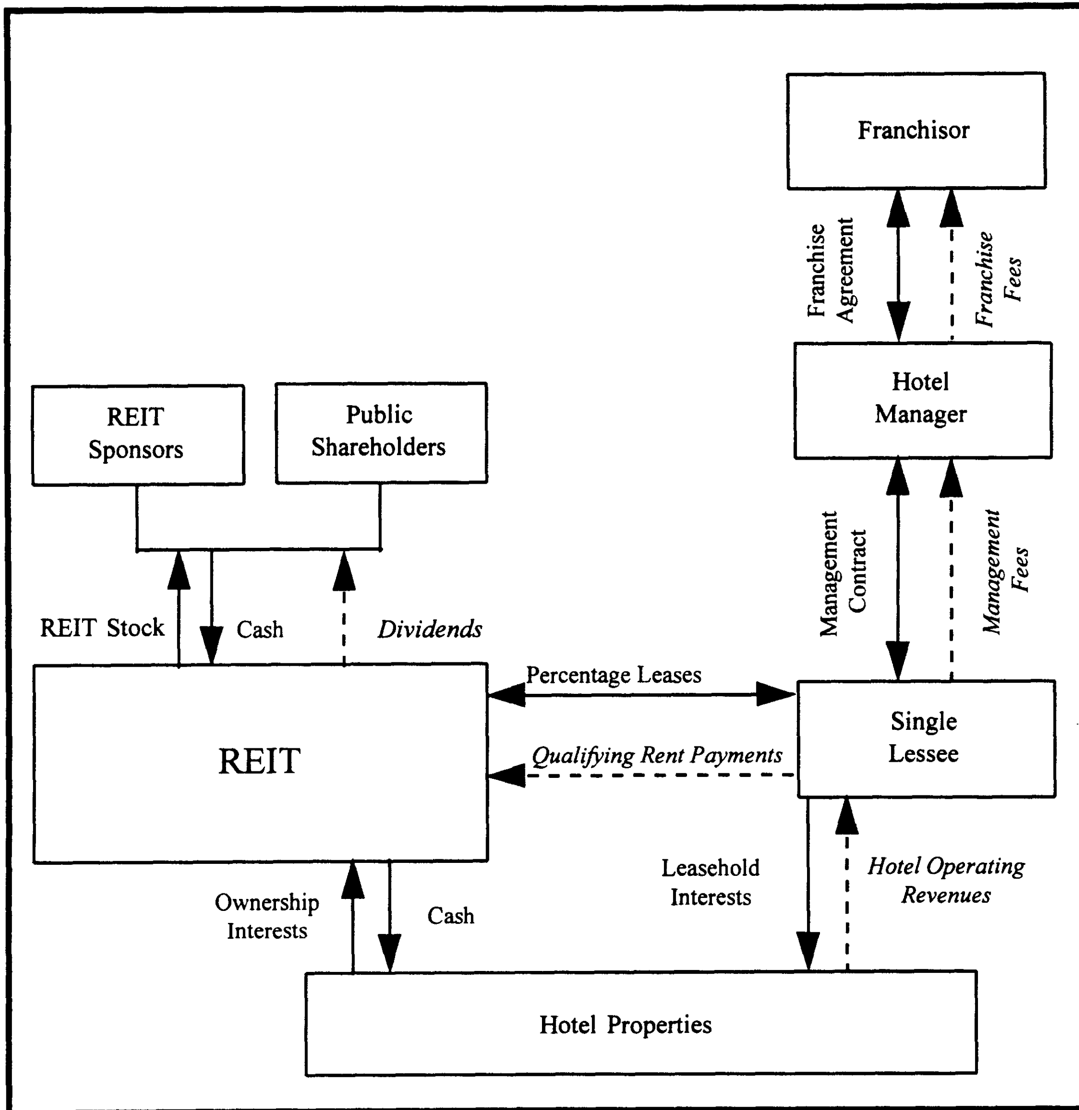
these parties may be related entities or may, in fact, be the same entity. Figure 1.1 on the following page depicts the relationships among the various parties involved in a hotel REIT.

The REIT sponsor is the entity forming the REIT. Generally, in the case of hotel REITs, the sponsor is a privately-held entity that both owns and operates hotels. Sponsors may also develop hotels. Many sponsors were recently formed and have experienced a substantial growth in the past few years by acquiring hotel properties from distressed sellers such as the FDIC, financial institutions, and insurance companies. Sponsors typically retain significant ownership interest in the REIT and serve as senior management of the REIT.

The REIT, usually created just prior to the initial public offering, is the entity which owns the hotel properties. Most REITs are structured as either C-corporations or state business trusts. The REIT, owned by its shareholders, is the lessor in the lease agreements with the hotel lessee. Depending upon the size of the REIT and certain other considerations, the REIT will either be operated and managed by employees of the REIT (self-administered), or the trustees or directors of the REIT may chose to retain, on a fee basis, an external advisor to manage the REIT (externally-advised). In the case of self-administered REITs, the senior management positions are generally assumed by senior management of the sponsor. In the case of externally advised REITs, the advisor is typically an entity that is wholly-owned by the sponsor.

Figure 1.1

Basic Hotel REIT Structure



The choice between being self-administered and externally-advised generally depends upon the REIT's size. A larger REIT can afford the overhead costs associated with a full-time professional staff. Such costs, however, may be too great a burden on earnings for smaller REITs, which instead retain an external advisor. Some REITs, such as RFS Hotel Investors, have gone public with an external-advisor and changed to a self-administered structure after experiencing substantial growth.

The lessee is the entity that actually controls the hotels and is charged with operating or arranging for the operation of the hotels. In most of the early hotel REITs, the lessee was owned by the sponsor. The lessee acquires operational control of the hotel properties via the lease agreements with the REIT, which are generally referred to as percentage leases because the rental payments are based on a percentage of hotel gross revenues. The lessee will then enter into management agreements with hotel management companies who actually operate the hotels. In some cases, however, the lessee also functions as the hotel management company. The lessee will typically receive the hotel operating revenues, and then make rental payments to the REIT based on the terms of the percentage leases.

The hotel manager is the entity that is responsible for the staffing and day-to-day operations of the hotel as an operating business. Management companies may own their own brand names, or "flags", such as Doubletree Hotel Corporation, Marriott International, and Hilton Hotels, or may be independent and secure a national brand affiliation for the REIT's hotels by entering into franchise agreements with a hotel franchisor such as Hospitality Franchise Systems or Prime Hospitality Corporation. Hotel management companies receive a fee for operating the hotels, which is typically structured as 1 to 5 percent of the hotel's gross revenues plus various incentive

fees (Webster 1995). As mentioned above, the lessee and the management company may be the same or related entities.

The hotel manager may enter into a franchise agreement with a franchisor to secure a national brand for the REIT's hotels. Franchisors typically provide benefits and services such as the use of a nationally recognized brand name and logo, access to national reservation systems, employee training services, and participation in national marketing programs. For these services franchisors typically receive fees of 2 to 10 percent of gross revenues (Webster 1995). In a typical hotel structure, the owner of the hotel holds the rights to the franchise. However, in the case of hotel REITs, the lessee typically controls the rights to the franchise, subject to an agreement between the REIT and the franchisor allowing the REIT to transfer the franchise to another lessee in the event the percentage lease with the initial lessee is terminated or expires.

From the REIT's standpoint, the key to the feasibility of this arguably passive ownership/operating structure are the terms of the percentage lease agreements between the REIT and the lessee. In structuring the percentage lease agreements, there are two major concerns. First, the leases must qualify for tax purposes as true leases rather than service contracts or partnerships. If the leases are deemed by the Internal Revenue Service to be service contracts or partnerships, the income stream received by the REIT will not satisfy the REIT income source tests and the REIT will lose its tax status. To ensure compliance with the tax code, lease agreements between REITs and their lessees have typically exhibited most or all of the following characteristics:

1. the lease agreement is drafted as, and is intended to be, a lease;
2. the lessee has exclusive possession and a right to quite enjoyment of the hotel property under the terms of the lease;

3. the lessee bears all costs and expenses for operation and maintenance of the property except for real property taxes, casualty insurance for the structure, and negotiated replacement costs for furniture;

4. the leases are for a length of time equivalent to a substantial portion of the economic life of the physical property, typically 7 to 10 years;

5. the lessee is required to indemnify the REIT for damage to the property;

6. replacement of the property by the lessee is generally required in the event of destruction of the hotel other caused by casualty, and;

7. the lessee has a substantial risk of loss or financial gain depending upon its management of the hotel (Clifton, 1994-1995, p. 4).

The second objective is that the rental payments in the leases be structured so as to capture and return to the REIT, to the greatest extent possible, the full profitability of the hotels. The leases, therefore, are structured as percentage leases in which the rent payments are composed of a certain minimum base rent plus an additional percentage rent. Table 1.2 on the following page is taken from a prospectus for a secondary equity offering for a hotel REIT and describes the percentage rent terms contained in the leases between the REIT and its lessee. To comply with the REIT statutes and tax code however, the rent cannot be based on the net income of the hotels, rather the rent must be based on the hotel's gross revenues. Additionally, as required in characteristic number 7 above, the rent must be structured so as allow the lessee the opportunity to make an economic profit. This presents certain challenges in designing the leases because if the percentages are set too low, an undue amount of the hotel's profits are trapped in the lessee. Conversely, if the percentages are set too high, the lessee will either have to starve the hotels to make the rent payments or default on its lease with the REIT. Designing the leases, therefore, requires a certain amount of skill and experience both in the lodging industry, in general, and

Table 1.2
Sample Percentage Leases

Location	Annual Base Rent	Percentage Rent Terms	Annual Percentage Rent
Holiday Inn - Clayton, MO	$ 557,228	17% of room revenue up to $2,505,320	$ 907,012
		30% of room revenue between $2,505,320 and $2,755,320	
		50% of room revenue in excess of $2,755,320	
		20 % of beverage revenue	
		5% of food revenue	
Holiday Inn - Louisville, KY	$ 409,727	23% of room revenue up to $1,537,499	$ 780,341
		45% of room revenue between $1,537,499 and $1,787,499	
		60% of room revenue in excess of $1,787,499	
		20 % of beverage revenue	
		5% of food revenue	
Holiday Inn - Columbia, SC	$ 368,754	17.5% of room revenue up to $1,475,513	$ 591,750
		30% of room revenue between $1,475,513 and $1,725,513	
		50% of room revenue in excess of $1,725,513	
		20 % of beverage revenue	
		5% of food revenue	
Holiday Inn - Franklin, TN	$ 237,642	20% of room revenue up to $893,885	$ 409,762
		35% of room revenue between $893,885 and $1,143,885	
		60% of room revenue in excess of $1,143,885	
		20 % of beverage revenue	
		5% of food revenue	
Holiday Inn Express - Tupelo, MS	$ 245,836	27.5% of room revenue up to $1,014,503	$ 367,251
		50% of room revenue in excess of $1,014,503	
Executive Inn - Tupelo, MS	$ 278,614	34% of room revenue up to $1,007,909	$ 532,086
		60% of room revenue in excess of $1,007,909	
		20 % of beverage revenue	
		5% of food revenue	
Ramada Hotel, Lexington, KY	$ 303,198	14% of room revenue up to $1,305,603	$ 497,410
		30% of room revenue between $1,305,603 and $1,555,603	
		40% of room revenue in excess of $1,555,603	
		20 % of beverage revenue	
		5% of food revenue	
Comfort Inn - Conyers, GA	$ 234,500	32% of room revenue up to $1,000,000	$ 490,483
		75% of room revenue in excess of $1,000,000	
Holiday Inn - Lafayette, LA	$ 700,000	24% of room revenue up to $2,750,000	$ 1,262,354
		35% of room revenue between $2,750,000 and $3,000,000	
		70% of room revenue in excess of $3,000,000	
		20 % of beverage revenue	
		5% of food revenue	
Comfort Inn - Marietta, GA	$ 472,500	27.5% of room revenue up to $1,400,000	$ 778,555
		60% of room revenue in excess of $1,400,000	
Totals	$ 3,807,999		$ 6,617,004

with the particular hotel property. For this reason, ideal acquisition candidates for hotel REITs are seasoned hotels with well documented operating histories.

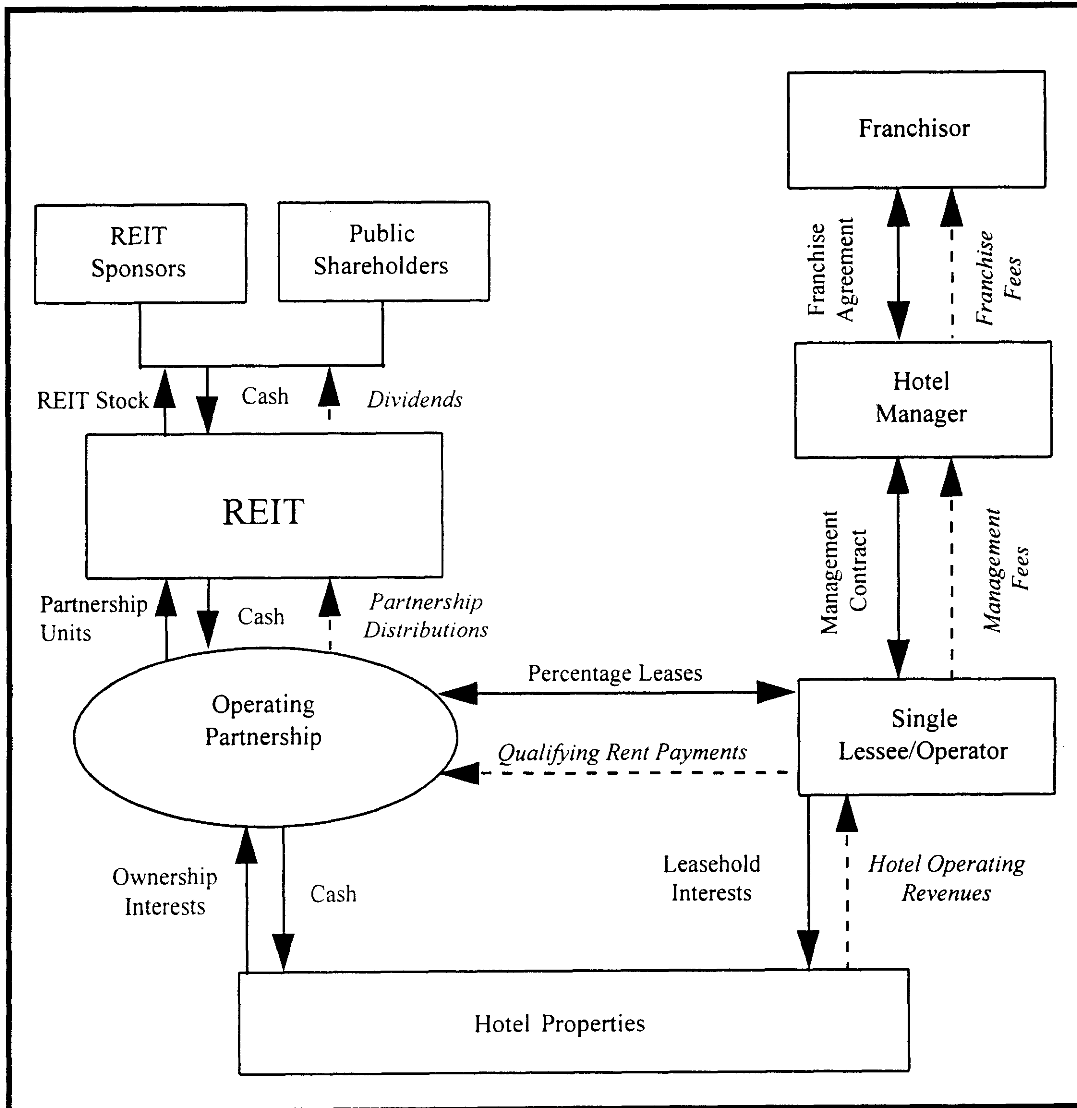
The Hotel UPREIT

A variation of the basic hotel REIT structure is the hotel umbrella partnership REIT (UPREIT) depicted in figure 1.2 on the following page. Of the thirteen publicly traded hotel REITs in existence today, eleven are organized as UPREITs. Only Jameson Inns and Hospitality Properties Trust are organized with the simpler structure depicted in figure 1.1. The difference between the basic REIT and the UPREIT is the inclusion of an operating partnership (OP) which exists between the REIT and real estate assets. In an UPREIT, the REIT owns general and limited partnership interests in the OP, rather than the properties, and receives distributions on its OP units rather than direct rental income. The REIT then pays dividends to its shareholders with the proceeds from the OP unit distributions. The operating partnership actually owns the properties and, in the case of hotel REITs, is the lessor in the percentage lease agreements.

The UPREIT structure was designed to allow property owners to contribute real estate assets to REITs in exchange for an interest in the REIT, without the contribution being deemed a taxable sale. Although the specific details of the tax code governing this issue are outside the scope of this thesis, the fundamental feature of an UPREIT which prevents such a contribution being deemed a taxable event is that instead of receiving shares in the REIT, the contributing property owners receive OP units and rights to exchange the OP units for REIT common stock in the future. The contributing property owners thereby defer the recognition of capital gain income until they sell their OP units or convert them to REIT shares (Kaplan and Stern, 1994).

Figure 1.2

Basic Hotel UPREIT Structure



In addition to the UPREIT structure aiding the initial REIT formation, the structure offers the advantage going forward of using OP units as an additional form of currency for acquisitions. Investors with a relatively low tax basis in a property may be reluctant to sell the property if such a sale will result in the recognition of significant taxable income. In such a situation, the owners can transfer the property to an UPREIT in exchange for OP units, without having to recognize taxable income on the exchange. By using OP units for acquisitions, an UPREIT may be able to acquire assets that would not otherwise be available for sale (Kaplan and Stern, 1994).

The tax deferral characteristic of an UPREIT also gives rise to one of the primary disadvantages with the structure. An owner contributing property to a REIT in exchange for OP units is still linked to the tax basis of the contributed property. Consequently, if the REIT sells the property or even reduces the debt on the property, the contributing owner is forced to recognize its allocable share of taxable income. A conflict can therefore arise in determining when to sell, or recapitalize, certain properties because such actions may have dramatically different tax consequences for the contributor of the property as compared to the other unit holders.

Paired Shares

In addition to the basic REIT and UPREIT structures, there is one other variant of hotel REIT structures, which is the paired or "stapled" share format. In this structure, each share of common stock in the REIT is paired with one share of common stock in the taxable lessee/operator. The shares are referred to as being stapled because they trade as a pair and cannot be traded separately. This structure, therefore, negates many of the material conflicts of interests, to be discussed in chapters 3 and 4, present in non-paired REITs. Unfortunately, the tax code has prohibited, since 1983, the pairing of shares between a hotel REIT and an operating company. One hotel REIT, however, Hotel Investors Trust, was in existence and operating in a paired-share structure prior to

the 1983 change and is, therefore, grandfathered. Hotel Investors Trust was reorganized in 1995 and renamed Starwood Lodging Trust, the shares of which are paired with its lessee, Starwood Lodging Corporation. No other hotel REIT enjoys the paired-share format, although Starwood's controller believes that two other public companies, the Santa Anita (California) thoroughbred horse race track, and the Jockey Club, a Miami condominium and marina project, respectively, were grandfathered along with it by the Deficit Reduction Act of 1984. It should be apparent at this point that the preferential tax treatment (no entity-level tax) enjoyed by REITs does not come without effort, at least in compliance and organizational complexity. The next chapter will specifically compare certain characteristics of hotel REITs versus taxable hotel corporations to explore some of the operational differences of the two structures.

Chapter 2: A Comparison of Organizational Structures of Public Hotel Companies

Based on information compiled from Bloomberg Business News, over the past three years the total equity market capitalization of public lodging companies has grown from $1.1 billion dollars to $13.1 billion dollars. Approximately 25 companies have gone public or been spun off from other companies since August of 1993 (through July, 1996). Interestingly though, approximately 12 companies with a current equity market value of approximately $9.9 billion have gone public as taxable corporations, while approximately 13 companies, with a current equity market value of approximately $3.2 billion, have gone public as REITs. The previous chapter outlined many of the requirements an entity must continually satisfy to maintain its tax status as a REIT. Additionally, the previous chapter presented a discussion of a relatively basic hotel REIT structure. To fully appreciate the added organizational complexity associated with REIT status, it is only necessary to recall that the REIT in Figure 1.1 is very likely to be a C-corporation. Were it not for the statutorily imposed requirements for REITs, the structure presented in Figure 1.1 could be greatly simplified by eliminating the lessee, the management company, and perhaps even the franchisor. The result would simply be the corporate body, its shareholders and the hotel properties themselves.

Considering the organizational complexity required to secure the preferential tax treatment of a REIT, it is important to compare and contrast some of the characteristics of REITs versus their taxable counterparts. Table 2.1 below overviews four important points of comparison between hotel REITs and taxable hotel corporations; namely, conflicts of interest among the various parties involved in operating the hotels, the degree of flexibility afforded the entity in its business operations, the degree to which shareholders can influence management actions, and the effects of their respective tax status.

Table 2.1

	Conflicts	Flexibility\ Growth	Shareholder Control	Tax Status
C-Corporations	usually low	high	subject to statutory antitakeover rules	income subject to double taxation
REITs	high	low	Concentration of Ownership limitations	no entity-level taxation due to deduction for dividends paid

Conflicts of Interest

As previously mentioned, to qualify for REIT status a hotel company must divest itself of management and operational activities and assume the role of a passive real estate owner. This required separation of asset ownership from management and operations may give rise to situations or conditions in which the interests of REIT management may not be fully aligned with those of the REIT's shareholders. In most REITs, the sponsors generally retain a relatively small financial interest in, but retain full managerial control of, the REIT, either by assuming the senior management positions in a self-administered REIT or by owning the REIT's advisor in the case of an externally advised REIT. Conflicts arise in hotel REITs because, at least with the early hotel REITs, the sponsors owned the lessee to which the REIT leased all of its properties. Given this situation, there is a clear potential for agreements between the REIT and its lessee to deviate from otherwise arms length outcomes, because the sponsor of the REIT is, in effect, negotiating in the mirror; both on behalf of the REIT senior management, and on behalf of itself as lessee. This potential conflict of interest can be further compounded if the REIT's senior management also owns the hotel management company retained to operate the REIT's hotels.

The situation described above can act to negatively impact the REIT in several ways. First, in the structuring of the lease agreements between the hotel REIT and the lessee, it is to the lessee's benefit to negotiate the lowest possible level for the percentage rent provisions, while the REIT's shareholders would obviously benefit by the highest possible percentages. In situations where the lessee is owned by the sponsor and the sponsor is also representing the REIT, there is a risk that the sponsor will commit the REIT to a lease that is, on the margin, more favorable to the lessee than would occur in an arm's-length transaction, as all of the lessee profits accrue to the sponsor whereas only a proportionate share of the REIT profits reach the sponsor as a shareholder of the REIT.

Consider, for example, the conflicting incentives which may arise from tying the lease rates on a hotel to its room revenues by means of a minimum rent plus a percentage of incremental revenues. In a typical lease, the REIT might be entitled to 75% of the next incremental dollar of room revenues above a base amount of room sales. If the incremental revenue is generated by increasing the average daily rate charged for a room that is already occupied, then the lessee still earns a profit, because the incremental costs associated with raising the room rate may be as low as 10%. Thus, the lessee retains 15% of the incremental revenue as profit ($1.00 - $0.75 - $0.10 = $0.15) and its interests, and those of the REIT, are aligned because both benefit from increasing revenues by means increasing the room rate. However, under the terms of the lease, the REIT would also benefit from an incremental dollar in room revenues generated by selling more occupied rooms, even at a lower room rate. Increasing room revenues by selling more rooms, however, incurs incremental expenses which may be 35%, or more. Clearly, if the lessee pays 75% of the incremental revenue to the REIT, and 35% of the revenue as expenses, it has lost money ($1.00 -

\$0.75 - \$0.35 = \$ - 0.10) and, thus, has no incentive to boost room revenues by means of dropping room rates to increase occupancy.

Other lease provisions may be affected by conflicting incentives between the REIT and its lessee. In the case of default provisions, the lessee would obviously prefer that the default provisions in the lease offer generous opportunities to cure any defaults and not allow the REIT to easily terminate the lease. The REIT, on the other hand, would prefer precisely the opposite. As with the rental percentages, since the sponsor is representing both the REIT and the lessee, there is a risk that the default provisions in the lease will favor the lessee. Additionally, should the lessee default on one or more of its lease agreements with the REIT, one might question how vigorous the REIT's senior management would be in enforcing its remedies against the lessee they, themselves, own.

Another area of the lease agreement subject to negative influence by such agency conflicts is the funding and control of reserves for capital expenditures. In most of the early structures, the REIT was responsible for funding the reserve for capital expenditures, but the reserve was spent at the discretion of the lessee. This creates a situation in which the lessee may invest the REIT's money in capital projects from which the lessee receives substantially all of the benefits, and not invest in projects which primarily benefit the REIT. An example of this adverse selection problem would be a decision by the lessee to invest the capital reserve funds in a project that reduces operating expenses and increases operating income, such as more efficient mechanical equipment or repaving a parking lot. Both of these projects might be prudent investments in the hotel asset, but neither are likely generate significant additional hotel room revenues. Since the rental payments to the REIT are based on gross revenue, not operating income, and the aforementioned capital projects only reduce expenses, the REIT would see little if any increase in their rental payments while the lessee's operational income from the hotel would increase due to the reduced operating expenses.

The REIT would obviously prefer that the capital reserve be invested in projects that are likely to generate additional hotel revenues, such as updating guest room and common area finishes or adding hotel amenities, commonly referred to as furniture, fixtures and equipment (FF&E). Related to this, it should be recalled that FF&E is personal property, not real property and, if it is owned by the REIT and leased to the lessee, then it constitutes unqualified lease income to the REIT. Because the value of FF&E typically ranges between 10% and 20% of the total development costs of new hotels (Rushmore 1992), ownership by the REIT may, potentially, strain compliance with the REIT income tests and asset tests. In addition, the REIT must pay excise taxes on the value of its personal property.

Alternatively, the lease structure can cause problems in the operation and maintenance of the hotels. Since the lessee's rental obligations to the REIT are based on the hotel's gross revenues, the benefit of any reductions in operating expenses accrue only to the lessee. As such, the lessee may have an incentive to skimp on maintenance and other areas to reduce operating expenses and increase its profits. This may result in the hotel failing to maintain its market position relative to its competition and leave the REIT with an underperforming asset in need of substantial improvements when the lessee's lease expires.

The potential for conflicts also exists outside the four corners of the lease agreements. These include controlling the ability of the sponsor-controlled lessee to develop new hotels or operate hotels owned by competitors of the REIT. Again, as all of the benefits from additional management contracts accrue only to the sponsors via the lessee, and the lessee effectively has long-term control of the REIT's hotel properties via the lease agreements, the sponsor may be tempted to engage in business in direct competition with the REIT, to maximize its financial self-interest.

Another conflict may arise in negotiating leases for newly acquired hotels. If the sponsor controls the REIT and owns the lessee, there is little implicit incentive for the sponsor to entertain or solicit offers from lessees other than the lessee owned by the sponsor. In the absence of competition for new leases, characteristics of existing leases that are overly favorable to the lessee may be repeated in future leases.

In general, the conflicts created by the sponsor controlling the REIT, the lessee, and even the management company, may result in the sponsor operating or growing the REIT in such a way as to primarily benefit the lessee, rather than the REIT's shareholders (George, 1995). All hotel REITs have attempted to eliminate or mitigate the effects of these conflicts on the REIT's shareholders. Chapter 2 will discuss the evolution of the hotel REIT structure in terms of dealing with these conflicts.

Because a taxable C-corporation is not subject to any of the income source restrictions of a REIT, there is no need to separate ownership of the physical asset from the operation of the business. Consequently, parties involved in contracts or transactions with a taxable hotel corporation are less likely to be related entities and far fewer conflicts are likely to exist. Shareholders and investors may, therefore, be more comfortable that agreements between the hotel corporation and other parties will be negotiated on a truly arms-length basis.

Flexibility and Growth

The requirements for REIT status can impede a REIT's ability to grow primarily in two ways. First, as a result of the *de facto* requirement that REITs lease their hotel properties, REITs effectively relinquish control of their assets for a significant portion of the assets' economic lives. As a result, the REIT may have little opportunity to influence projects or decisions affecting the

longer-term value of the hotel properties. The duration of the lessee's interest is determined by the term of its lease. The fact that the lessee's interest may have a finite life may cause the it to operate the hotels with a shorter-term perspective.

Additionally, as mentioned above, the lessee may control the initiation of capital projects at the hotels. As such, even though a REIT may accurately sense a need to renovate or reposition a property, the REIT will probably lack the control to do so. Also, a REIT's lessee may resist a desirable change in franchise affiliation if the resulting franchise fees and expenses would reduce the operating profit to the lessee. Finally, most existing hotel lease agreements include an operating provision, analogous to a "yield-maintenance" provision in debt contracts, by which in the event a REIT sells a hotel, the REIT must compensate its lessee for the value of its leasehold interest, either with a cash settlement or by substituting an equivalent hotel. The lessee, therefore, will directly participate in the proceeds from a sale. In comparison, typical hotel management agreements today allow for termination with minimal notice (30 to 60 days) and a cash settlement of one-half to three times the management fee paid during the previous twelve months (Jones and Rushmore, 1996). This arrangement may be much less costly than having to compensate a lessee for its leasehold interest.

The REIT structure also impedes growth more directly by prohibiting the REIT from pursuing third-party hotel management contracts or developing and franchising new brands and concepts. Such activities are less capital intensive and provide opportunities for a hotel owner to leverage and profit from expertise gained operating its own hotels. Instead, REITs are relegated to engaging only in the capital intensive hotel ownership aspect of the business.

Regular taxable hotel corporations generally do not face any restrictions on their activities and are free to explore growth opportunities in all facets of the hotel industry. Additionally, taxable hotel corporations retain more direct control over their properties and can, therefore, more freely initiate a sale, repositioning, or major renovation.

Shareholder Control

The shareholders of a REIT generally have all of the rights granted stock holders in a regular taxable corporation. In fact, as many REITs are organized as corporations; they specifically have the same statutory rights. Shareholders of REITs have the power via the voting rights vested in their shares to influence management of the REIT by voting on the composition of the REIT's board of directors. Additionally, shareholders may also have voting authority over certain other corporate activities, such as mergers. However, the ability of shareholders in REITs to enhance their influence by accumulating large or controlling blocks of shares is very limited, if not impossible. As with any other corporation, a REIT organized as a C-corporation is subject to (benefits from) any antitakeover legislation enacted in its state of incorporation. In addition to any such restrictions, in response to two of the REIT qualification requirements, the 100-or-greater test and the 5-or-fewer test discussed in Chapter 1, most REIT's have provisions in their charters that prohibit any single investor from accumulating 10 percent or more of the outstanding stock of the REIT.

To enforce the restrictions on ownership, most hotel REITs have provisions in their corporate charters or bylaws granting the REIT the right to redeem any shares owned by a single shareholder that exceed the specified ownership limitation percentage. The provisions usually stipulate that the REIT may redeem the shares at the *lesser* of the then current market price and the price on the date

the shares were purchased. Thus, at best, the offending shareholder gains nothing and, at worst, risks incurring a loss if the excess shares are redeemed for less than the original purchase price. The espoused reason for this is to avoid loss of REIT status as a result of inadequate diversification of ownership. As noted in many prospectuses for REIT public equity offerings, an unfortunate side-effect of this provision is that the ability of a single investor or a small group of investors to effect a change in REIT management is significantly constrained.

As with REITs, shareholders of regular taxable hotel corporations have the power via the voting authority vested in their shares to influence changes in corporate management and policies. Additionally, taxable hotel corporations are subject to any antitakeover statutes enacted in their respective states of incorporation, as well as any self-imposed antitakeover measures, that may impede a single investor or small group of investors from accumulating a controlling interest in the corporation. However, unlike REITs, a concentration of ownership in a small group of investors does not jeopardize something as significant as the entity's tax status.

Tax Status

After reviewing all of the requirements to qualify as a REIT and all of the restrictions imposed on hotel companies operating as REITs, one may wonder why any hotel firm would elect to operate as a REIT. The payoff for adhering to all of the REIT requirements, which are all incremental to those imposed on a taxable public hotel corporation, is the right to receive a deduction from taxable income for dividends paid to shareholders. Therefore, unlike a regular hotel corporation, REITs avoid income taxes at the entity level. REIT income distributed to shareholders is only taxed at the shareholder level.

Regular hotel corporations, while enjoying much simpler organizational structures, greater flexibility, and greater shareholder control, suffer from double taxation. Income distributed to shareholders as dividends is taxed both at the entity level and again at the shareholder level. Although for a taxable hotel corporation, income will always be taxable at the entity level, there are other ways that a firm can return profits to shareholders that are more tax efficient than paying regular dividends One approach is to repurchase outstanding shares. In a share repurchase, shareholders are taxed only on the amount of gain realized on the shares sold. Additionally, as the tax rate for capital gains is currently below the highest marginal rates for ordinary or portfolio income, that portion which is taxable is taxed at a lower rate than if it had been distributed as a dividend. Taxable hotel corporations, therefore, can reduce the impact of taxes at the shareholder level, but not to the extent enjoyed by REITs.

Taxable hotel corporations can also reduce their tax exposure by modifying their capital structure. Specifically, because interest payments may be deducted from taxable income, increasing the level of debt in a firm's capital structure increases interest payments and reduces taxable income. As an example of this approach to minimizing taxes at the entity level, the following example illustrates the tax liability a typical hotel REIT would incur if the REIT and the lessee operated together as a taxable entity. For this illustration, operating data for RFS Hotel Investors, Inc. (RFSHI), and its taxable lessee RFS, Inc. (RFS) was extracted from the RFSHI 10-K filing for December 31, 1995. Table 2.2 presents slightly re-formatted income statements for RFSHI and RFS, as presented in the RFSHI 10-K report. The RFS provision for income taxes is well below the federal rate of 34% because effective January 1, 1995, RFS elected to be taxed as an S-corporation for federal and most state income tax jurisdictions.

To analyze the process and effects of utilizing debt to shield a firm from income tax liability, certain data from table 2.2 was first combined in table 2.3 to model the earnings and tax liability that would result if RFSHI and RFS were combined as a taxable hotel corporation, and paid taxes at the highest marginal tax rate of 34%. The first step in this process of evaluating the impact on the corporate tax liability of adding debt to the combined entity's capital structure, was calculating the combined earnings before interest and taxes (EBIT) and earnings before interest taxes depreciation and amortization (EBITDA). EBIT is equal to the combined entity's taxable income without any debt in its capital structure. To model the amount of debt the combined entity could support we first calculated the earnings before interest taxes depreciation and amortization (EBITDA), which is equal to the cash flow from operations that would be available for debt service. We then estimated the interest expenses the combined entity would incur on various levels of debt secured by its hotels.

Tables 2.4 and 2.5 present the impacts to a combined RFSHI\RFS of utilizing debt to reduce entity level income tax liability. Significantly, table 2.4 presents a model estimating the interest rates that would be required for various levels of debt secured by the combined entity's hotels. The model in table 2.4 is based on the structures employed in creating commercial mortgage backed securities (CMBS). In a CMBS offering, rated debt securities are created from the interest and principal payments originating from one or more loans with sequential repayment priorities, secured by mortgages on real property. Through this process, the various risks inherent in a real estate mortgage loan can be segregated into specific groups or classes of securities. Theoretically, the loan(s) will then be more efficiently priced by the market because investors can select only those risks they want to take and then purchase that corresponding class of security.

The key inputs to a CMBS model are the credit support levels and pricing spreads required for each credit rating. Credit support is a measure of the level of collateral that protects a particular class of securities from losses. In table 2.4, the AAA securities represent 60 percent of the offering and consequently have a credit support of 40 percent. In the event of a default by the borrower, the first 40 percent of losses are absorbed by the junior classes of securities and it is only once losses exceed 40 percent that the AAA holders suffer. The lowest rated securities, the BB's have no credit support and absorb the first losses. The credit support data in table 2.4 is based on published Standard and Poor's rating standards for hotel loans with a loan-to-value ratio of 80 percent and a minimum debt service coverage ratio of 1.15. The pricing spreads represent the yield spread above comparable term U.S. Treasury securities. As indicated in table 2.4, as the level of credit support declines, the pricing spreads increase. The pricing spreads presented in table 2.4 are based on industry data as of December 1995, as published by Nomura Securities.

The CMBS interest rate model generates estimated yields ranging from 7.72 percent for the AAA securities to 11.39 percent for the lowest BB securities, with a weighted average yield of 8.51 percent. This model does not precisely reflect the security or interest rate structure that could be achieved on a hotel-backed CMBS offering, but the estimated required yields are representative of market requirements for the purposes of this comparison. As a test of their reasonableness, borrowing data included in December 31, 1995 10-K reports was reviewed for several taxable hotel corporations. These firms reported interest rates of ranging from 8 percent to 12 percent for loans backed by first mortgages, and interest rates of 9.25 percent to 12 percent for loans backed by second mortgages. Although the precise details of the loans were not disclosed, this information does seem to support that the interest rates generated with the CMBS model are reasonable, at least for a hotel company with a diversified asset base.

Using the EBIT and EBITDA figures in table 2.3 calculated for the combined RFSHI\RFS and the interest rate structure presented in table 2.4, table 2.5 illustrates the effects of adding incrementally greater levels of debt to the combined entity's capital structure. The asset book values presented in table 2.5 were taken from the RFSHI 1995 annual report. The estimated asset market values are based on asset descriptions contained in the RFSHI 1995 annual report and hotel market value data presented in appendix B, table B.6. Specifically, as of December 31, 1995, RFSHI owned 48 hotels containing 6,667 rooms. Of these, 3,561 were described as limited-service, 1,506 were described as full-service, and 1,600 were described as extended-stay. Using the data in table B.6, if the limited-service rooms are valued as "budget" rooms at $45,000 per room and the full-service and extended-stay rooms are valued as "mid-rate" rooms at $70,000, RFSHI's portfolio has an approximate market value of $377,665,000. This amount, combined with $26,995,000 in other assets appearing on the December 31, 1995 balance sheets for RFSHI and RFS appears as the estimated asset market value on table 2.5.

Scenario 1 illustrates the tax liability to RFSHI\RFS without any debt, and consequently no interest payments to reduce its tax liability. In this scenario, RFSHI\RFS faces a tax liability of approximately $11.7 million. Scenarios 2 through 6 add additional levels of debt by assuming that incrementally lower rated securities are offered in each successive scenario. The amount of incremental debt offered in each scenario is based on the credit support levels for each security presented in table 2.4.

In scenario 2, which assumes that only AAA rated securities are issued, the credit condition of RFSHI\RFS is not severely compromised. The firm's debt as a percent of its total book value of assets is just slightly over 61 percent and its EBITDA is 2.36 times required interest payments. However, the firm still faces a tax liability of $5.3 million. Advancing from scenario 2 to scenario

6, the firm's income tax liability progressively declines, however, with a proportionate degradation in its credit condition. In scenario 6, the firm faces no tax liability, as would a REIT, but the debt level has increased to almost 102 percent of the book value of its assets, or 98.5 percent of the estimated market value of its assets, and its debt coverage ratio (EBITDA) has plunged to 1.28 times required interest payments. This example illustrates that, while a firm could pursue this strategy, the level of debt required to completely shield a firm's income from tax exposure would probably be so great as to be imprudent, even for a firm with a diversified asset base in terms of geography and hotel concept. Furthermore, a zero tax liability would imply near zero GAAP earnings (due to the near parity between tax and GAAP depreciation schedules). For many companies and investors, this would be problematic in terms of evaluating the financial performance of the company compared to its peers. This situation, created in part by large non-cash depreciation deductions, is precisely what prompted the REIT industry to advocate the development and use of funds from operations (FFO) to gauge REIT operational performance. (For a more complete discussion of the genesis and rationale for FFO, see NAREIT, 1995a.).

However, some taxable hotel corporations at present do substantially reduce or eliminate their income tax liabilities in this fashion. For instance, based on the December 31, 1995 10-K filing for Host Marriott Corporation (HMT), HMT had hotel properties and equipment with book values of $2.9 billion and outstanding debt of $2.2 billion. For the year 1995, HMT reported an operating loss of approximately $75 million, resulting in no income tax liability for the year and a net operating loss carryforward of $13 million, which can be used to shielded taxable income in future years. Therefore, through its capital structure HMT is enjoying a tax shield similar to a REIT, without all of the statutory constraints suffered upon REITs.

Table 2.2
Unmodified Comparison
(000's)

RFS, Inc. (Lessee)		RFS Hotel Investors, Inc. (REIT)	
Revenue:		**Revenue:**	
Hotel operations	$ 122,253	Lease revenue	$ 47,249
Management & consulting fees	$ 452	Interest and dividend income	$ 1,058
Interest and dividend income	$ 455	Other	$ -
Other	$ 100		$ -
Total revenue	$ 123,260	Total revenue	$ 48,307
Expenses:		**Expenses:**	
Hotel operating costs	$ 32,552	Real estate taxes & property and casualty insr.	$ 5,019
General & administrative	$ 12,874	Depreciation and amortization	$ 9,114
Management bonuses	$ 582	Advisory fees	$ -
Franchise costs	$ 8,315	Compensation	$ 936
Advertising & promotion	$ 4,294	Franchise taxes	$ 283
Utilities	$ 6,151	General & administrative	$ 968
Repairs and maintenance	$ 6,006	Amortization of loan costs	$ 310
Depreciation and amortization	$ 172		$ -
Leases, insurance and taxes	$ 1,603		$ -
Equity in loss (earnings) of partnerships	$ 198		$ -
Business combination expenses	$ 1,007		$ -
	$ -		$ -
Lease expense	$ 47,249		$ -
	$ 121,003		$ 16,630
Earnings before interest and taxes (Operating income)	$ 2,257	**Earnings before interest and taxes (Operating income)**	$ 31,677
Interest expense	$ 93	Interest expense	$ 592
	$ 2,164		$ 31,085
Dividends paid	$ -	Dividends paid	$ 29,176
Earnings before taxes (GAAP taxable income)	$ 2,164	**Earnings before taxes (GAAP taxable income)**	$ 1,909
Provision for income taxes	$ 35	Provision for income taxes	$ -
After-tax net income	$ 2,129	**After tax income**	$ 1,909

Table 2.3

RFSHI\RFS Federal Income Tax Liability without REIT Status

(000's)

RFSHI\RFS Combined (Non-REIT)	
Revenue:	
Hotel Operations	$ 122,253
Management & Consulting Fees	$ 452
Interest & Dividend Income	$ 1,513
Other	$ 100
Total revenue	$ 124,318
Expenses:	
Hotel operating costs	$ 32,552
General & administrative	$ 13,842
Management bonuses	$ 582
Franchise costs	$ 8,315
Advertising & promotion	$ 4,294
Utilities	$ 6,151
Repairs & maintenance	$ 6,006
Equity in loss (earnings) of partnerships	$ 198
Business combination expense	$ 1,007
Real estate taxes & property and casualty insr.	$ 6,622
Depreciation and amortization	$ 9,286
Advisory fees	$ -
Compensation	$ 936
Franchise taxes	$ 283
Amortization of loan costs	$ 310
	$ 90,384
Earnings before interest and taxes (Operting income)	$ 33,934
Interest expense	$ 685
	$ 33,249
Dividends paid	$ -
Earnings before taxes (GAAP taxable income)	$ 33,249
Provision for income taxes	$ 11,305
After tax income	$ 21,944

Table 2.4
CMBS Interest Rate Model

Credit Rating	Bonds $ millions	Share of Offering	Credit Support	DSCR	Pricing Spread (bp)	Pricing Yield	Price	Coupon	Interest Expense
AAA	$ 239,154,284	60.00%	40.00%	2.36	83	7.72%	$ 1.000	7.72%	$ 18,462,711
AA	$ 27,901,333	7.00%	33.00%	2.10	115	8.04%	$ 1.000	8.04%	$ 2,243,267
A	$ 39,859,047	10.00%	23.00%	1.81	140	8.29%	$ 1.000	8.29%	$ 3,304,315
BBB	$ 19,929,524	5.00%	18.00%	1.69	190	8.79%	$ 1.000	8.79%	$ 1,751,805
BB	$ 71,746,285	18.00%	0.00%	1.28	450	11.39%	$ 1.000	11.39%	$ 8,171,902
Total/Avg.	$ 398,590,473	100.00%		1.28	162	8.51%	$ 1.000	8.51%	$ 33,934,000
10 Year Treasury ***(August 1, 1996)***						6.89%			

source: Standard & Poor's, Nomura Securities, The Wall Street Journal

Table 2.5
Iterative Modifications to Capital Structure

Scenario			1	2	3	4	5	6
Principal Amount of Debt	% of Total Debt	Effective Interest Rate						
AAA	60.00%		$ -	$ 239,154,284	$ 239,154,284	$ 239,154,284	$ 239,154,284	$ 239,154,284
AA	7.00%		$ -	$ -	$ 27,901,333	$ 27,901,333	$ 27,901,333	$ 27,901,333
A	10.00%		$ -	$ -	$ -	$ 39,859,047	$ 39,859,047	$ 39,859,047
BBB	5.00%		$ -	$ -	$ -	$ -	$ 19,929,524	$ 19,929,524
BB	18.00%		$ -	$ -	$ -	$ -	$ -	$ 71,746,285
Total Principal Amount of Debt				$ 239,154,284	$ 267,055,618	$ 306,914,665	$ 326,844,189	$ 398,590,474
Total Assets (Book Value 12/31/95)			$ 391,092,000	$ 391,092,000	$ 391,092,000	$ 391,092,000	$ 391,092,000	$ 391,092,000
Estimated Asset Market Value (12/31/95)			$ 404,660,000	$ 404,660,000	$ 404,660,000	$ 404,660,000	$ 404,660,000	$ 404,660,000
Total Debt as a % of Asset Book Value			0.0%	61.2%	68.3%	78.5%	83.6%	101.9%
Total Debt as a % of Asset Market Value			0.0%	59.1%	66.0%	75.8%	80.8%	98.5%
Interest Expense								
AAA	60.00%	7.72%	$ -	$ 18,462,711	$ 18,462,711	$ 18,462,711	$ 18,462,711	$ 18,462,711
AA	7.00%	8.04%	$ -	$ -	$ 2,243,267	$ 2,243,267	$ 2,243,267	$ 2,243,267
A	10.00%	8.29%	$ -	$ -	$ -	$ 3,304,315	$ 3,304,315	$ 3,304,315
BBB	5.00%	8.79%	$ -	$ -	$ -	$ -	$ 1,751,805	$ 1,751,805
BB	18.00%	11.39%	$ -	$ -	$ -	$ -	$ -	$ 8,171,902
Total Interest Expense			$ -	$ 18,462,711	$ 20,705,978	$ 24,010,293	$ 25,762,098	$ 33,934,000
EBITDA			$ 43,530,000	$ 43,530,000	$ 43,530,000	$ 43,530,000	$ 43,530,000	$ 43,530,000
Debt Service Coverage Ratios								
AAA			n/a	2.36	2.36	2.36	2.36	2.36
AA			n/a	n/a	2.10	2.10	2.10	2.10
A			n/a	n/a	n/a	1.81	1.81	1.81
BBB			n/a	n/a	n/a	n/a	1.69	1.69
BB			n/a	n/a	n/a	n/a	n/a	1.28
Overall DSCR			n/a	2.36	2.10	1.81	1.69	1.28
EBITDA			$ 43,530,000	$ 43,530,000	$ 43,530,000	$ 43,530,000	$ 43,530,000	$ 43,530,000
less D/A			$ (9,596,000)	$ (9,596,000)	$ (9,596,000)	$ (9,596,000)	$ (9,596,000)	$ (9,596,000)
EBIT			$ 33,934,000	$ 33,934,000	$ 33,934,000	$ 33,934,000	$ 33,934,000	$ 33,934,000
Less Interest Expense (from above)			$ -	$ (18,462,711)	$ (20,705,978)	$ (24,010,293)	$ (25,762,098)	$ (33,934,000)
Taxable Income			$ 33,934,000	$ 15,471,289	$ 13,228,022	$ 9,923,707	$ 8,171,902	$ (0)
Federal Income Tax Liability @ 34%			$ (11,537,560)	$ (5,260,238)	$ (4,497,527)	$ (3,374,060)	$ (2,778,447)	$ 0
After-Tax Earnings (Net Income)			$ 22,396,440	$ 10,211,051	$ 8,730,495	$ 6,549,647	$ 5,393,455	$ (0)

REIT vs. Taxable Hotel Company Returns

After having reviewed some of the operating and structural differences between hotel REITs and taxable hotel corporations, it is instructive to compare the returns that investors have realized since the resurgence of hotel REITs in 1993. In making the comparison, several existing hotel and lodging stock indices were reviewed but all were found to be based on too few stocks or too heavily weighted to gaming or hotel franchising. For example, the Standard & Poor's Hotel-Motel Index, (discussed in Appendix B) currently contains only four stocks: Marriott International, Harrah's Entertainment, ITT Sheraton, and Hilton Hotels. Harrah's derives the vast majority of its income from gaming activities and has relatively little if any true hotel operations. Marriott International is a hotel operator and franchisor, but does not own any hotels. Hilton and Sheraton both own hotels, but derive a large portion of their earnings from gaming operations. Thus the S&P Hotel-Motel index is not a good proxy for the performance of companies that primarily own, operate and/or manage non-gaming hotels.

Therefore, we felt compelled to create several new indices which we believed would better reflect the investment performance of hotel REITs and comparable taxable hotel corporations. The rationale for the comparison between hotel REITs and taxable hotel corporations is that (i) were it not for the benefits offered, and restrictions imposed, by the tax code, there is no logical reason why hotel REITs would operate under their current lessor/lessee structure, and (ii) we were interested to whether such operating burdens negatively affected the value of the firm, even after accounting for the benefit of no corporate-level taxation. In other words, we sought to answer the question of whether the prospect of receiving the dividends paid deduction (with all of its associated requirements) is a net asset or a net liability to the shareholders of a publicly-traded

hotel operating company. By our reckoning, the public capital markets could best answer that question.

For purposes of comparison, a total of eight indices were created. Two pools of public hotel companies were compiled and four indexes were created for each pool. The indices are based on weekly closing share price and dividend data, as maintained by Bloomberg Business News (Bloomberg) for the observation period of August 6, 1993 (the date of RFSHI's IPO) through and including June 28, 1996. All of the indices have an initial value of 100 as of August 6, 1993. The resulting eight indices are:

Hotel REITs	Taxable Hotel Corporations
Equally Weighted Price Return	Equally Weighted Price Return
Equally Weighted Total Return	Equally Weighted Total Return
Market Weighted Price Return	Market Weighted Price Return
Market Weighted Total Return	Market Weighted Total Return

The hotel REIT indices include every publicly-traded hotel REIT actively traded on a U.S. stock exchange as of March 31, 1996. Subsequent to March 31, 1996, two additional hotel REITs completed initial public offerings, Host Funding Inc. (April 1996) and American General Hospitality Corporation (June 1996), but were not included in the indices due to insufficient data. In constructing the taxable hotel corporation indices, the objective was to measure the returns from companies that most closely resemble those which would result from combining a hotel REIT, with its lessee, operator, and management company. The taxable hotel corporation indices, therefore, are comprised of lodging companies that focus on hotel ownership, operations, management or any

combination thereof. Companies such as Hospitality Franchise Systems and Marriott International, which are primarily franchisors and do not own hotels, were not included in the indices. Additionally, companies such as Hilton Hotels and Ballys International, which may own and operate hotels but also generate a substantial portion of their income from gaming operations, were also excluded. With the exception of Starwood Lodging Trust and Corporation, none of the major public hotel REITs derive a material portion of their income from gaming. A list of the specific firms included in each index is provided as Appendix E.

Price Returns

The four price return indices measure the cumulative change in the share prices of the firms contained in each index. Any dividends or distributions made by the firms during the observation period are ignored. The weekly price return $PR_{y,t}$ for each stock was calculated as outlined below:

$$PR_{y,t} = \frac{SP_{y,t} - SP_{y,t-1}}{SP_{y,t-1}}$$

$PR_{y,t}$= Share price return for stock y, during the period $t-1$ to t.
$SP_{y,t}$= Closing share price for stock y, week t.
$SP_{t,t-1}$= Closing share price for stock y, week $t-1$.

As most of the firms included in the taxable hotel corporations do not pay dividends, there is virtually no difference between the price return indices and total return indices for taxable hotel corporations. In fact, the lines on the resulting graphs of the indices are indistinguishable from each other. However, because REITs are required to distribute 95 percent of their taxable income (and often distribute much more), and consequently pay relatively large dividends, there is a substantial divergence between the price return and total return indices for hotel REITs.

Total Returns

The total return indices measure the cumulative returns of the stocks comprising each index, adjusted for dividends paid by the companies during the observation period. Initially, for firms that were actively traded as of August 6, 1993, we assumed that $1 dollar was invested in a fractional share of each company at the beginning of the observation period. For firms that began trading during the observation period, we assumed that at the end of the first week of trading, $1 dollar was invested in a fractional share of stock at the closing price for the first week of trading. Dividends paid by companies comprising the indices were incorporated into the total return values by using a dividend paid (in proportion to the original fractional share held) to purchase an additional fractional share of stock in the respective company. The additional fractional share was assumed to be purchased at the closing price for the week in which the dividend is paid. This approach effectively reinvests dividends in the company paying the dividend. The weekly total returns were calculated using the following equations:

$$TR_{y,t} = \frac{V_{y,t} - V_{y,t-1}}{V_{y,t-1}}$$

$TR_{y,t}$ = Total return for stock y, during the period $t-1$ to t.
$V_{y,t}$ = Value of stock y in index at week t.
$V_{y,t-1}$ = Value of stock y in index at week $t-1$.

$$V_{y,t} = \left(FS_{y,t-1} + \frac{D_{y,t} * FS_{y,t-1}}{SP_{y,t}} \right) * SP_{y,t}$$

$V_{y,t}$ = Value of stock y in index at week t.
$FS_{y,t-1}$ = Fractional share of stock y owned at time $t-1$.
$D_{y,t}$ = Dividend received on stock y at time t.
$SP_{y,t}$ = Closing share price for stock y, week t.

An alternative approach would be to invest dividends paid at some defined interest rate, such as the rate paid on one or more U.S. Treasury securities, and then calculate the index return as the price

return plus the interest earned on the dividends. This approach, however, creates an index that is initially a pure hotel index but grows to an index that reflects the returns on a basket of hotel and other securities. The approach employed of reinvesting dividends in the respective firm's stock reflects performance based solely on the rates of return generated by the firm's performance.

Market Capitalization Weighted Price and Total Return Indices

In preparing the market-weighted indices, first the weekly share price and total return values for the individual stocks were calculated as described above. For each pool of companies, hotel REITs and taxable hotel corporations, weighted-average weekly returns were then calculated by multiplying each company's weekly share price or total return by its equity market value for that week. The sum of the products was then divided by the total equity market value of all companies in the index to arrive at an equity market capitalization weighted-average return. The composition of the market-weighted indices was rebalanced each week based on changes in the equity market value of each firm relative to the total equity market value represented by the index. This process is summarized by the equation below:

$$I_t = I_{t-1} * \left(1 + \frac{\sum_{y=1}^{N} \left(R_{y,t} * EMV_{y,t} \right)}{\sum_{y=1}^{N} EMV_{y,t}} \right)$$

I_t = Index value at week t.
I_{t-1} = Index value at week $t-1$.
$R_{y,t}$ = Share price or total return for stock y, during the period $t-1$ to t.
N_t = Number of stocks included in the index at week t.
$EMV_{y,t}$ = Equity market value of firm y at week t.

The equity market value of each firm was calculated as the number of shares and share equivalents outstanding at the end of each week, multiplied by the closing price of the stock for each week.

Information on the number of equity shares and share equivalents was gathered from company 10-K reports, annual reports, and quarterly financial statements as maintained by Bloomberg. For hotel REITs, information regarding the number of operating partnership units outstanding was gathered from prospectuses for public equity offerings, company 10-K filings, annual reports, and company press releases.

The market-weighted indices measure the performance of an industry segment or sector. These indices reflect the returns that could have been achieved if an investor could costlessly rebalance its portfolio to reflect changes in the composition of the market. There are two problems associated with market-weighted indices worth noting. First, the majority of individual investors cannot pursue a market-weighted investment strategy. The amount of capital that would be required to construct the initial portfolio is beyond what most individuals would prudently commit to a single industry. Additionally, the transaction costs associated with constant trading to keep a market-weighted portfolio in balance would be prohibitive for anyone other than an institutional investor.

The second shortcoming of market-weighted indices is that the performance of the index can be dominated by a few large firms. If the market capitalization of the firms included in the index varies significantly, and the performance of the firms is in any way correlated with firm size, the behavior of the index will reflect the performance of the larger firms. When reviewing market-weighted indices it is, therefore, important to be aware of the relative weightings of the firms included in an index (Giliberto and Sidroff, 1996).

Equally Weighted Price and Total Return Indices

The equally-weighted indices were calculated in much the same way as the weighted indices previously described. The difference is that for the equally-weighted indices, the weekly index

return is calculated simply as the arithmetic average of the weekly share price or total returns for all of the companies comprising the index. The individual returns are simply added together then divided by number of companies comprising the index that week. This process is described by the equation below:

$$I_t = I_{t-1} * \left(1 + \frac{\sum_{y=1}^{N} R_{y,t}}{N_t} \right)$$

I_t= Index value at week t.
I_{t-1}= Index value at week $t-1$.
$R_{y,t}$= Share price or total return for stock y, during the period $t-1$ to t.
N_t = Number of stocks included in the index at week t.

The equally-weighted indices reflect the performance of a basket of stocks in which the same amount is initially invested in each stock, and then is not adjusted or rebalanced with respect to the other stocks in the index after the initial investment. An equally-weighted index reflects the performance of the average firm in the group. Unlike market capitalization weighted indices, the performance of larger firms in an index does not dominate the performance of the index (Giliberto and Sidroff 1996).

The resulting equally-weighted and market-weighted indices are presented below in figures 2.1 and 2.2 respectively. For the taxable hotel corporations, only the total return indices are included in figures 2.1 and 2.2. Because most of the taxable hotel corporations do not pay dividends there is virtually no difference between the price and total return indices and they are virtually indistinguishable when graphed at the scales used for figures 2.1 and 2.2. Additionally, the S&P Hotel-Motel index is included in both figures to contrast the performance of a hotel index that is

heavily weighted to gaming against those created for REITs and taxable hotel corporations that exclude gaming.

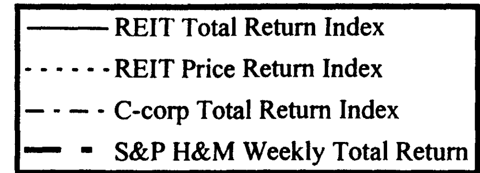
Two distinct trends are apparent in figures 2.1 and 2.2. First, the market-weighted indices outperformed their equally-weighted counterparts. As mentioned above, this is evidence that the behavior of market-weighted indexes can be dominated by one, or a few, large firms. In the case of hotel REITs, Starwood Lodging Trust, with an equity market capitalization of approximately $750 million, benefited from a major recapitalization in 1995, and generated total returns in excess of 130% from December 1994 through June 1996. In December 1994, Starwood represented almost 40 percent of the index. Although Starwood's contribution declined to roughly 28 percent in June 1996, the market-weighted hotel REIT index is still heavily influenced by Starwood's performance. The taxable hotel corporation market-weighted index is dominated by Prime Hospitality, Host Marriott, LaQuinta Inns, and Promus Hotel Corporation, with weightings in June 1996 of 11 percent, 16 percent, 23 percent, and 17 percent, respectively. These four firms thus comprised roughly 67 percent of the index, with the remaining 13 firms accounting for only 33 percent. As mentioned above, because the market-weighted indices are so heavily dominated by a few large firms, the equally-weighted indices provide a better illustration the average returns realized by investors' hotel stocks.

However, perhaps the most notable trend is the performance of hotel REITs relative to taxable hotel corporations. Taxable hotel corporations *substantially* outperformed hotel REITs (by about 40% over the three year period) in both the equal-weighted and market-weighted indices. Considering the complicated organizational structures hotel REIT investors must endure in order to receive the value of the preferential tax treatment afforded REITs, it seems very surprising that their performance has lagged their taxable counterparts by such a margin. A possible explanation

for this relationship is that the hotel REIT market is still relatively young as compared to the more mature taxable market, and the lower performance of REITs may reflect investor discounting due to their lack of familiarity with the complicated hotel REIT structures. Alternatively, such performance differentials may reflect the market's perception of the costs (both direct and opportunity) of investing in a venture that can only hold, but not manage, its assets nor exploit service-related growth opportunities. The significance of service-related growth, further explained in Appendix B ("Components of Hotel Value"), is offered, by some investment bankers, as a justification for according higher price/EBITDA multiples to hotel C-corporations than to REITs (DLJ, 1996; Hsieh, 1996). The discussion of RFS Hotel Investors, exploration of "de-REITing" itself may shed some light on this important issue.

Figure 2.1
Hotel REITs v. Taxable Hotel Corporations v. S&P Hotel-Motel

August 6, 1993 - June 28, 1996
(equally weighted, except S&P)



Index Values

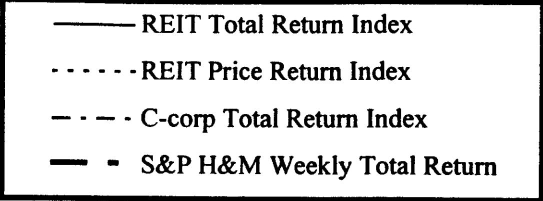
440
420
400
380
360
340
320
300
280
260
240
220
200
180
160
140
120
100

8/6/93 10/29/93 1/21/94 4/15/94 7/8/94 9/30/94 12/23/94 3/17/95 6/9/95 9/1/95 11/24/95 2/16/96 5/10/96

Weeks

Figure 2.2
Hotel REITs v. Taxable Hotel Corporations v. S&P Hotel Motel

August 6, 1993 - June 28, 1996
(market cap weighted)



Index Values

440
420
400
380
360
340
320
300
280
260
240
220
200
180
160
140
120
100

8/6/93 10/29/93 1/21/94 4/15/94 7/8/94 9/30/94 12/23/94 3/17/95 6/9/95 9/1/95 11/24/95 2/16/96 5/10/96

Weeks

Chapter 3: Curing the Conflicts

Since RFS Hotel Investors' initial public offering in August of 1993, investors began to recognize the existence of the conflicts between the REIT shareholders and its sponsors. As investors became more aware of the conflicts and their effects became more measurable, hotel REIT investors demanded changes in the structure of new companies going public. Small changes began to appear in the early to mid-1994 offerings, but substantial mitigations were not achieved until late 1995 with the initial public offerings of Hospitality Properties Trust and Patriot American Hospitality. Table 3.1 on the following page presents a chronological comparison of the changes that have occurred in the elements of hotel REITs that impact on management's alignment with shareholders and eliminating conflicts of interests between shareholders and sponsors. The first part of this chapter discusses some examples of the costs to shareholders associated with separating hotel ownership from operations; the second section discusses specific changes that have occurred in hotel REIT structures and how these changes have served to better align the interests of management and shareholders.

Costs of the Conflicts

RFS Management Sale

In the fall of 1994, share prices of hotel REITs and other REITs declined in response to an increase in interest rates. As with other REITs, hotel REITs rely on ready access to public equity markets to finance their growth. An overall decline in REIT share prices therefore increases the cost of new equity to REITs and hinders their ability to grow. In November of 1994, RFS Hotel Investors (RFSHI) retained the investment banking firm of Morgan Keegan & Co. to explore options for financing its future growth, as more fully described by Robert M. Solmson, RFSHI president:

Table 3.1
Hotel REIT Comparison

	RFS Hotel Investors	Jameson Inns	Equity Inns	Winston Hotels	FelCor Suites Hotels	Innkeepers USA	Humphrey Hospitality	Hospitality Properties Trust	Sunstone Hotel Investors	Patriot American Hospitality	Starwood Lodging
IPO Date	Aug-93	Jan-94	Feb-96	May-94	Jul-94	Sep-94	Nov-94	Aug-95	Aug-95	Sep-95	n.a.
Lessee:											
Single or multi-tenant	Single	Single	Single	Single	Single	Single	Single	Multiple	Single	Multiple	Multiple
Independent lessee	No	No	No	No	No	No	No	Yes	No	Yes	Minimal
Independent management	Minimal	No	No	Minimal	Yes	No	No	Yes	No	Yes	Minimal
Lessee net worth req.	No	No	No	No	No	No	No	Yes	No	Yes	n.a.
Lessee non-compete	No	No	Yes	Yes	No	No	Yes	Yes	Yes	No	n.a.
Responsibility for payment of:											
Real Estate Taxes	REIT	REIT	REIT	REIT	REIT	REIT	REIT	Lessee	REIT	REIT	Lessee
Property Insurance	REIT	REIT	Lessee	REIT	REIT	REIT	REIT	Lessee	REIT	REIT	Lessee
Captial Exp. Reserve	REIT	Lessee	REIT	REIT	REIT	REIT	REIT	Lessee	REIT	REIT	Lessee
Reserve Spending Controlled by:	Lessee	Lessee	Lessee	Lessee	Lessee	Lessee	Lessee	Lessee	Lessee	REIT	n.a.

> "By undertaking this analysis, we are attempting to fully explore all our options, including, but not limited to, relinquishing the company's tax status as a REIT and acquiring the operating companies that manage certain of our hotel properties."(Burgess, 1994)

One option Morgan Keegan analyzed was that of RFSHI abandoning its REIT status and operating as a taxable entity. By abandoning its REIT status, RFSHI could significantly reduce or even eliminate dividends to its shareholders. The funds that would otherwise have been paid as dividends could then be retained to fund RFSHI's growth. Additionally, as discussed in chapter 2, many of the requirements for preserving REIT tax status can constrain a hotel company's ability to grow. The requirement that a REIT remain a passive investment vehicle and not engage in an active trade or business prohibits hotel REITs from receiving directly fees for providing hotel operations, management or franchise services. This limits the scope of business activities in which a REIT may engage and consequently its growth opportunities, as noted by Jon Litt, a real estate analyst with Salomon Brothers Inc.:

> "While there is widespread agreement that hotel industry fundamentals are strengthening and offer attractive investment opportunities, there is growing concern that investing in the industry via the REIT structure may be an inappropriate way of participating in the recovery."(Burgess, 1994)

Under the de-REITing option, RFHSI would acquire the operating companies that leased or operated its hotels, thereby returning to its shareholders a greater portion of the profits generated by the hotels and eliminating many of the shortcomings of hotel REIT structures outlined in chapter 2. There was some question at the time as to how such a purchase by RFSHI should be priced, as the operating companies were owned by RFHSI senior management and had grown substantially since RFSHI's initial public offering. There was some sentiment that the REIT should be allowed to acquire the operating companies at a discount to market value as substantially all of their value derived from leasehold interest in hotels owned by the REIT. This dilemma

however became irrelevant in December 1994 when the RFSHI board of directors elected to retain its REIT status, but to reduce its dividend payout level to only that which was necessary to continue to qualify as a REIT. Cash-flow generated by RFSHI which was not distributed was to be retained to assist in funding the REIT's growth.

Interestingly, during the two weeks following the announcement that RFSHI's senior management was considering de-REITing, RFSHI's share price declined from $14.000 on November 22, 1994 to $11.625 on December 12, 1994, or approximately 17 percent. By December 19, 1994, when RFHSI's senior management publicly disclosed its intention to preserve its REIT status, the share price had rebounded to $14.500 per share. In general, other REITs did not experience similar share price declines during this time. Apparently the public markets were strongly in favor of RFSHI remaining a REIT.

RFS Management Sale

Approximately one year later, in December 1995, RFS, Inc., (RFS) the lessee to RFSHI agreed to be acquired by Doubletree Corporation, a hotel management and franchising company, for approximately $75 million (Bloomberg, February 28, 1996). At the time of the RFSHI initial public offering, other than necessary working capital, RFS's only assets were its leasehold interests in the hotels owned by RFSHI (RFS Prospectus, November 19, 1993). At the time Doubletree agreed to the acquisition, RFS had grown substantially by acquiring additional hotel leases through its related REIT, RFSHI. RFS did not manage any hotels except those owned by RFSHI and had substantially no other assets than its leases on RFSHI hotel properties. At the time of the sale to Doubletree, RFSHI had an equity market capitalization of approximately $400 million, with approximately 25 million shares and share equivalents outstanding. At the time the sale was announced, RFSHI shares were trading at approximately $15 per share. Were it not for the

required separation of ownership and operations, the value represented by the RFS sale would otherwise have accrued to the shareholders in the REIT. In other words, by not owning RFS, the shareholders of the REIT lost out on $75 million which was approximately $3 per share, or approximately 17 percent of the then current value of the REIT's shares. Some might argue that this is *prima-facie* evidence that REIT status is a net liability to investors in hotel investment and operating companies.

As additional evidence of the financial inefficiencies associated with percentage leases and unavoidable REIT conflicts of interest, in its acquisition of RFS, Inc., Doubletree projected that the leases it acquired for hotels owned by RFSHI will yield the equivalent of a management fee of 5.5 percent of gross revenues under normal operating conditions and 7.5 percent if it is able to reduce hotel operating expenses (Rohs and Pinsk, 1995). For Doubletree, this compares very favorably a management fee of 1.5 percent to 4 percent typical in hotel management contracts today (Jones and Rushmore, 1996). Additionally, another advantage cited by Doubletree was a ten-year right of first refusal it was granted for leases on all hotels subsequently acquired by RFSHI, transforming the REIT into what has been described as a "captive capital source" (Rohs and Pinsk, 1995). Considering that the REIT shareholders did not share in the RFS sale proceeds, it is probably not terribly rewarding to be considered a "captive" anything.

Leakage

One of the most common mechanisms for measuring the inefficiencies in the hotel lessor\lessee structure is the calculation of "leakage". Leakage is generally defined as the sum of the fees paid to the hotel management company and the lessee's pre-tax income. Leakage represents income which would accrue to the REIT and its shareholders absent the required separation of ownership and operations. Leakage is typically expressed as a percentage of lessee net operating income

before lease payments to the REIT. One of the objectives in structuring hotel REITs is obviously to reduce leakage to the greatest extent possible. Table 3.2 below contains an example of the leakage calculation taken from an analyst report for the hotel REIT Starwood Lodging Trust (George, 1995)

Table 3.2

Lessee Leakage Example		
Total Lessee Revenues	$	10,000
Hotel Operating Expenses	$	(7,150)
Lessee NOI	$	2,850
Management Profit (1.5%)	$	150
Lessee EBIT	$	135
Leakage	$	285
Leakage as a % of NOI		10%

Table 3.3 on the following page contains leakage calculations for all of the existing hotel REITs for which the requisite financial data was available in their respective December 31, 1995 10-K reports.

Table 3.3
Hotel REIT Leakage Comparison

	RFS Hotel Investors, Inc. *RFS*	Equity Inns, Inc. *ENNS*	Winston Hotels, Inc. *WINN*	FelCor Suite Hotels, Inc. *FCH*	Innkeepers USA Trust *NKPR*	Humphrey Hospitality Trust, Inc. *HUMP*	Hospitality Properties Trust *HPT*	Patriot American Hospitality, Inc. *PAH*
Year of IPO	*8/93*	*2/94*	*5/94*	*7/94*	*9/94*	*11/94*	*8/95*	*9/95*
Total Lessee Revenues	$ 122,805	$ 56,568	$ 40,749	$ 72,569	$ 45,976	$ 8,054	$ 76,192	$ 126,677
Hotel Operating Expenses	$ (73,754)	$ (31,310)	$ (21,285)	$ (44,303)	$ (25,612)	$ (4,166)	$ (11,464)	$ (81,704)
Lessee NOI	$ 49,051	$ 25,258	$ 19,464	$ 28,266	$ 20,364	$ 3,888	$ 64,728	$ 44,973
Management Fees (% of Revenues)	2.50%	n.a.	1.92%	2.15%	2.50%	2.99%	4.77%	1.95%
Management Fees	$ 3,070	n.a.	$ 782	$ 1,560	$ 1,149	$ 241	$ 3,634	$ 2,470
Lessee EBIT	$ 1,802	$ 1,157	$ 1,532	$ (240)	$ 391	$ 139	$ 3,632	$ 98
Leakage	$ 4,872	$ 1,157	$ 2,314	$ 1,320	$ 1,540	$ 380	$ 7,266	$ 2,568
Leakage as a % of NOI	9.9%	4.6%	11.9%	4.7%	7.6%	9.8%	11.2%	5.7%

1. For PAH and NKPR, data is from 12/31/95 Pro forma statements as presented in 10-K reports.
2. For HPT, data is for the period 3/24/95 -12/31/95, as presented in 10-K report.
3. For RFS and NKPR, terms of management fees were not disclosed therefore a management fee of 2.5% was assumed.

Curing the Conflicts

Development of the Independent Lessee

Because the lessee/lessor relationship governs the control and distribution of hotel income, the development and use of an independent lessee is one of the most significant structural improvements in terms of eliminating the effects of management conflicts of interest in hotel REITs. As presented in Table 3.1, the early hotel REITs all employed lessees that were not independent of REIT management. In general, this meant that the sponsors who controlled the REIT also owned the lessee. The introduction of an independent lessee means that all leases and other agreements between the REIT and the lessee will be negotiated on a true arms-length basis. Patriot American Hospitality and Hospitality Properties Trust are the only two public REITs with independent lessees. As discussed below, the introduction of an independent lessee has resulted in readily apparent improvements in many of the characteristics of the percentage lease agreements.

Single vs. Multiple Lessees

In addition to introducing an independent lessee, the Patriot American Hospitality structure also introduced the use of multiple lessees. Previously, all earlier hotel REIT structures had employed a single lessee. In the single lessee structure, all hotels owned by a REIT are leased to the same lessee. There may or may not exist an explicit agreement obligating the REIT to lease all of its hotels to the lessee. However, because in most of the REITs the lessee is wholly owned by the sponsor and the sponsor manages the REIT, there is little incentive for the sponsor to enter into lease agreements with anyone other than the lessee owned by the sponsor. Consequently, most hotel REITs have evolved as *de facto* single lessee REITs.

The introduction of multiple lessees, which coincides with the introduction of an independent lessee, benefits the REIT in two ways. First, the use of multiple lessees enables the REIT to market a single hotel for lease to multiple operators, thus increasing competition at the lessee level. Additionally, the use of multiple lessees may increase acquisition opportunities for a REIT. A hotel/owner operator may look to a REIT as a source of sale-leaseback financing. Additionally, a successful hotel manager may present an acquisition opportunity to a REIT to avoid losing its management contract due to the imminent sale of a property. Specifically, hotel managers face a potential penalty for successfully increasing the value of a hotel in that the hotel owner may elect to sell the hotel, in which case the hotel manager's management contract may be terminated. To avoid this, a successful hotel manager may initiate a preemptive sale of the property to a REIT, in which it leases the property back from the REIT, thus assisting the current owner in executing its desired disposition strategy, while retaining the management contract. Therefore, the use of multiple lessees may afford a REIT access to properties for acquisition which would otherwise not be presented to it until a broader marketing campaign was underway.

Evolution of Lease Terms

Over the past few years, many of the terms of the percentage lease agreements have evolved in favor of the REITs. The specific areas include: percentage rent structures, lessee credit requirements, lease default provisions, and funding and disbursement of capital reserves.

With respect to percentage rent structures, one of the criticisms of early leases was that the rent structures did not adequately reflect the nature of cash flows inherent in a hotel's rooms, food and beverage, and other revenue sources. The rent structures were criticized as lacking adequate stratification across differing revenue levels to capture the relationship between fixed and variable costs in hotel operations. Specifically, the concern was that the initial rent tiers might extract too

much revenue during a business downturn, leaving the lessee unable to cover its fixed costs and the required rental payments. Conversely, there was also concern that the upper rent tiers might be too low and not extract enough revenue during peak business periods in which variable expenses dominate the operating cost structure (Webster and Garrison, 1995, p. 37). In response, hotel leases have evolved to more precisely segregate revenues based on their source and to increase the number of tiers in calculating rent payments to the REIT.

Additionally, the timing of the required rental payments has also improved in favor of the REIT. In the early RFSHI leases, the lessee was required to pay base rental on a monthly basis, but was only required to remit the percentage rental, above the base rental amount, quarterly, Additionally, the lessee was not in default under the terms of the lease agreement if it failed to pay quarterly any percentage rental amounts, so long as it made all required payments within 90 days of the end of the respective calendar year (RFS Prospectus, November 19, 1993). The lessee, effectively, did not have to pay any percentage rent until 90 days after the calendar year and was able to invest or otherwise earn interest, or float, on the REIT's funds for that time. In contrast, the Patriot American Hospitality leases, which were all negotiated on an arms-length basis due to its independence from the lessee, provide that base rent is due on the first of each month and percentage rent in excess of the base rent is due on the tenth day of each month. Additionally, the lessee is in default under the lease agreement if it fails to make either the base or percentage rent payments when due (Patriot American Prospectus, October 1995). Thus the Patriot American structure limits the ability of its lessee(s) to earn float on the REIT's otherwise earned revenues. Interestingly, when RFS was sold to Doubletree, the existing percentage leases were amended to provide that percentage rental payments were due approximately 35 days following the end of each calendar quarter, versus the previous requirement of 90 days following the end of the calendar year

(RFS Hotel Investors, Inc. 10-K Report, 1995). This change is a significant improvement, though still not as favorable to the REIT as the Patriot American leases.

Lessee credit requirements also increased, from being almost non-existent to specifying explicit credit or net-worth requirements. In early hotel REITs, the lessee was formed contemporaneously with the formation of the REIT. Consequently, the lessee had little if any assets other than its leasehold interests in the REIT and a minimal amount of working capital. The REIT, therefore, was entrusting the operation and control of its primary assets to an entity with very little net worth. The lessee was completely dependent upon the hotel revenues to fund its rental obligations. If any of the hotels leased to the lessee encountered operating difficulties, the lessee did not have any appreciable cash reserves on which to draw to meet its rental obligations to the REIT and there was a risk that the lessee would default on its lease. The structures employed for Patriot American Hospitality and Hospitality Properties Trust included credit requirements for its lessees. In the case of Patriot American, the lessee is required to maintain a minimum net worth equal to the greater of (i) 17.5 percent of the projected annual lease payments for all hotels leased by the REIT to the lessee (ii) and $10 million dollars (Patriot American Hospitality 10-K Report, 1995). Hospitality Properties Trust requires that its lessee(s) maintain a security deposit equal to one year's base rental for all hotels leased from the REIT (Hospitality Properties Trust 10-K Report, 1995).

Finally, the relationship between the funding and disbursement of capital improvements has been improved. As previously mentioned, many of the early hotel REITs required that the REIT make periodic contributions to a reserve fund for capital improvements; however, the funds were spent at the discretion of the lessee. As described in chapter 2, this misalignment of the funding and expenditure could lead to adverse selection of projects that disproportionately benefit the lessee. In

both the Patriot American and the Hospitality Properties Trust structures, the party funding the reserve maintains control over expenditures, thus avoiding the adverse selection problem.

In general, hotel REITs have made significant contractual improvements in aligning the interests of REIT management with shareholders. Through the sale of its lessee to Doubletree, RFS Hotel Investors substantially reduced the probability that future leases will favor the lessee. Patriot American Hospitality avoided the conflict problem altogether by starting with an independent lessee and not obligating itself to a single lessee. However, although the elimination of many of the conflicts of interests between management and shareholders may improve the REIT's lease structures, by necessity of the tax code, a REIT's lessee must be allowed to earn a profit and, therefore, some of the operating profits of hotels will continue to leak back to the lessee. Eliminating this is complicated by the differing incentives between the REIT and the lessee regarding increases in room revenues generated by increases in room rates as opposed to occupancy rates. As discussed in the next chapter, efforts are underway to develop superior hotel REIT structures that will more efficiently repatriate operating profits that now get trapped at the lessee level.

Chapter 4: The Future of Hotel REITs

The hotel and lodging industry is presently five years into a recovery period that began in 1992. Acquisition prices of existing hotels are approaching replacement costs for almost every product type and new construction is beginning to appear for all but high-end, full-service hotels. As the hotel markets continue to recover and more companies turn to the public markets for capital, two important issues arise. First, given that of all of the hotel related companies entering the public markets during the previous three years approximately half elected REIT status and half did not, the question arises as to under what conditions it is appropriate for a hotel company to elect REIT tax status, and under what conditions are the flexibility of a taxable structure is preferable. Second, and perhaps importantly, have the returns to investors in REIT shares been appropriate, particularly as compared to taxable hotel company returns.

Although hotel REIT structures have improved since 1993, if the REIT structure is to continue to be viable to finance hotel companies, the evolutionary process underway must continue. Substantial improvements have already been made in aligning the interests of REIT shareholders and management. The next area of focus should address reducing profit leakage to the lessee and returning a greater portion of the operating profits of the hotels to the REIT's shareholders. In an attempt to reduce leakage, many hotel REITs now include provisions requiring the lessee and/or management company to purchase REIT shares with a portion of its earnings. However, this strategy is still short of ideal because it does not reduce leakage, it merely changes its form, from cash to shares in the REIT. An example of a recently developed hotel REIT structure which is able to reduce leakage is presented at the end of this chapter.

To REIT or Not to REIT?

The evolution of the hotel industry over the previous sixty years has led to the creation of very defined roles for hotel owners, operators, managers, and franchisors (see Appendix A). Each party has a unique role in the business of owning and operating hotels, adding value and extracting fees at different points along the revenue stream. As previously discussed in chapters 1 and 2, hotel companies wishing to enjoy the preferential tax treatment available with REIT status are prohibited from participating directly in many of these roles. Hotel REITs are mandated to operate strictly as passive owners of real estate and real estate related investments. And, as discussed in the previous chapter, the structures that have been created to accommodate these mandated restrictions constrain REITs in various ways. Consequently, it is not always optimal or even possible for a hotel company to elect or maintain REIT status.

When to REIT

Hotel REITs are mandated by the tax code to focus their activities primarily on the capital intensive hotel ownership segment of the hospitality business. As such, a REIT election only seems to make sense when there are substantial gains to be realized in hotel ownership. This has certainly been the case over the previous five to six years as many involuntary owners disposed of hotel properties at distressed prices. In this market, would-be hotel owners could acquire hotel properties based on their existing cash-flows and were able to earn an adequate return on their investment at the current market levels of utilization. These new owners were effectively protected from new competition until room rates and occupancies increased enough to support new development. This protection afforded them the opportunity for capital gains in the values of their assets as room rate and occupancy levels improved. Although such acquisition opportunities are becoming more scarce, they do still exist.

As noted in chapter 1, the lessor\lessee structure and the complexities of negotiating the percentage lease agreements require a high level of expertise from REIT management. Given the wide variety of hotel property types, the expertise required to understand the operations of a limited-service hotel may be far different from that required to understand a full-service or all-suite property. Consequently, it may not be possible for an individual or small group of individuals to maintain sufficient expertise in a wide variety of hotel product types to adequately represent a REIT's interests in negotiating percentage lease agreements.

Therefore, it seems that, since 1993, the two most prevalent requirements for a successful REIT have been product focus and asset appreciation potential. In 1993-1994, REITs used a similar formula, namely; a portfolio focused on a single, or a few very similar, hotel product types such as limited-service hotels. This focus was justifiable because, at the time, the limited service operating strategy of simply renting rooms produced higher and more stable earnings than did the more varied operations of full-service hotels. In addition, in 1993-1994 there were significant opportunities for appreciation in the values of the company's hotel assets. The source of the appreciation can be either below replacement cost acquisition prices or owning assets in markets in which new development is tightly controlled and revenue per available room is expected to increase significantly over time. As hotel prices have increased, the current appreciation potential of some sectors, such as limited service, has diminished, while it remains substantial in others, such as full-service and luxury properties which still sell below replacement cost (Appendix B). Thus, a focused portfolio is still justifiable, however, that focus should now be on more expensive and service-oriented hotels.

When Not to REIT

There are numerous reasons why a company may decide not to pursue REIT status. Generally, they are all linked to the statutory requirements that a hotel company must continually meet to qualify as a REIT, and restrictions limiting which segments of the business REITs can operate. For companies wishing to pursue the less capital-intensive operating segments of the business, such as hotel management or franchising, a REIT election obviously does not make sense because the tax code severely limits the amount of such income that a REIT can receive. Most of the taxable hotel corporations listed in Appendix E are active to some extent in the service segments of the business, and as such would have to substantially modify their business strategy or curtail their operations to qualify as REITs.

Additionally, hotel companies which started as a private, closely-held entities may have difficulty satisfying the 100-or-greater and the 5\50 ownership diversification requirements outlined in chapter 1. As an example, in May 1996 Wyndham Hotel Corporation (WHC) completed an initial public offering of approximately 3.7 million shares of stock, raising approximately $58 million. However, following the offering, WHC had approximately 19.5 million shares of common stock outstanding. WHC was formed by the Trammell Crow family of Dallas, Texas and as noted in the IPO prospectus, following the offering Crow family members beneficially owned approximately 48 percent of the outstanding common stock. Additionally, another small investor group owned approximately 12 percent of the outstanding stock. With two small groups of investors owning 60 percent of the outstanding stock, WHC could not qualify as a REIT unless the founding family substantially reduced its ownership interest in the company. As the main focus of WHC's business activities is operating hotels under the Wyndham brand name, it is likely that WHC would also have difficulty satisfying the REIT income source tests

Figure 4.1 below summarizes the major operating segments of the hotel industry and certain characteristics of each segment. As firms move from the asset oriented, capital intensive hotel ownership end of the spectrum to a more service oriented hotel operator, manager, franchisor focus, their practical ability to qualify for REIT status diminishes as they have difficulty satisfying the REIT income source and asset requirements. Operating as a REIT affords the qualifying entity the benefit of preferential tax treatment, but imposes a very complicated structure fraught with conflicts of interests and stringent operating constraints. Operating as a taxable corporation allows much greater flexibility and a much simpler organizational structure.

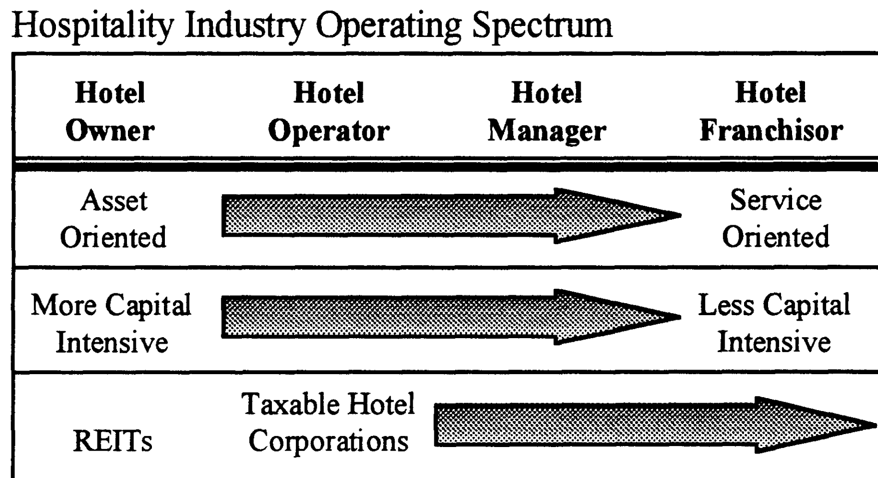


Figure 4. 1

Investor Returns

As illustrated by the stock return indices presented in figures 2.1 and 2.2, for the period of August 6, 1993 through June 28, 1996 the returns to investors in hotel REIT shares have lagged those of investors in taxable hotel companies by approximately 40 percent. Considering that most of the hotel REITs are organized as C-corporations, as are most public taxable hotel companies, and that

REITs enjoy preferential tax treatment at the entity level which is largely unavailable to taxable hotel companies, efficient market theory would suggest that investors would pay a premium for the incremental benefit of preferential tax treatment. On the other hand, considering cumbersome structures and rigorous operating requirements that REITs must endure to maintain their preferential tax status, efficient market theory might also suggest that investors would demand a premium return (price discount) vis-à-vis taxable hotel companies. The indices presented in Figures 2.1 and 2.2 clearly show that investors have demanded a premium (in the form of a much higher current return) to invest in REIT shares.

An obvious theory for the underperfomance of hotel REIT shares, in terms of total return, is based on their more limited opportunities for growth. Investors purchasing stock in a firm base their purchase decision on both the firm's current earnings and its prospects for earnings growth (growth opportunities). Growth prospects for hotel REITs suffer as a result of the restrictions imposed by the REIT tax code. As mentioned above, hotel REITs are relegated to the capital intensive hotel ownership segment of the business and are, by definition, not permitted to directly engage in any of the less capital intensive service sectors of the business. The service sectors such as hotel management and franchising allow a successful hotel owner/operator to leverage its knowledge and expertise by providing service to other owners. As this does not require significant additional capital, the fees generated by such services benefit existing shareholders. Conversely, hotel REITs must grow via the acquisition of additional hotels, which does require additional equity capital. Therefore, additional earnings generated by acquisitions must be shared with new equity holders.

Again, the example of the sale of RFS, Inc. (the lessee to the REIT RFS Hotel Investors) to Doubletree Corporation illustrates this problem. At its formation in 1993, RFS Management Company had total book assets of approximately $5.6 million and equity capital of approximately

$4 million. In less than three years, RFS Management had grown to a value of approximately $75 million. Although the market value of the REIT had grown from approximately $49 million in 1993 to $370 million at the end of 1995, this growth was accomplished by issuing over $300 million of new equity. The share price of RFS Hotel Investors stock increased from $11.75 per share in August 1993 to $14.63 per share in December 1995, just before the sale of its lessee to Doubletree was announced. This share price growth equates to less than 10 percent per year, while the growth in the value of the lessee exceeded 10 percent per month. This example illustrates that the majority of the growth opportunities accrue not to the assets of the hotel REIT, but to its lessee(s) via their ability to participate in the less capital intensive service areas of the hotel business. As private market real estate prices have increased, particularly in the limited service segment where most hotel REITs operate, the initial yields of new acquisitions are likely to be less than the REIT's existing portfolio. In other words, new acquisition prospects may dilute the REIT's current FFO, and make growth through acquisitions difficult to justify from an FFO per share perspective. At the same time, developing and stabilizing the operations of a new hotel requires a lead time of approximately three to five years. Thus, the underperformance of hotel REIT shares may be due to the public capital markets accurate assessment that for most public hotel REITs, the significant growth opportunities remain with the lessee, while the REIT has much more limited opportunities for non-dilutive growth.

Several factors must be considered that may somewhat temper the disparity between the performance of hotel REITs and their taxable counterparts. First, the hotel industry is several years into a sustained recovery. Therefore, all segments of the business are doing well. However, as discussed in greater detail in Appendix A, the hotel industry is subject to cyclical economic forces and the record profits enjoyed today will likely yield to declines in the future. second, as

most REITs maintain relatively low levels of leverage in their capital structures, a decline in revenues will impair their operating profits relatively less than the more highly levered taxable C-corporations. However, if taxable hotel companies have more highly levered balance sheets, a decline in revenues may impact them more severely as a greater portion of the return on their assets is pledged to their debt holders. Therefore, because there are significant differences in the capital structures of hotel REITs and taxable hotel companies, during an industry downturn the returns to more highly levered taxable hotel companies may be more volatile and in fact underperform more conservatively structured hotel REITs.

Another factor which may have contributed to taxable hotel companies outpacing hotel REITs is also related to the industry recovery. Just a few years ago most hotel companies were generating taxable losses. As such, many otherwise taxable hotel companies may have been using net operating loss (NOL) carryforwards from previous years to insulate income generated in recent years. In such a case, a taxable hotel company would have had no tax liability, similar to a REIT. As profitable taxable hotel companies exhaust any NOL's they may have accumulated, this may begin to diminish the investment performance differential between REITs and taxable C-corporations in the near future.

From a broader perspective, hotel REITs should not be maligned because they underperformed stocks in a rising market. The same criticism can be made of all REITs, as the conditions which are usually favorable for stocks- low inflation and rising earnings- are not necessarily the best conditions for REITs. REITs have performed best when there has been a material threat of inflation (they are considered to be hedges) or a forthcoming recession. In those situations, their income (derived from lease contracts) is deemed more stable and protected in comparison to

operating companies. However, we have not seen how capable of withstanding a downturn the lessees will be.

Hotel REITs are probably too new to have meaningful Betas (the regression co-efficient of their returns and those of a broad market index such as the S&P 500 over time). However REITs, in general, have Betas which are less than one and so their share prices should rise more slowly in an up-market, and likewise, fall more slowly during market declines. Combined with a high dividend payout, this makes REITs somewhat of a "defensive" stock, in some ways like a utility stock, or a bond, which satisfies the risk-return profile of a particular investment clientele: the more conservative investors.

Therefore, hotel REITs may be appropriate for investors seeking income with some growth potential, who, for any number of reasons, may (i) prefer to receive dividends rather than an equivalent amount in capital gains from periodically selling a portion of their holdings, (ii) for investors who feel that the general market may decline and wish to remain invested in stocks which have a propensity for stability in falling markets, or (iii) for those who feel that hotel real estate is going to appreciate and want to invest in a pure play in hotel ownership.

For the above reasons, it is more perhaps appropriate to compare the performance of hotel REITs with other REITs than with that of taxable C-corporations. Hotel REITs, in fact, compare favorably with other types of REITs ; they were the second highest performers among all REIT types in 1995 (after office REITs) returning over 17% in price appreciation (Lehman Brothers, 1996). Still, they trade at a 16% discount to the average REIT on adjusted funds from operations (AFFO) multiples, and it is clear that some hotel REIT structures have fewer conflicts than others.

In any event, whether or not future hotel REIT returns match or exceed returns to stock investments in taxable hotel companies, it certainly appears that investors wishing to capitalize on the recovery of the lodging industry would have been better off thus far by investing in the taxable alternative. It appears that the cost of the dividends paid deduction, in terms of reduced flexibility, more complicated organizational structures and diminished growth opportunities, has thus far exceeded its value.

Modified Hotel REIT Structure

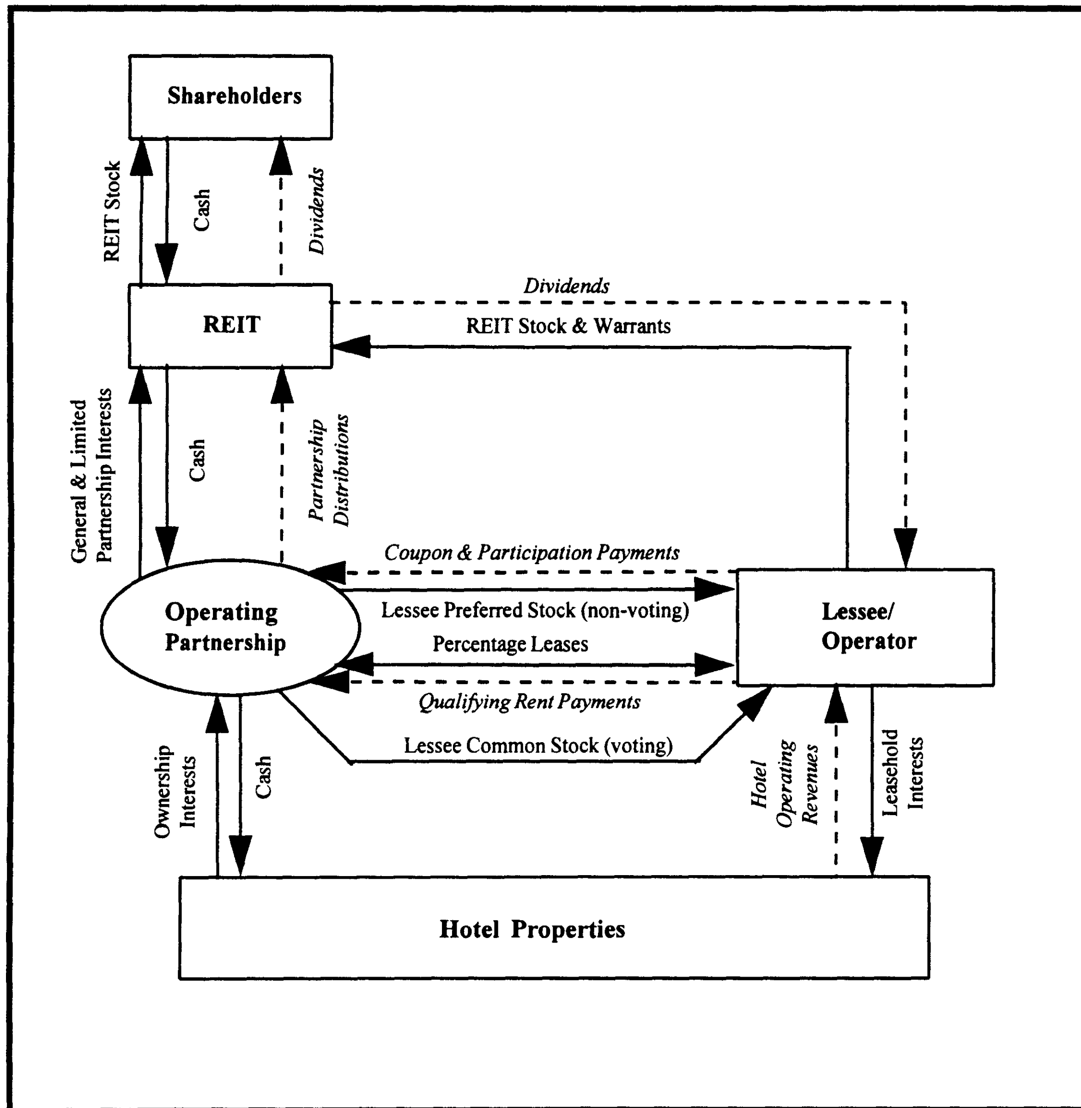
One of the primary objectives in structuring a hotel REIT is to return to the REIT's shareholders substantially all of the economic benefits of owning and operating the hotels. As discussed in the previous chapters, the myriad of requirements to qualify as a REIT make doing this extremely difficult, if not impossible. Although, many changes have been made to the early hotel REIT structures to improve the returns to REIT investors and reduce leakage at the lessee level, there are still substantial shortcomings with most hotel REITs as compared to taxable hotel corporations. However, an institutional real estate investment advisory firm recently devised a hotel REIT structure for its institutional clients which makes tremendous improvements in aligning the interests of the REIT shareholders with the lessee, returning the majority of the economics of the REIT's hotels to the shareholders, and otherwise mitigating the negative effects of the REIT requirements while retaining the tax benefit of the deduction for dividends paid. This structure revolves around, and perhaps exploits, the definition in the tax code of related-party rents. Figure 4.2 on the following page outlines the structure of this improved hotel REIT.

The core of the improved structure is a basic single-lessee hotel UPREIT, comprised of the REIT shareholders, the REIT entity, an operating partnership, and an independent lessee/operator. The hotels owned by the operating partnership and REIT are leased to the lessee/operator under typical

percentage lease agreements. The unique feature of the improved structure, however, lies in the ownership of the lessee/operator. In Figure 4.2, the operating partnership owns both common and preferred stock in the lessee/operator. The REIT owns a 5 percent interest in the lessee's common shares and an issue of non-voting preferred stock. The preferred stock carries an annual coupon of approximately 8 to 10 percent, plus a large participation in lessee cash flow in excess of the preferred stock coupon payment. In this structure, the REIT extracts from the lessee substantially all of the lessee's profits. Therefore, even if the leases between the REIT and the lessee contain flaws allowing for leakage at the lessee level, any such leakage is returned to the REIT via the preferred stock coupon and participation payments. Unfortunately, income generated at the lessee level is subject to taxation as the lessee is not permitted a deduction for dividends paid on either its common or preferred stock, but the REIT effectively captures a significant portion of the lessee's after-tax operating profit. (Similar structures have been used in office REITs to enable the REIT to capture substantially all of the financial benefits and fees associated with construction, management, leasing, and development.)

Figure 4.2

Modified Hotel REIT Structure



To facilitate the creation of this REIT, the investment advisory firm identified a hotel operating firm that was willing to be acquired. The investment advisor then structured the acquisition of the operating firm such that, for REIT organizational purposes, the operator would remain an independent entity, but the REIT would receive substantially all of the economic benefits of the operator's activities. Additionally, because the operator remains an independent entity, it can pursue industry growth areas off limits to REITs , such as third-party hotel management contracts or developing and franchising a new hotel brand. As the REIT participates in the lessee's income in excess of the preferred stock coupon payments, the REIT receives a large portion of the benefit generated in these prohibited areas of the business. Thus, the REIT comes closer to enjoying the flexibility of operating as a taxable hotel corporation.

To further align the interests of the REIT with the lessee/operator , the lessee maintains an investment in the REIT's stock. The former owners of the lessee/operator invested approximately one-half of the net proceeds from the sale of the lessee to the REIT in REIT common stock and warrants. Additionally, the senior management of the lessee/operator are scheduled to receive a portion of lessee profits in the form of additional REIT equity securities, thus further serving to align the interests of the REIT with its lessee.

The use of this structure relies on a strict interpretation of the definition of related-party rents. Under the current tax code, rents from real property do not include amounts received from entities in which the REIT owns (1) more than a 10 percent voting interest or a 10 percent ownership interest, in the case of a lessee who is a corporation or (2) more than a 10 percent interest in assets or net profits, in the case of a lessee who is not a corporation. The lessee in this case is a corporation, thus the REIT is subject to constraint (1). In Figure 4.2, the REIT owns 5 percent of the lessee's common stock plus a preferred stock interest, which represents substantially all of the

economic value of the lessee. For the voting interest test required in (1), the REIT only owns a 5 percent voting interest, as the preferred stock has no voting rights. For purposes of the 10 percent ownership test, ownership interest is measured as the percentage of outstanding shares of all classes of stock owned by the REIT, without regard to the economic value represented by those shares. As an example, if the lessee had 10,000 shares of common stock and 100 shares of preferred stock outstanding, and the REIT owned 500 common shares and all 100 preferred shares, the REIT would be deemed to hold a 5.9 percent ownership interest in the lessee. This would be the case even if the 100 shares of preferred stock represented substantially all of the equity value of the lessee.

Conclusion

Over the previous three years, the real estate investment trust has been a popular vehicle for many private hotel companies wishing to raise equity in the public markets. A REIT election is probably appropriate when a particular firm is focused on the ownership of hotels rather than operating hotels, when there is an opportunity for capital appreciation in its portfolio of properties, and when it does not own its own brand. A REIT election is not feasible for companies focusing on growth in the service or operating segments of the hotel industry, or when existing ownership is too concentrated.

In recent years, asset and operating conditions in the hotel markets have been favorable for REIT elections by hotel ownership companies. However, as total returns for hotel REITs have thus far lagged those for taxable hotel companies, and as the hotel markets continue to recover and returns to hotel ownership are expected to get squeezed, hotel REITs may begin to fall out of favor. To stem the possibility of this, existing and future hotel REITs must continue to work to reduce the negative effects of the conflicts of interests inherent in their structures, and enable them to better

exploit business growth opportunities. Hotel REITs must also strive to engineer structures which reduce profit leakage to the lessee, by allowing the REIT investors to participate in lessee profits.

Appendix A: Overview of the Hotel Industry

The real estate industry is considered to be cyclical in nature (DiPasquale and Wheaton, 1995) and among real estate assets, hotels are viewed as being the most cyclical due to high correlation between the demand for rooms and the state of the domestic economy (Rossof, 1995). Good economic conditions generate travel, whereas poor economic conditions discourage it, however, ephemeral changes in demand for rooms has had less impact on the industry than changes in supply, which persists after it is built. A brief review of the history of the hotel industry confirms that the cyclical performance of hotels has often been magnified by increases in new supply resulting from periods of liberal financing.

During the peak of a cycle, hotels have high occupancies, high profits, and ready access to financing. During cyclical troughs, occupancy and operating cash flows are low and capital sources are few. The most prolific periods of hotel development, leading to overbuilding, occurred during the 1920s, 1970s, and 1980s. These were periods when significant sources of new financing were identified: namely, real estate bonds in the 1920s; mortgage real estate investment trusts in the 1970s; and the combined source of savings and loan associations, tax-driven partnerships, and foreign investors during the 1980s (Gottschalk 1987; Jarchow 1988; Rushmore 1992; Mahone 1996).

Trends in the Lodging Industry 1920 - 1990

The period from 1900 to the 1920s might be considered the birth of the modern hotel industry. Properties began offering services and amenities similar to those found in today's hotels and the first chains began either by building or acquiring properties (Statler Hotels, and Hilton Hotels), or by licensing, or franchising, its name (Ritz Hotels). The booming U.S economy of the 1920s led to increased business travel and associated room demand, and further development was spurred by

anecdotal evidence of hotel profits and general economic euphoria rather than by objective measures of lodging industry conditions. However, favorable conditions dissipated by 1928, so that hotel occupancies fell to 67%, from 85%, and hotel failures increased at an annual rate of 15% for several years (Rushmore, 1992). Nevertheless, because of the number of large, successful, hotels constructed during this period, the 1920s has been referred to as the "golden age" of hotels (Dittmer and Griffin, 1993).

In the Depression-era economy of the 1930s, hotels experienced reduced room sales and the same financial difficulties as other industries. Over 80% of hotels were in foreclosure or liquidation (Rushmore, 1992) and little new development occurred to replace those which failed and were converted to other uses. The distress of the industry was an opportunity for some, such as Conrad Hilton, who having lost three of his eight hotels in 1929 was, by 1935, able to use cash-flow from oil leases to fund several new acquisitions. Similarly, in 1937, the first hotel of what would become the Sheraton chain was acquired by Ernest Henderson.

Hotels which survived the Great Depression, saw an upsurge in room demand during the economy surrounding World War II, and nationwide occupancies exceeded 90%. While industry leaders Sheraton and Hilton, were each listed on the New York Stock Exchange in 1946, war-time rationing and competition for capital precluded much new hotel development.

The 1950s, however, was a period of new development, spurred on by construction and good profitability from operations. In this period , the successful track records of the few larger chains allowed them to gain financing for further expansion, primarily by acquisitions. Hilton purchased the Statler chain in 1954 and other companies, such as Ramada Inns, Marriott, and Sonesta Hotels initiated public offerings. Also during this time, small (20 to 50 room), family-operated, motor

hotels began to be constructed along the newly-expanded interstate highway system. Providing a standard room and amenities to motorists became the basis for the success of Holiday Inn which went public in 1957, after starting with one hotel in 1952. Its other innovation was to mass-market franchises to owner-operators, so that by 1960, the company had grown to over 100 hotels.

Beginning around 1965, the U.S. economy experienced another inflationary boom and an attendant rise in interest rates, that was interrupted by a recession in 1970 (Homer and Sylla, 1991). However, the rise in long-bond yields in the late 1960s was not accompanied by a rise in short-term interest rates. Federal funds and Treasury Bill rates actually declined, prompting financial disintermediation as investors withdrew bank deposits to buy higher yielding bonds. To counteract this disintermediation, banks and insurance companies began forming real estate investment trusts in the late 1960s which provided financing for commercial real estate development. Investors, seeking high yields, poured money into these public vehicles, many of which financed hotel development and were highly leveraged (Sasser and Banks, 1976).

By 1970, REITs set the stage for a significant round of overbuilding in the hotel industry in which the total room supply grew by about 25%, reaching 2.3 million rooms in 1978. Along the way, in the oil-crisis and recession of 1973-1974, the hotel industry collapsed, along with the stock market, REITs, and the U.S economy. Afterwards, however, growth in room demand resumed at a rate that far exceeded new supply, and occupancies reached a peak (72%) in 1979, that has not, since, been equaled.

Given strong occupancies as a starting point, the 1980s saw the greatest building boom in the history of the hotel industry in which total room supply increased nearly 30% , reaching 3 million rooms by 1990. Hotel chains encouraged this development by introducing multiple new franchise

brands. The different brands targeted different categories of guests in order to take advantage of a new operating strategy, namely, market segmentation. The supply of new rooms was financed, somewhat in succession, by savings and loan associations seeking high-yielding fees, public and private partnerships seeking tax-sheltered investments, and foreign investors who purchased hotels for "pride of ownership" reasons (Anonymous, 1990; Jarchow 1988). Annual supply growth, often reached 100,000 rooms, and exceeded demand growth by 50%, or more. The result unbalanced the economics of hotel operation. Nationwide occupancies slid from over 70% in 1980, to around 63% and stayed there through the rest of the decade. Likewise, the lodging industry's pre-tax profits (after debt service, depreciation, and management fees) declined and turned to ever-deepening losses. In spite of this, prices for hotel properties soared through the 1980s and reached record highs in 1988. The end of this speculative period began in 1989 when a banking crisis, followed by recession, first in the U.S. and then in Japan, produced severe repercussions in the U.S. hotel industry, and caused the prices of hotel stocks and hotel values to fall precipitously.

The hotel industry began the 1990s with record pre-tax operating losses and a severe capital shortage. Traditional lenders such as banks and insurance companies had left the market so that development financing was almost non-existent and seller financing was required in order to sell existing properties. Federal agencies such as the Resolution Trust Corporation and the Federal Deposit Insurance Corporation, which acquired many hotels from the asset portfolios of failed financial institutions, sold hotels at auction and by other means, by supplying up to 85%, non-recourse financing. Since 1993, the industry has rebounded from its losses to report record profits in 1994 and 1995, and has been recapitalized, in growing proportion, by the public markets.

Recent Changes in Industry Operating Statistics

Changes in Room Demand

Since the 1980s, room demand growth has been seen to correlate closely with changes in Gross Domestic Product (Figure A.1). It is rare for demand to actually decline and, in fact, it has grown every year except during the period from 1980 to 1983. In the recession year 1991, demand growth fell abruptly and was basically zero. Its rebound afterwards, however, has been greater than after the 1982 recession.

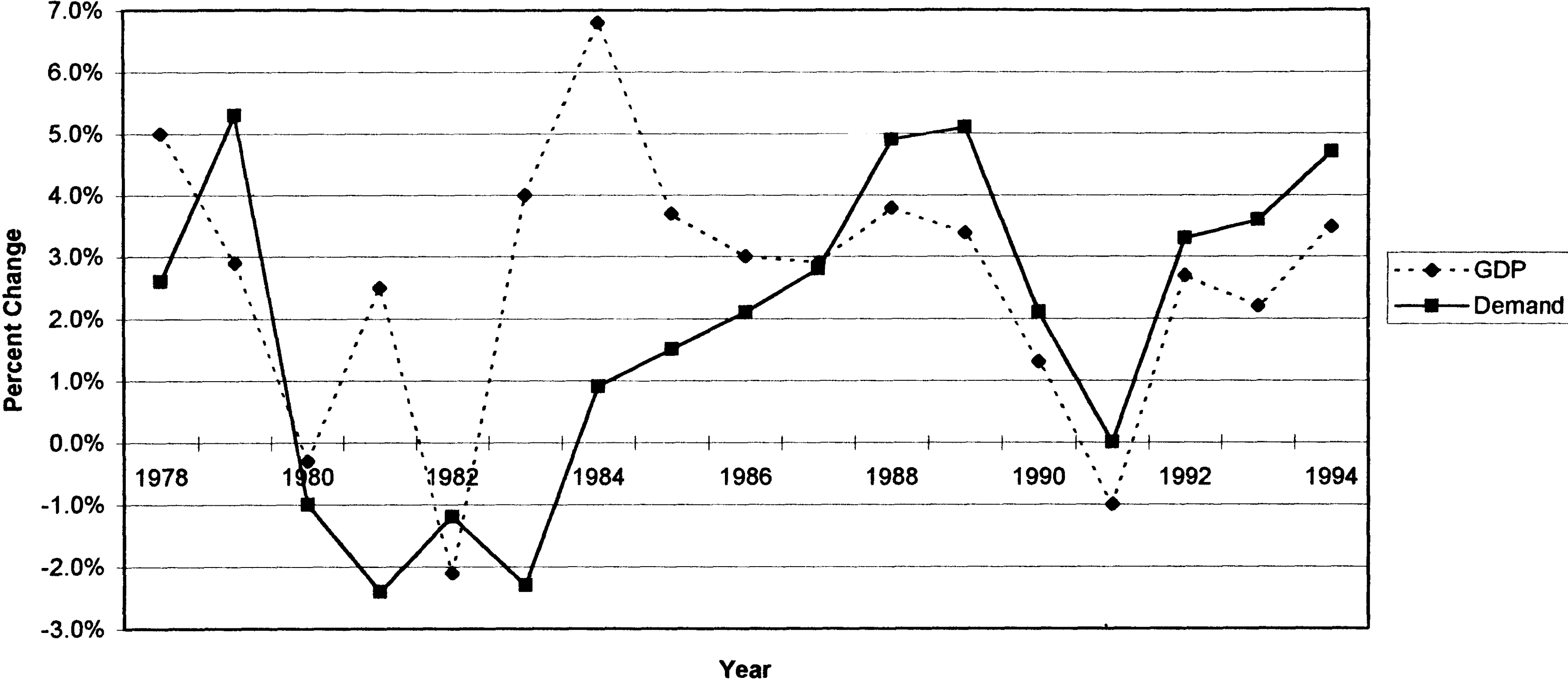
Changes in Room Supply

Room supply growth exceeded demand growth through most of the 1980s, and was particularly strong between 1985 and 1991 when, on average, 100,000 new rooms per year were added (Figure A.2). However, annual additions of new rooms fell in 1992 and 1993, to about 34,000 (about one percent of existing supply). Since then, growth in new supply has increased again, reaching 56,000 rooms in 1995. Most new hotels developed since 1992 have been limited-service properties averaging about 80 rooms apiece, and affiliated with a major franchise.

Changes in Hotel Occupancy

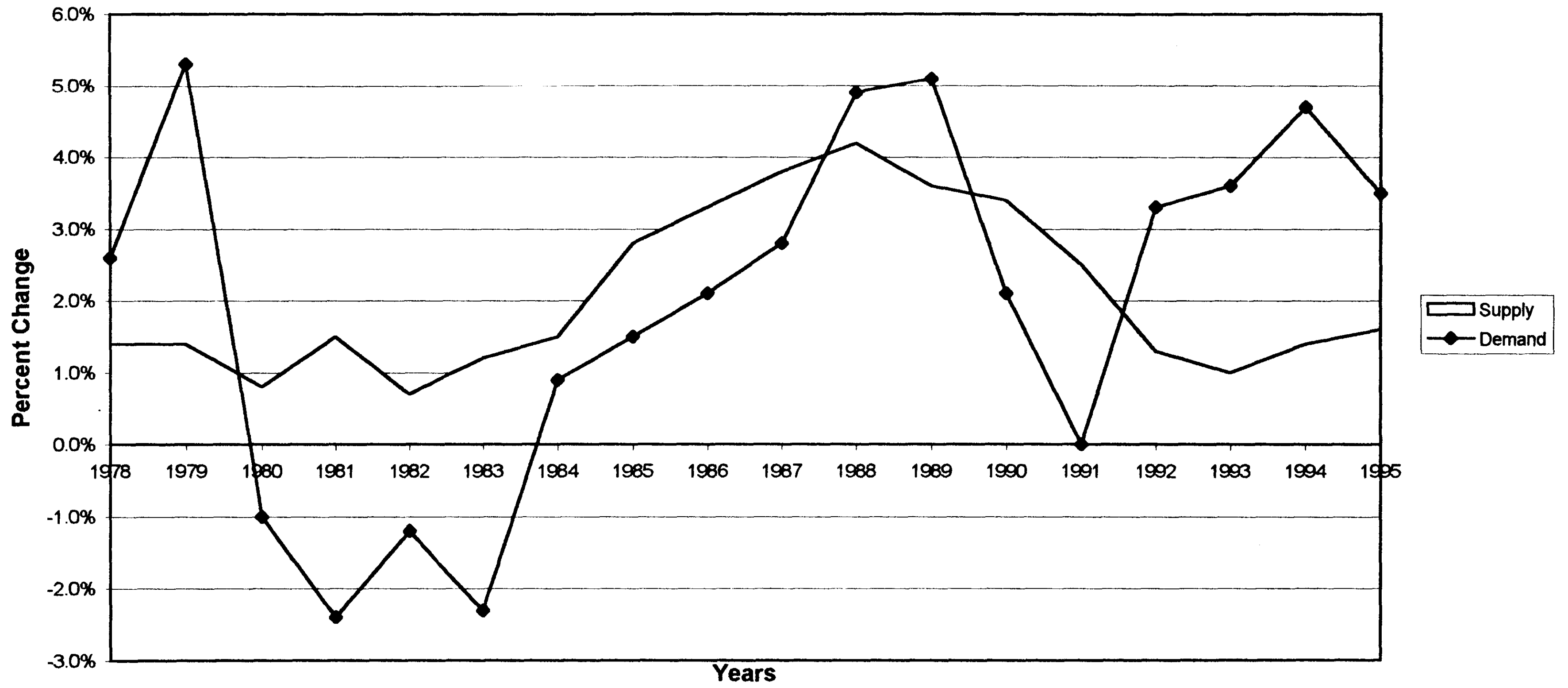
In the period since 1970, the highest hotel occupancies occurred in 1979, when they reached about 72% (Figure A.3). However, occupancies declined through most of the 1980s, bottoming at around 62% for the years 1987-1991. It is only since 1991, that consecutive annual increases have been sustained, allowing occupancy to reach about 67% in 1995.

Figure A.1. U.S. Lodging Industry: Room Demand Growth vs GDP Growth 1978 - 1994



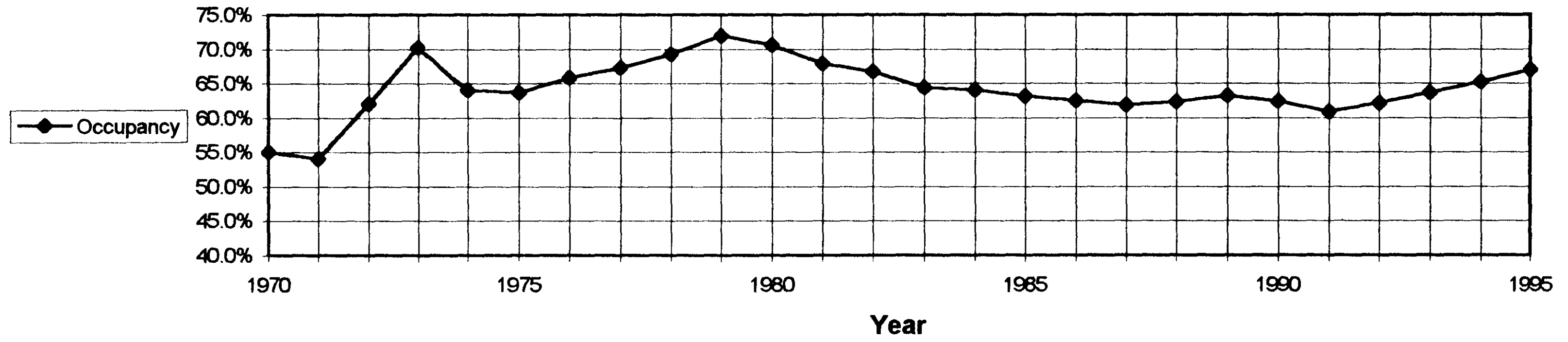
source: *Smith Travel Research*

Figure A.2. U.S. Lodging Industry: Room Supply / Demand Percent Change 1978 -1995



source: Smith Travel Research

Figure A.3. U.S. Lodging Industry: Annual Occupancies 1970 - 1995



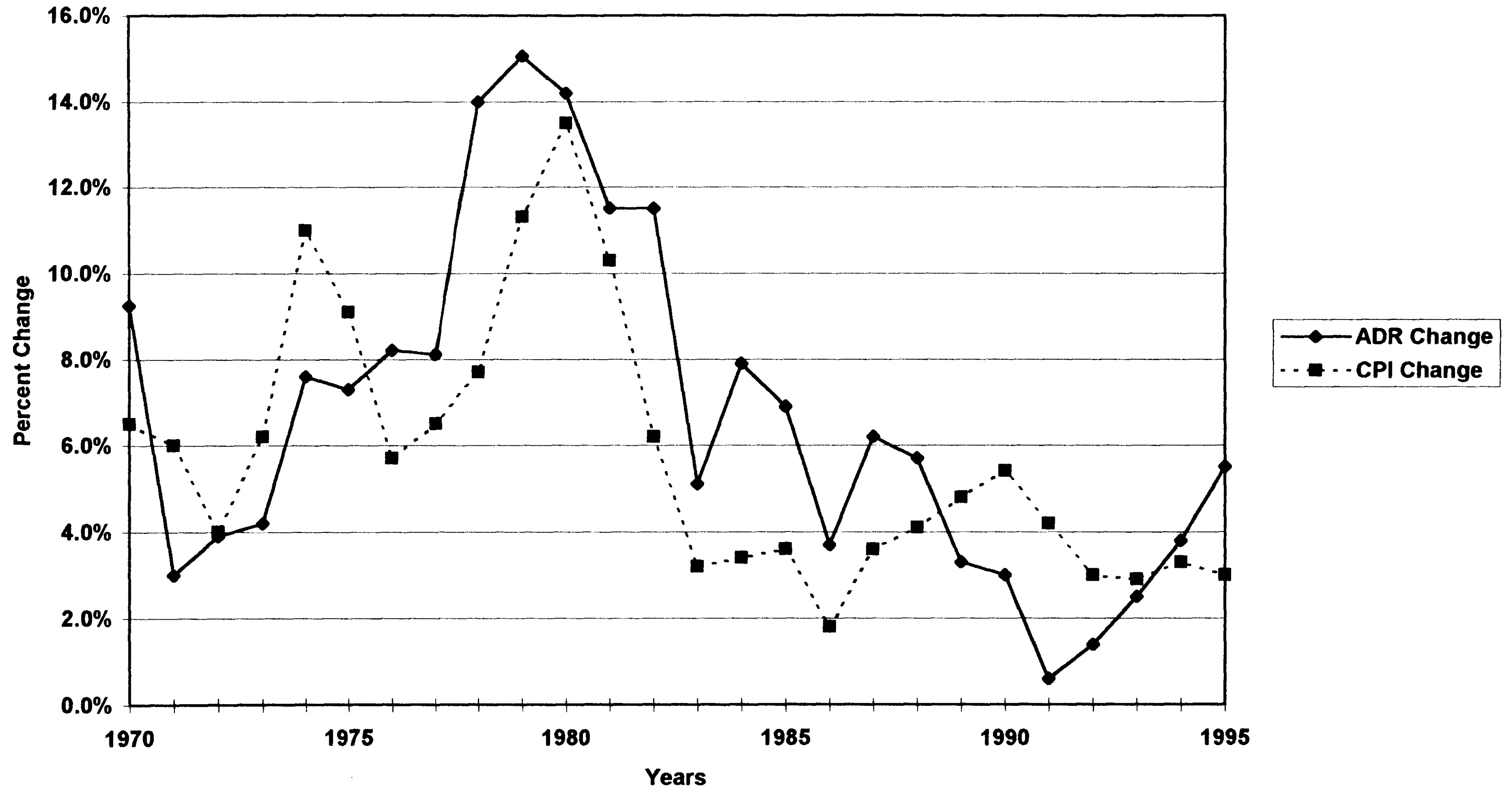
source: Smith Travel Research

Changes in Hotel Room Rates

Among real property types, hotels are perceived to have the best ability to adjust prices for inflation because room rates are not tied to long-term leases and can change daily. Since 1975, this perception has, generally, been borne out. Although there was almost no growth in hotel room rates in 1991, nominal Average Daily Room Rates (ADR) never declined during the period 1970 - 1995 (Figure A.4). There were periods, however, when ADR did not keep pace with changes in the Consumer Price Index (CPI). This occurred most recently in 1993, but since then, ADR increases have exceeded CPI increases.

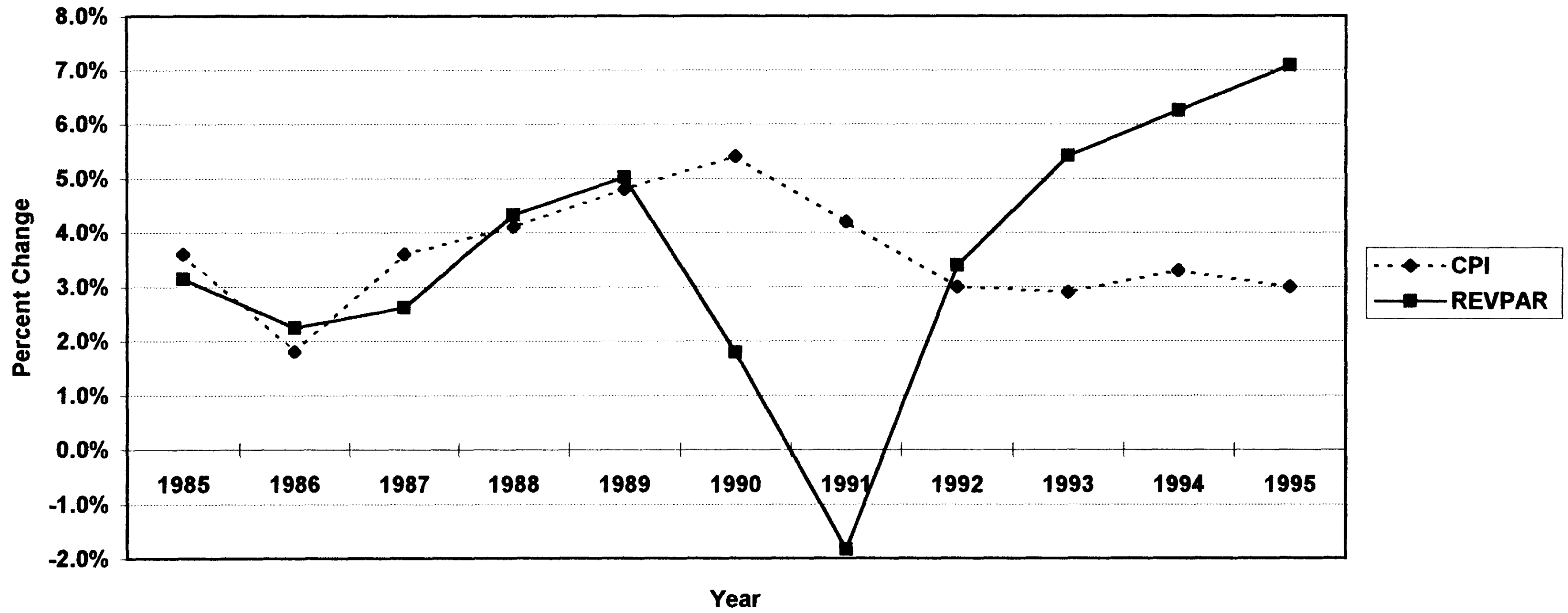
A comparison of changes in Revenue Per Available Room (REVPAR) and CPI is shown in Figure A.5. REVPAR, the product of the occupancy rate and ADR, represents the average annual revenue that a hotel room can be expected to generate. Because room rates and occupancy are related, REVPAR is useful as a means of describing their combined effect in a single number. Figure A.5 shows that nominal changes in room revenues closely matched CPI changes through 1989 before falling sharply below the inflation rate in 1990 and 1991. Since 1991, REVPAR has increased rapidly and has been outpacing CPI by a widening margin since 1992.

Figure A.4. U.S. Lodging Industry: Average Daily Rate vs CPI 1970 -1995



source: Smith Travel Research

Figure A.5. U.S. Lodging Industry: Change in REVPAR vs CPI 1985 -1995



source: Smith Travel Research

Changes in Hotel Profitability

Annual profits for the U. S. lodging industry are shown in Figure A.6. The industry custom is to report profits as pre-income tax net operating income after deductions for management fees, depreciation, amortization, real estate taxes, and mortgage interest payments. From an industry profit of $2.5 billion in 1982, profits declined to zero in 1985, and turned to losses in 1986. The losses progressively deepened for the remainder of the decade, reaching a low, in 1990, of (-$5.7) billion. Afterwards, with major debt restructuring, cost cutting, and increased room demand, the industry's fortunes quickly improved, breaking even in 1992, and achieving record profits of $8.8 billion in 1995.

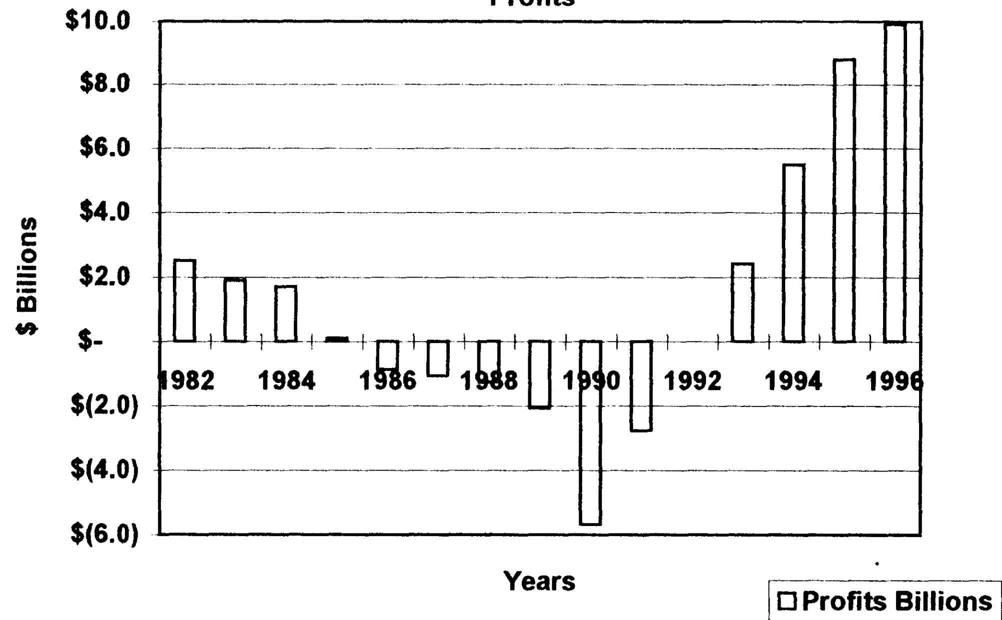
The turnaround in profitability occurred more quickly in limited service hotels than in full service hotels. The average annual reduction in fixed charges (which includes interest payments, depreciation, and amortization) and increases in pre-tax net income for full service and limited-service hotels in the U.S. for the years 1990-1995 are shown in Table A.1 Limited service hotels, which typically lack food and beverage operations, were particularly adept at reducing fixed expense charges and growing their net income. Thus, by 1994, limited service hotels, unlike full service hotels, could show investors three consecutive years of increasingly profitable operations.

Table A.1: Hotel Fixed Charges and Net Income - Ratio To Sales

Year	Full Service Fixed Charges	Full Service Net Income	Limited Service Fixed Charges	Limited Service Net Income
1990	29.8%	-10.2%	40.8%	-1.5%
1991	28.4%	-6.0%	35.6%	1.9%
1992	25.8%	-1.4%	29.0%	10.5%
1993	22.8%	2.6%	25.2%	13.1%
1994	21.9%	7.5%	21.1%	23.4%
1995	19.6%	9.7%	19.4%	24.6%

source: Smith Travel Research

Figure A.6. U.S. Lodging Industry 1982 -1996: Before Tax Profits



source: Smith Travel Research

However, the industry's profits may not be as high as indicated. The accuracy of reported hotel expenses was questioned in a 1995 study of capital expenditures by the International Society of Hospitality Consultants (Berg and French 1995). The industry standard of reserving 3% of gross revenues to fund capital expenditures and replace furniture, fixtures, and equipment (FF&E) was concluded to be insufficient to maintain a hotel's competitive condition. A reserve amount closer to 8% was required to fund long-term maintenance of FF&E and major renovations. This means some hotels are distributing too much of their income and will require a capital infusion to fund deferred maintenance and renovation. By extension, it begs the question of whether REITs are distributing too much income.

Appendix B: Overview of Hotel Investment

During the period 1991-1994, many investors were unable to purchase hotel properties because third-party financing was not available. Thus, hotel investment was largely confined to private pools of capital (venture funds) which made opportune investments in distressed hotel chains and hotel properties. The reliance on private funding has since been followed by a continuing wave of initial public offerings by hotel REITs and hotel C-corporations. A review of the transition from private to public funding in the hotel industry is instructive for understanding the conditions that led to the recent wave of REITs and C-corporations.

Table B.1 shows the approximate proportion of hotel financing which came from publicly-traded companies and private sources in 1992 and 1994. By 1994, the importance of public hotel C-corporations and several new hotel REITs in providing capital was already evident.

Table B.1 Lodging Investment Capital Sources

Source of Financing	1992	1994
Public Sources	12.4%	49.7%
Private Sources	87.6%	50.3%

Source: Coopers & Lybrand, 1995; Hospitality Valuation Services

In contrast to the investors of the 1980s, private sources such as venture funds were professional investors, often from Wall Street, teamed with hotel operating companies (Pacelle 1993). The evolution of venture fund activities in hotel investment in the 1990s is summarized in table 2.2.

Table B.2. Hotel Venture Fund Genesis

Period	Activity	Players
1990 to 1992	RTC Bulk & Asset Sales	Hotel Operators with private Investment Groups: Ashford; Patriot American
1992 to 1993	Private Bank Bulk Sales	Wall Street Firms
1993 to 1995	Single Asset Deals Portfolio Sales	Hotel Operators with Private Investment Groups: Equistar, Interstone, Olympus, Carlyle
1996 and onward	Hotel Company Transactions Asset Management Exit Planning	

Source: Arthur Andersen LLP, 1996

Between 1991 and 1996, as real estate markets improved and hotel operations recovered, Wall Street raised $10.2 billion in the public markets for hotel REITs, C-corporations, and gaming companies. Half of this total was raised between July 1995 and March 1996 (Ford 1996a; Ford 1996b). Table B.3, below, summarizing hotel company IPO activity, was compiled from various trade and business periodicals (for example, see Pacelle, 1996; and Sandler and Pacelle, 1996).

Table B.3. Hotel Company Initial Public Offerings, 1993-1996

	1993	1994	1995	1996
Equity REITs Number of IPOs	1	6	3	2
Equity REITs IPO Volume ($)	$40,000,000	$293,000,000	$885,000,000	$155,000,000
C-Corporation Number of IPOs	0	2	5	5
C-Corporation IPO Volume ($)	$0	$130,000,000	$475,000,000	$880,000,000
Total IPOs (REITs + C-Corp)	1	8	8	7
*Total Volume ($) (REITs + C-Corp)	$40,000,000	$423,000,000	$1,360,000,000	$980,000,000

*excluding secondary offerings

The table shows a trend from several small hotel REITs in 1994, to fewer, larger REITs and C-corporations in 1995-1996. As IPO volume and prices increased, some of the venture funds active

in 1992-1994 (Table B.2 above), cashed out in the public markets by forming real estate investment trusts (Patriot American), while others formed hotel owner-operator C-corporations (Interstone). In the case of Interstate Hotel's IPO, the Blackstone Group, (Interstate's partner in Interstone) reportedly reaped more than twice the $82 million investment which it had held for less than two years. The IPO activity illustrates that hotel investments offer investors the opportunity to distinguish between the operating business value of a hotel and the real estate value of a hotel. The relative market values of these components can influence the owner/operator's decision about the appropriate organizational structure for a public hotel company, that is, between a REIT and a taxable C-corporation.

Components of Hotel Value

Three basic types of entities make up the hotel industry, namely; franchisors, management companies, and hotel owners. Franchisors and management companies benefit from the business of operating a hotel by sharing in its revenues, while hotel owners benefit from increases in the hotel's property value which is tied to its profitability. The three entities are not mutually exclusive and examples of each of these types, or combinations of types, can be found among public companies. The entities are further described as follows:

Franchisors are companies which own hotel brands and rent, to franchisees, the right to use the name, logo, reservations system, and marketing and other services associated with operating a hotel. A franchisor's revenues are usually derived from a percentage of the hotel's room revenues. Franchisors' revenue and earnings growth can be achieved with little additional capital investment, merely by signing franchise agreements with more hotels. Examples of franchisors among public companies include Hospitality Franchise Systems, Marriott International, and Doubletree Hotels.

Management companies are responsible for the day to day operation of hotels and may be part of a chain or independently owned. A management company's revenues are derived from a percentage of the hotel's total revenues (from all sources including food & beverage, telephone, banquets and meetings, etc) and often include an incentive bonus tied to the hotel's profits. Like franchisors, management companies can grow by signing new business contracts and, thus, require relatively little additional capital for growth. Examples of publicly-listed chain management companies include Marriott International, and Hilton Hotels while an example of a public, independent management company is Interstate Hotels.

Hotel owners may include both franchisors and managers, or they may be completely separated from the property's operation , and contract for a franchise and manager. Hotel owners, generally, benefit from the profitable operation of the hotel (although some owners, such as REITs, may lease the property to a lessee under terms not dependent on profits). Hotel ownership is much more capital-intensive than either franchising or managing. In addition, acquisition or development of another hotel requires may require relatively long lead times before significant profits are realized. Examples of public companies which own, but do not manage or franchise, hotels include Host Marriott and numerous hotel REITs. Other companies such as La Quinta, ITT Sheraton, and Hilton are owners, managers, and franchisors while John Q. Hammons Company is a franchisee which owns and manages hotels but does not own a brand.

The issue of which type of entity is the most profitable and capital efficient is related to the entity's operating leverage; that is, the proportion of each incremental dollar of *a given hotel's revenue* that will reach the *entity's* bottom line as pre-tax net income. At a given hotel, the owner enjoys the highest operating leverage, as each additional revenue dollar raised by charging more for an occupied room may reap profits as high as 90% . In other words, the owner incurs additional

expenses of 10% (for management and franchise fees which are tied to revenues). On the other hand, raising an incremental dollar of revenue by selling an additional room incurs additional expenses of about 35% (for additional cleaning, utilities, repair and maintenance, etc) leaving about 65% as pre-tax net income. Given a choice between increasing room rates or occupancy, it is far more profitable to the owner, to raise room rates.

By comparison incremental pre-tax income for franchisors and management companies is about 4% -5% of incremental revenue. While this figure appears low, it is important to remember that the figure is expressed as a percentage of the incremental revenue of the *hotel*, not as a percentage of the revenue of the franchisor or management company. The incremental expense ratios of *franchisors and managers* are quite low (10% to 20%), and their incremental pre-tax income may be as much as 80% to 90% of their own incremental revenues. In other words, a management company which receives a management fee equal to 5% of a hotel's total revenues, will receive five cents of each incremental dollar of hotel revenue, but four cents of that (80% of 5 cents) will be profit to the management company. Furthermore, it is far easier and less expensive for franchisors and managers to increase their revenues by contracting for additional hotel business than it is for owners to build ,or buy, new properties. These growth differentials between hotel business operators and hotel owners is critical to understanding the investment value of hotel companies.

Changes in Hotel Real Estate Values

Table B.4, compiled by hotel appraisal firm, Hospitality Valuation Services, lists the weighted-average per-room selling prices of U.S. hotels for the years 1980-1995. According to this data, hotel prices rose steadily from $35,000 per room in 1980 to a peak value of $74,000 per room in

1988 and then collapsed back to $35,000 per room in 1991. In 1996, private market hotel prices are still below their peak prices of 1988, but have rebounded almost 80% from their lows of 1991.

Table B.4. Annual Average Hotel Sales Prices (Per Room), 1980 - 1995

Year	Average Price Per Room	Number of Transactions
1980	$35,000	209
1981	$35,000	309
1982	$38,000	369
1983	$48,000	451
1984	$54,000	467
1985	$56,000	509
1986	$55,000	726
1987	$71,000	489
1988	$74,000	659
1989	$67,000	673
1990	$66,000	658
1991	$34,000	605
1992	$35,000	567
1993	$40,000	512
1994	$46,000	471
1995	$61,000	373

Source: Hospitality Valuation Services, HVS International

The increase in hotel prices since 1991, followed the turnaround in industry profitability. And, as was seen in appendix A, table A.1, limited service properties experienced a more dramatic return to profitability than did full service hotels.

By 1995, investor demand for limited-service properties had driven their market values to meet or exceed replacement cost, so that further appreciation will be difficult without stimulating competing supply. However, a sizable discount to replacement cost still exists in the upper-end hotel properties, and further appreciation in prices may be possible for those types of properties.

Table B.6. Hotel Prices and Replacement Cost (Per Room)

Property Type	Sales Price	Replacement Cost	Price/Replacement Cost
Budget	$45,000	$43,000	105%
Mid-Rate	$70,000	$70,000	100%
First-Class	$87,000	$100,000	87%
Luxury	$122,500	$175,000	70%

Source: Hospitality Valuation Services, HVS International

Changes in Hotel Stock Prices

In Chapter 2, we closely examine the stock returns of hotel REITs and hotel C-corporations during the period 1993 -1996. However, the price performance of hotel stocks prior to 1993 may be helpful in assessing the public market response to changes in hotel operating statistics and real estate values. Hotel companies have been publicly traded since at least 1946 when Hilton Hotels Corporation, and Sheraton (U.S. Realty-Sheraton Corporation) completed initial public offerings (see Figure B.1 for an IPO and trading history of selected lodging companies). An approximate means for tracking the investment performance of public hotel companies is provided by the Standard & Poor's Hotel-Motel Index.

The Standard & Poor's Hotel-Motel Index

The Standard & Poor's' Hotel-Motel Index reports the market value-weighted, average price of an indexed sample of three to five hotel companies listed on the New York Stock Exchange (Standard & Poor's , 1996). The average annual prices of this index, between 1965 and 1995, are depicted in Figure B.2 and have shown great volatility compared to the S&P500. After out-performing the broader market by increasing seven-fold from 1965 to 1969, the Hotel-Motel Index dropped sharply in 1973-1974, losing 75% of its value. It, then, approximately followed the trend of the S&P 500 until 1989, when it sharply rose about 40%. Over the next two years, however, it again,

lost half its value. In 1992, the index started an upward trend, and had risen 160% by the end of 1995, compared to a gain of 44% for the S&P 500.

Appendix B.1 IPO and Trading History of Selected Public Hotel Companies

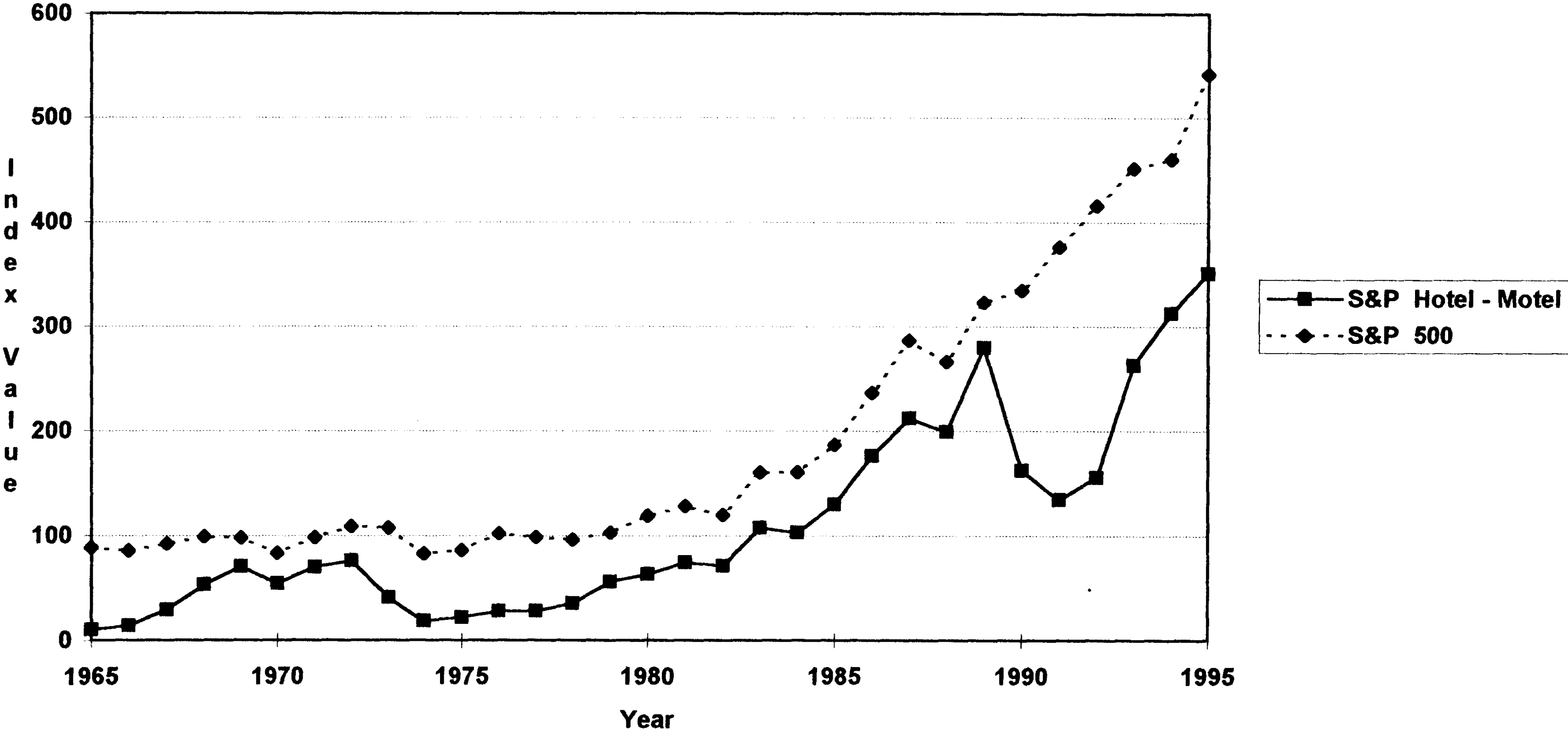
	STOCK	TYPE	YEAR																											
			1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
1	AIRCOA Hotel Investors, LP	MLP																		IPO										
2	Amerihost	C-Corporation																	IPO											
3	Bay Financial Corporation (former mortgage REIT)	C-Corporation									1977 conversion from REIT														1991 bankruptcy					
4	Brock Hotel Corporation	C-Corporation											IPO						1985 Restructured as Integra											
5	Bristol	C-Corporation																											IPO	
6	Days	C-Corporation																	IPO						1991 acquired by HFS					
7	Divi Hotels	C-Corporation																	IPO						1991 Chapter 11					
8	Doubletree Hotels	C-Corporation																										IPO		
9	Extended Stay America	C-Corporation																											IPO	
10	Hospitality Franchise Systems (HFS)	C-Corporation																								IPO				
11	Hilton	C-Corporation	IPO=1946																											
12	Holiday Inn	C-Corporation	IPO=1957																					1990 acquired by Bass PLC						
13	Host Marriott (formerly Marriott Corp)	C-Corporation	IPO=1959																											
14	Howard Johnson	C-Corporation	IPO=1961											1980 Acquired by Imperial Group PLC																
15	Interstate Hotels	C-Corporation																												IPO
16	Integra (formerly Brock Hotel Corp)	C-Corporation																	IPO							1992 Chapter 11				
17	ITT (owns Sheraton)	C-Corporation																												IPO
18	John Q. Hammons	C-Corporation																										IPO		
19	Kahler Management Corporation	C-Corporation																							IPO			1994 de-listed		
20	La Quinta	C-Corporation					IPO																							
21	Marcus	C-Corporation																												
22	Marriott International (Marriott spin-off)	C-Corporation																									IPO			
23	Microtel	C-Corporation																					IPO							
24	Motel 6	C-Corporation																IPO						1990 acquired by Accor SA						
25	Nendels	C-Corporation																							IPO	1992 de-listed				
26	Prime Motor Inns	C-Corporation											IPO																	
27	Promus Co. (Holiday Inn spin-off)	C-Corporation																						IPO					1995 spinoff	
28	Promus Hotel Corp (Promus spin-off)	C-Corporation																											IPO	
29	Ramada	C-Corporation	IPO=1961																					1989 acquired by HFS						
30	Red Lion	C-Corporation																											IPO	
31	Red Roof Inns	C-Corporation																												IPO
32	Renaissance	C-Corporation																											IPO	
33	Servico	C-Corporation												IPO																
34	Sheraton	C-Corporation	IPO=1946, acquired by ITT 1968																											
35	ShoLodge	C-Corporation																								IPO				
36	Sonesta	C-Corporation	IPO=1954																											
37	Studio Plus	C-Corporation																											IPO	
38	Sun International Hotels	C-Corporation																												IPO
39	Travelodge International Inc	C-Corporation	IPO=1946																		1986 merged into Trust House Forte PLC									
40	United Inns	C-Corporation	IPO=1968						IPO																				1995 merger/Harvey	
41	Wyndham	C-Corporation																												IPO
	Choice Hotels (announced)	C-Corporation																												

source: Value Line Investment Survey, Capital Changes Report, Wall Street Journal

	Appendix B.1 IPO and Trading History of Selected Public Hotel Companies STOCK	TYPE	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
1	American General Hospitality	Equity REIT																												IPO
2	Equity Inns	Equity REIT																										IPO		
3	FelCor Suites	Equity REIT																										IPO		
4	Hospitality Properties Trust	Equity REIT																											IPO	
5	Host Funding	Equity REIT																												IPO
6	Humphrey Hospitality Trust	Equity REIT																										IPO		
7	Innkeeper's USA Trust	Equity REIT																										IPO		
8	Kahler Realty Corporation	Equity REIT																												
9	Jameson Inns	Equity REIT																										IPO		
10	Patriot American	Equity REIT																											IPO	
11	Property Capital Trust (includes hotels)	Equity REIT			IPO																		1989 liquidated							
12	RFS Hotel Investors	Equity REIT																									IPO			
13	Sunstone Hotel Investors	Equity REIT																											IPO	
14	Winston Hotels	Equity REIT																										IPO		
	Boykin Hotels (announced)	Equity REIT																												
	Mortgage REITs (percentage of hotels in portfolio)																													
1	Allied Capital Commercial Corporation (7%)	Mortgage REIT																										IPO		
2	Banyan Hotel Investors Fund (15 years finite life)	Mortgage REIT																	IPO											
3	Bay Financial Corp (16%)	Mortgage REIT			IPO						1977 terminated REIT status																			
4	BT Mortgage Investors	Mortgage REIT		IPO												1982 merged into Charan Industries														
5	Burnham Pacific Prop (3.8%) (converted from LP)	Mortgage REIT																			IPO									
6	California REIT (14%)	Mortgage REIT																										IPO		
7	Chase Manhattan Mtge & Realty Trust (9%)	Mortgage REIT		IPO									1979 de-listed																	
8	CV REIT Inc (4%)	Mortgage REIT												IPO																
9	Equitable Life Mortgage and Realty Investors (21%)	Mortgage REIT		IPO																										
10	First Mortgage Investors (4%)	Mortgage REIT	IPO=1964						1975 de-listed																					
11	Great American Mortgage Investors (15%)	Mortgage REIT	IPO=1969																				1989 de-listed							
12	HMG/Courtland Properties Inc (31%)	Mortgage REIT				IPO																								
13	Mass Mutual Mortgage and Realty Investors (9%)	Mortgage REIT		IPO														1985 merged into Mass Mutual Life Insurance Co												
14	Mortgage & Realty Trust (2%)	Mortgage REIT																												
15	Mortgage Trust of America	Mortgage REIT	IPO=1969																											
16	Northwestern Mut Life Mtge & Rlty Investors (9%)	Mortgage REIT			IPO												1983 merged into Northwesterm Mutual Life Insurance Co													
17	Peregrin REIT (25%)	Mortgage REIT																										IPO		
18	Realty Refund Trust (13%)	Mortgage REIT			IPO																									
19	Republic Mortgage Investors (3%)	Mortgage REIT	IPO=1968																											
20	Resort Income Investors	Mortgage REIT																				IPO						1994 In liquidation		
21	State Mutual Investors (13%)	Mortgage REIT		IPO										1980 merged into First City Properties																
22	Sutro Mortgage Investors Trust (18%)	Mortgage REIT	IPO=1969										1979 sold to PNB Mortgage & Rlty Investors																	
23	Wachovia Realty Investments (14%)	Mortgage REIT			IPO											1982 acquired by Old Stone Corporation														
1	Americana Hotels and Realty Corp	Hybrid REIT														IPO							1989 in liquidation							
2	BRE Properties (12%)	Hybrid REIT		IPO																										
3	Cousins Mortgage & Equity Investments (16%)	Hybrid REIT		IPO 1970 as C-corporation																	IPO 1987 conversion to REIT									
4	Property Capital Trust (16%)	Hybrid REIT	IPO=1969																											
5	Starwood Lodging Trust	Hybrid REIT	IPO =1969																											
6	Transcontinental Realty Investors Inc (2%)	Hybrid REIT																		IPO										

source: Value Line Investment Survey, Capital Changes Reporter, Wall Street Journal

Figure B.2. Index Values 1965-1995:
S&P 500 vs S&P Hotel-Motel

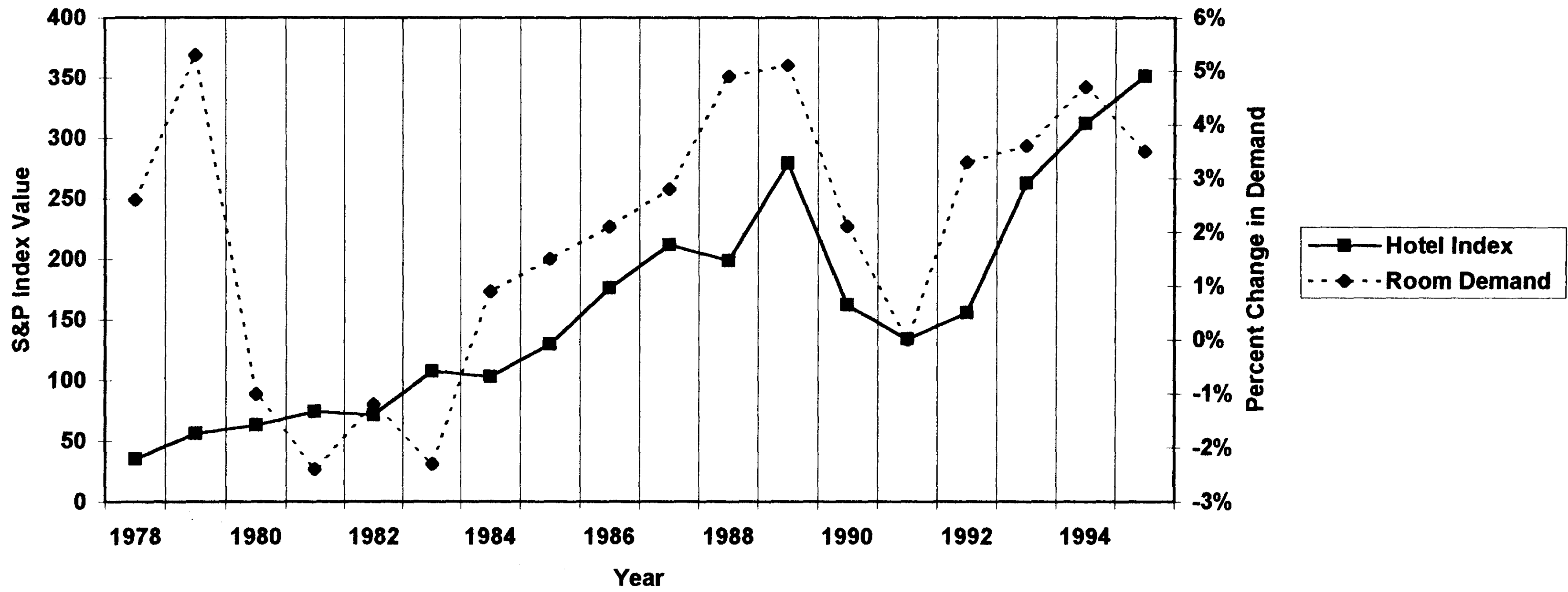


source: Standard Poor's

The S&P Hotel-Motel Index ignored, and kept rising through, the great volatility shown in room demand during 1978-1983 (Figure B.3). From 1984, onwards the index approximately mirrored the trend in room demand growth. Although it is commonly known that lodging industry rebounds follow recovery from a recession, it appears that the increase in the Hotel-Motel Index was contemporaneous with, and not in advance of, increases in annual changes in room demand.

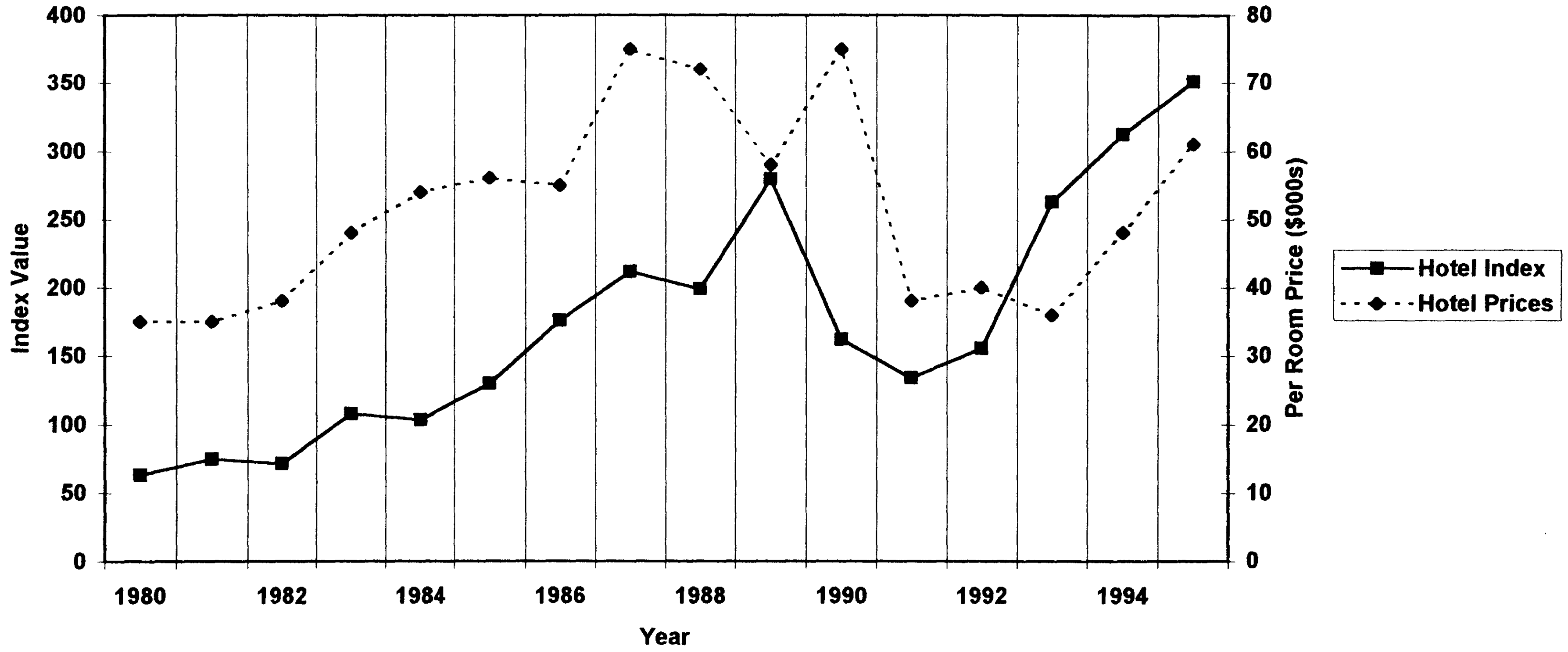
Between 1980 and 1989 real estate prices and the Hotel-Motel Index showed a somewhat similar upward trend (Figure B.4). On the other hand, the decline and subsequent improvement in sales prices of private market hotel real estate between 1989 and 1995, appears to lag the improvement in the Hotel-Motel Index by about one year. Public ownership of real estate, as exhibited by the general REIT market, appreciated along with other stocks after 1991 (NAREIT, 1995b). However, average private market hotel values in 1992, were almost unchanged from 1991.

The appreciation of hotel C-corporation stocks and general types of REIT stocks, in advance of appreciation in private market hotel prices, suggests a potential for arbitrage between public and private markets. A hypothetical example is described by Burritt (1994) in which a portfolio of hotels could be purchased in the private market at a terminal capitalization rate of 14.25%, while at the same time, a REIT was being priced for an initial public offering at a capitalization rate of 11%. The 3.25% spread represents additional benefits to the sponsors and underwriters of the REIT who purchase the portfolio and securitize it as a REIT.



source: Smith Travel Research; Standard Poor's

Figure B.4. Hotel Prices vs S&P Hotel-Motel Index Values 1980 - 1995



source: Hospitality Valuation Services, HVS International; Standard Poor's

Stock market investors who wanted to participate in the appreciation of hotel real estate, as opposed to hotel operations, had little opportunity to do so before 1993. At that time, only two hotel REITs were listed, and both were in financial difficulty[1]. Americana Hotels was still in liquidation and Hotel Investors Trust was restructuring by selling assets and re-negotiating with its lenders[t1]. Consequently, taxable C-corporations were the only stable public vehicles by which to purchase hotel property, but, because of their business activities, very few of these companies constituted pure real estate investments.

---

[1] The first publicly-traded hotel REIT was Hotel Investors Trust, set up by Harold Milner, in 1969, as a mortgage REIT to finance development of Marriott hotels. Seven years later, its market value, was the 19th largest of 218 public REITs (NAREIT, 1977). In 1980, Hotel Investors Trust, became a hybrid REIT and set up a separate company as lessee and operator of its hotels. Shares of this company were "paired" with the REIT and they traded together on the NYSE. The Deficit Reduction Act of 1984 disallowed paired-share REITs for companies which adopted it after 1983, however because it existed prior to 1983 Hotel Investors Trust's paired-share structure was grandfathered. In 1989, the Company was urged by its lenders to rescind its REIT status (de-REIT). Their reasoning was that this would improve the collateral securing the REIT's hotel loans by combining the income and assets of the REIT borrower with those of its unique "paired share" operating company. It would also reduce the potential problem that, should the REIT default on its loans, the lender would have to take title to a hotel subject to an existing lease. Such a structure might impair the market value of the asset and make it difficult for the lender to sell the property. On the other hand, Hotel Investors Trust's paired shares had value as a unique structure that eliminated a number of problems inherent to hotel REITs. It had no interest in giving up that structure, or the future value of its tax shields, and so, did not "de-REIT".

In 1982, Harold Milner set up another hotel REIT by combining the assets of Pick Hotels with a chain purchased from American Airlines. Americana Hotels and Realty Corporation, which was listed on the NYSE in 1983, was set up as a hybrid REIT with mortgages and equity positions on 21 hotels. Beginning in 1985 Americana experienced financial difficulties which culminated, in 1988, in a decision to liquidate. As of August 1996, the liquidation process is almost complete.

Appendix C: REIT Qualification Requirements

Organizational Requirements

In order to qualify as a REIT, an entity must be organized as a domestic corporation, association, or business trust. As such, the management of the qualifying entity must be centralized in one or more directors or trustees. The qualifying entity must also possess at least two of the additional requisite organizational characteristics which, but for its REIT election, would cause it to be taxed as a domestic corporation. These characteristics are: continuity of life, limited liability, and freely transferable ownership interests. Under the tax code, insurance companies and financial institutions cannot elect REIT status, nor may foreign corporations, associations, and business trusts qualify as REITs.

The qualifying entity must satisfy certain tests with respect to the minimum diversification and the maximum concentration of its ownership. First, the qualifying entity must maintain at least 100 independent shareholders for at least 335 days out of each tax year. For purposes of the 100-person test pension funds are counted as a single investor. Second, no more than 50 percent of the equity value of the qualifying entity may be concentrated in the holdings of 5 or fewer investors. Unlike the 100 or greater test above, the concentration of pension fund holdings under the tax attribution rules is based on the number of beneficiaries represented by each fund respectively.

Asset Tests

To qualify as a REIT, an entity must satisfy two tests regarding the composition of its portfolio of assets. These are commonly referred to as the 75-percent asset test and the diversification test. These tests must be satisfied at the end of each quarter during a tax year in which an entity elects REIT status. The 75-percent asset test is designed to ensure that a REIT remains primarily a vehicle for investment in real estate. The 75-percent test requires that at the end of each quarter, at

least 75 percent of the assets held by the REIT consist only of real estate, cash, ordinarily occurring receivables, and government securities. The definition of real estate includes direct and partnership investments in real property, loans backed by mortgages on real property, interests in real estate mortgage investment conduits, ownership shares in other qualifying REITs, and assets attributable to temporary investments of new capital such as from an initial or secondary public equity offering.

The asset diversification test is intended to insure that the remaining 25 percent of a REIT's assets are adequately diversified. This test has three components. First, not more than 25 percent of the value of a REIT's assets may consist of non-REIT, non-government securities. Second, not more than 5 percent of a REIT's assets may be from a single issuer. Finally, a REIT may not hold more than 10 percent of the outstanding voting securities a corporation that is not either a REIT or a qualifying subsidiary of the subject REIT.

Failure of a REIT to satisfy either the 75-percent test or the asset diversification test at the close of any quarter will result in the loss of REIT status for that year and consequently subject the REIT to taxation of income at the entity level. REITs are afforded a grace period of thirty days following the end of any quarter in which an asset test was not met to correct the deficiency and preserve its tax status as a REIT.

Income Source Tests

In addition to the asset tests above, entities seeking REIT status must also satisfy three tests with respect to the sources from which they derive income. These tests are commonly known as the 95-percent test, the 75-percent test, and the 30-percent test. Under the 95-percent test, at least 95 percent of the gross income received by a REIT for a taxable year must be derived from the

following: dividends, interest, rents from real property, gain from the sale of real property not held primarily for sale to customers in the ordinary course of business, income and gain from foreclosure property, property tax refunds, and loan or contract commitment fees. The primary purpose of the 95-percent test is to insure that a REIT remains a passive investment vehicle and does not engage in an active trade or business.

Unlike the 95-percent income test, the 75-percent income test is designed to insure that a REIT's income is derived primarily from real estate and real estate related investments. As such, the 75-percent income test requires that for a tax year in which an entity is electing REIT status, at least 75 percent of its gross income must be derived from the following: rents from real property, interest on loans secured by mortgages on real property, gain from the sale of real property other than prohibited transactions, dividends and other distributions from interests in other REITs, refunds of taxes on real property, income and gain from foreclosure property, loan and contract commitment fees, and qualified temporary investment income.

Finally, the 30-percent test exists to make certain that REITs do not function as dealers in real estate and real estate related investments by limiting the portion of REIT income than may be derived from short-term investments. Specifically, the 30-percent test stipulates that no more than 30-percent of a REIT's income during a tax year may be derived from the following: sales of stock or securities held for less than one year, sales of real property held for less than four years other than property acquired involuntarily such as through foreclosure, and gain from sales qualifying as prohibited transactions.

A REIT's failure to satisfy any of the three income source tests for a tax year will result in its loss of REIT status and subject it to an entity-level tax on its income. However, as with the asset tests,

REITs are afforded a measure of relief in the event failure to satisfy one or more of the income tests is due to a reasonable cause and not willful neglect. In such an event, the REIT becomes subject to a 100 percent tax on the non-qualifying income, but does not lose its REIT tax status for the balance of its income.

Income Distribution Requirements

The final and perhaps most commonly recognized operational requirement for electing and preserving tax status as a REIT is the required distribution of taxable income. Under the current tax code, REITs are required to distribute to shareholders 95 percent of their taxable income each year (IRC § 857(a)(1)). Taxable income for a REIT is defined by the tax code as regular corporate taxable income adjusted by disallowing the standard corporate dividends received deduction and excluding any REIT income that is taxed under other provisions of the tax code (IRC § 857(b)(2). REIT income that is actually subject to taxation at the entity level is then the taxable income calculated per the code, less a deduction for dividends paid to the REITs shareholders.

As with other REIT qualification tests, REITs are afforded relief from an inadvertent failure to meet the income distribution requirement. In such case, when it is determined that a REIT distributed less than 95 percent of its REIT taxable income during a prior year, the REIT is allowed to distribute a special dividend, or deficiency dividend, and receive a deduction for such in the tax year in which it is paid. In such a case the REIT does not lose its tax status. The REIT must however pay statutory penalties and interest based on the amount of the deficiency dividend.

Appendix D: The History and Evolution of REITs

Massachusetts Business Trusts

Although the modern Real Estate Investment Trust (REIT) was not created until 1960, the use of the trust structure as an entity through which to engage in real estate ownership, development, and investment has a much longer history. The modern REIT is considered to be a descendant of the Massachusetts business trust, which was used during the early part of this century for the purposes of pooling the ownership interests of investors in real estate. The business trust vehicle was used because it afforded investors many of the benefits of a corporate structure such as limited liability and transferable ownership interests, but was treated as a conduit for tax purposes, thus avoiding taxation at the entity level. Additionally, state laws at this time often prohibited corporate ownership of real property (Lynn and Bloomfield, 1995, p. 1-7).

Legislative and Judicial Challenges

Although business trusts were initially not taxable at the entity level, this status faced a series of legislative and judicial challenges beginning in 1909 and culminating in the loss of their tax exemption in 1935. The challenges began in 1909 when Congress created the Corporation Tax in the Tariff Act of 1909. The Corporation Tax was an excise on the privilege of doing business in a corporate capacity. Section 38 of the Tariff Act read:

> § 38. That every corporation, joint stock company or association organized for profit and having a capital stock represented by shares, and every insurance company now or hereafter organized under the laws of the United States or any State or Territory of the United States or under the acts of Congress applicable to Alaska or the District of Columbia, or now or hereafter organized under the laws of any foreign country and engaged in business in any State or Territory of the United States or in Alaska or in the District of Columbia, shall be subject to pay annually a special excise tax with respect to the carrying on or doing business by such corporation, joint stock company or association or insurance company equivalent to one per centum upon the entire net income over an above five

> thousand dollars received by it from all sources during such year, exclusive of amounts received by it as dividends upon stock of other corporations, joint stock companies or associations or insurance companies subject to the tax hereby imposed; or if organized under the laws of any foreign country, upon the amount of net income over and above five thousand dollars received by it from business transacted and capital invested within the United States and its Territories, Alaska and the District of Columbia, during such year, exclusive of amounts so received by it as dividends upon stock of other corporations, joint stock companies or associations or insurance companies subject to the tax hereby imposed." (220 US 107 (1910), p. 143)

The applicability of the Corporate Tax to real estate companies was challenged in several court cases. First, in *Phillips v. Fifty Associates* (220 US 107 (1910))it was argued that the active care and attention given by an owner to his property is incidental to the protection and preservation of his investment and does not constitute carrying on or doing business within the meaning of the Tariff Act. This issue was settled in October 1910 by the U.S. Supreme Court in the case of *Flint v. Stone Tracy Company* (220 US 107 (1910)), in which the Court ruled that corporations engaged in such activities as leasing property, collecting rents, managing office buildings, and making investments of profits were in fact engaged in business within the meaning of the Tariff Act and subject to the Corporation Tax. In the case of *Zonne v. Minneapolis* Syndicate (220 US 187 (1911)), also decided by the Supreme Court in the October 1910 term, the Court held that an entity organized as a passive entity merely to hold title to a property, and receive and distribute rents and sale proceeds did not satisfy the requirement of being engaged in business and therefore was not subject to the Corporation Tax. However, in the case of *Eliot v. Freeman* (220 US 178 (1910)), decided by the Supreme Court in the same term, state business trusts were determined to be exempt from the Corporation Tax because they were not organized under a specific state statute from which they derived corporate qualities or benefits, such as perpetual life, unavailable under common law. The Court interpreted the language reading

"every corporation, joint stock company or association organized for profit and having a capital stock represented by shares, and every insurance company now or hereafter organized under the laws of the United States or any State"

as requiring that the entity to be taxed must enjoy some benefit or benefits granted under statutory laws that would not be otherwise available under common law.

Business trusts thus escaped entity level taxation until the passage of the Income Tax Act of 1913, which eliminated the requirement of statutory organization as cited in *Eliot v. Freeman* and the condition of carrying on a trade or business. However, in *Crocker v. Malley* (249 US 223 (1918)), the Court declared that realty trusts in which the trustees were effectively free from the control of the beneficiaries were still to be considered trusts and not subject to taxation at the entity level. This test was modified by the Revenue Act of 1918 and in 1923 in the case of *Hecht v. Malley* (265 US 144 (1924)), when the Court concluded that the measure of an entity's exposure to tax was whether or not it was "engaged in the active conduct of trade or business" rather than the degree of control the trust's beneficiaries were afforded over the trustees.

The Court's decisions in *Crocker v. Malley* and *Hecht v. Malley* failed to provide a clear test for determining when a trust was in fact a true trust and thus exempt from taxation, and when such was a business trust and thus subject to taxation. This confusion was resolved in the 1935 case of *Morrissey v. Commissioner*. In this case the Court ruled that a trust designed as a vehicle for the conducting of business was to be considered a corporation and subject to taxation as such when it possessed the following "corporate" characteristics:

1. Title to property owned by the enterprise is held by trustees, as a continuing body, during the existence of trust;

2. centralized management by trustees, as representatives of beneficial owners, whether selected by or with the advice of beneficiaries or designated in the trust instrument with power to select successors;

3. continuity uninterrupted by deaths among beneficial owners;

4. means for transfer of beneficial interests and introducing new participants without affecting continuity;

5. limitation of personal liability of participants to property invested and contributed in the undertaking.

Thus following the Court's decision in *Morrissey v. Commissioner*, business trusts lost all income tax preferences and became subject to double-taxation as suffered by corporations. Income generated by the business trust was taxed at the trust level and again at the beneficiary level when distributed by the trust.

The Real Estate Investment Trust Act of 1960

The Court's decision in *Morrissey v. Commissioner* severely damaged the real estate business trusts, causing many to liquidate. Those trusts that remained organized a lobbying effort to appeal to Congress to pass legislation specifically granting real estate business trusts preferential tax treatment. In response to their efforts, Congress passed the first REIT bill in 1956. Then President Eisenhower vetoed the legislation giving as an explanation the following:

> While the bill assumes a similarity between real estate trusts and regulated investment companies, there are important differences between the two situations. The income of regulated investment companies is generally derived from the securities of corporations which are fully subject to the corporate income tax. In the case of regulated investment companies, therefore, the conduit treatment merely avoids an additional level of corporate taxation... By contrast, the conduit treatment proposed for real estate trusts would entirely remove the corporate income tax from much of the income originating in their real estate operations.
>
> It is by no means clear how far a new provision of this sort might be applied. Though intended to be applicable only to a small number of trusts, it could, and might well, become available to many real estate companies which were originally organized and have always carried on their activities as fully taxable corporations (Channing, 1958).

Following the 1956 defeat there were several additional attempts to secure passage of REIT legislation, all of which failed for various reasons. Finally, in 1960, Congress passed and President Eisenhower signed HR 10960, the Real Estate Investment Trust Act of 1960 granting tax conduit treatment to the formerly taxable realty trusts.

One of the main objectives of the initial legislation was to ensure that REITs remained passive investment vehicles so as not to compete unfairly with other businesses which do not enjoy preferential tax treatment. Preferential tax treatment was therefore granted only if REITs met the following requirements:

1. The organization constituted an arrangement for the pooling of investment evidenced by its organizational structure;

2. its assets consisted mainly of real estate or interests in real estate;

3. its income was clearly passive income, derived from holding real estate investments rather than from the operation of an active trade or business involving real estate;

4. substantially all of its income was passed through to its shareholders on a current basis (Rosenberg, 1986).

To ensure compliance with these requirements, REITs had to satisfy a series of tests on an annual basis to maintain their preferential tax status. First, REITs were required to be organized either as unincorporated business trusts or unincorporated associations. Second, REITs had to satisfy certain tests regarding the sources from which they derived their income. Third, REITs had to satisfy tests regarding the character of assets it owned. Finally, REITs had to satisfy certain tests as to the distribution of their taxable income. All four of these requirements are discussed in more detail in Appendix C.

Legislative Evolution

The first major legislative changes to the initial REIT legislation came in 1975 and addressed a growing problem faced by many mortgage REITs of the time, that of managing, operating, and disposing of real property acquired via foreclosure (Lynn and Bloomfield, 1995, p. 1-17). Under the then existing legislation, such activities by a REIT jeopardized its tax status and placed it in danger of losing preferential tax treatment for all of its income. In 1975 amendments to the initial legislation were enacted providing that income from property acquired by REITs via foreclosure would be taxed at regular corporate rates, but only to the extent that such income would not otherwise qualify for exemption. The amendments also specified a period of time during which the REIT was to dispose of the foreclosure property or restructure its interest so as to satisfy all of the REIT requirements with respect to the property (Halpern, 1978).

The Tax Reform Act of 1976

As second series of revisions were enacted in the following year as part of the Tax Reform Act of 1976 (TRA 1976). The revisions in TRA 1976 included the elimination of a total loss of REIT status for failure to satisfy income, asset and distribution requirements. Prior to TRA 1976, failure by a REIT to satisfy any of the income, asset or income distribution tests for a given taxable year resulted in a total loss of REIT tax status and subjected all of the REIT's taxable income to taxes at the regular corporate rates. The TRA 1976 amendments provided that should a REIT fail an income source test, only that income which did not satisfy the test would be subject to taxation. Additionally, a REIT failing to meet the income distribution requirement could correct such failure by making an additional, deficiency distribution in a subsequent tax year. As a tradeoff though, the income distribution requirement was increased from 90 percent to 95 percent. Finally, REITs that engaged in prohibited transactions causing them to fail asset tests would be subject to a 100 percent tax only on the net income from such transactions.

TRA 1976 clarified the REIT income and asset tests as well as instituted certain modifications to the tests making them more consistent with business realities. TRA 1976 established that rent from real property included amounts received for services provided to tenants that are considered normal and customary with the renting of space for occupancy. Additionally, TRA 1976 amended the treatment of net operating losses (NOLs) by allowing REITs to carry forward NOLs to reduce taxable income in years subsequent to the year in which the loss was incurred. Finally, TRA 1976 relaxed existing organizational requirements and allowed REITs to organize as corporations as opposed to only trusts or associations. This change eliminated concerns that REITs had with respect to state laws governing trusts or associations versus corporations (Halpern, 1978, p. 332-334).

The Revenue Act of 1978

Although TRA 1976 relaxed the penalty for engaging in a prohibited transaction from complete loss of REIT status, the new remedy of a 100 percent tax on any gain realized on such transaction made the cost of a potential erroneous decision by the REIT extremely high. The Revenue Act of 1978 established a series of requirements that if met would ensure that a particular asset sale would not be deemed a prohibited transaction and subject to the 100 percent tax penalty. These requirements were: the REIT must have held the property for at least four years; the REIT could not have made substantial improvements to the property during the previous four years; the REIT could not have sold more than five properties, other than property acquired in foreclosure, during the taxable year of the sale in question; and the subject property must have been held primarily for the production of rental income during the previous four years (IRC § 857 (b)(6)(C)). These provisions were implemented to afford greater guidance and certainty to REIT management in

engaging in transactions, while further ensuring that REITs would remain passive vehicles and not engage in active businesses such as traditional real estate development or brokerage.

The Tax Reform Act of 1986

The Tax Reform Act of 1986 (TRA 1986) indirectly and directly impacted the REIT industry in several ways. Indirectly, TRA 1986 eliminated the use of passive losses generated by highly leveraged real estate investments to offset other sources of income. This eliminated most of the tax benefits previously afforded limited partnership investments and thus caused such investments to fall out of favor. With the tax benefits eliminated, real estate investments were then evaluated more on true economic fundamentals, which favored REITs.

Directly, TRA 1986 amended many of the provisions of the existing REIT legislation making the statutes more consistent with the practices and realities of the real estate industry. These changes addressed: qualification problems REITs faced during their initial year of existence; prohibited transactions; the required use of independent contractors for certain services; rents and interest based on net profits; the use of operating subsidiaries; and the income distribution requirement. Regarding problems faced by REITs during their initial year of existence, because REITs may be initiated by either by raising large amounts of equity with which to acquire assets or by electing REIT status for an existing portfolio of assets, during their initial year of existence many REITs found it difficult to meet the income and asset tests and the 100-or-greater shareholder test. Additionally, many REITs found it difficult to satisfy the income and asset tests immediately after secondary debt or equity offerings. To address this problem TRA 1986 relieved new REITs from the 100-or-greater shareholder diversification requirement during their first REIT tax year (IRC § 856(h)(2)). Additionally, if a REIT raises new equity capital, or public debt capital with a term to maturity of at least five years, for the year following the receipt of the new funds, any income

generated by the such new capital is treated as qualifying income under the 75-percent income source test. For purposes of the 75-percent asset test any temporary assets in which the new funds are invested are treated as real estate assets for the year following the initial receipt of the funds (IRC § 856(c)).

With respect to prohibited transactions, TRA 1986 amended the safe-harbor rules to increase the level of improvements that could be made to a property during the four years prior to its sale from 20 percent of its adjusted basis to 30 percent. Additionally, the maximum number of sales in the year of the sale in question was increased from 5 to 7. This maximum could be exceeded to allow for an unlimited number of sales so long as the total adjusted basis of all properties sold did not exceed 10 percent of the REITs assets at the beginning of the year (IRC § 857(b)(6)(C)).

Prior to TRA 1986, REITs were not permitted to provide any services directly to their tenants but rather were required to employ independent contractors to deliver even the most basic of tenant services. Under TRA 1986 this rule was amended to allow REITs to provide directly those services that were customarily provided to tenants using space for occupancy only(IRC § 856(d)(2)). Special services provided at the request or for the benefit of a single tenant were still required to be provided through an independent contractor.

TRA 1986 amended the existing REIT requirements to allow REITs to operate through subsidiary entities, thus affording REITs the flexibility to limit exposure created by a single venture on their entire portfolio. The general rule that REITs may not own more than 10 percent of the voting stock of another entity that is not itself a qualified REIT remained unchanged. However, TRA 1986 introduced an exception that the previous restriction does not apply to the stock of a company that is 100 percent owned by the REIT during its entire period of existence (IRC § 856(i)).

Effectively, the REIT attributes of the parent are passed through to the 100 percent owned subsidiary.

TRA 1986 also amended the REIT income distribution requirements to provide REITs relief from the certain events resulting in the recognition of taxable income, without the actual contemporaneous receipt of cash. In such cases REITs risked being forced into a situation of having to borrow moneys to fund the required 95 percent distribution. Such events included taxable income recognized in the case of deferred rental agreements, interest income recognized on certain original issue discount loans extended by the REIT, and any income recognized from the disposition of real estate in a 1031 tax-free exchange which is subsequently determined not to qualify for 1031 status. TRA 1986 provided REITs relief from the 95 percent distribution requirement in the aforementioned cases by generally reducing the required distribution by the amount of taxable income for which no cash was received (IRC § 857(e)(1)).

TRA 1986 also amended certain provisions related to a REIT's investment in shared appreciation mortgages and a REIT's receipt of rental or interest income based on net profits. With respect to shared appreciation mortgages, TRA 1986 treats income received by a REIT under a shared appreciation provision as income from an asset sale by the REIT itself. The asset sale must therefore conform to all of the prohibited transaction requirements as if the REIT had held the asset itself. With respect to rent and interest income which is based on a tenant or borrower's net income, such income is considered qualifying income under the 75 percent test if the tenant or borrower receives substantially all of its income from leasing the property and such income would be qualifying income if received directly by the REIT.

The Revenue Reconciliation Act of 1993

The Revenue Reconciliation Act of 1993 (RRA 1993) contained several provisions significantly affecting real estate but one in particular for the REIT industry specifically, that being an amendment to the 5-or-fewer rule as applied to domestic pension funds. Prior to RRA 1993, a domestic pension fund investing in a REIT was treated as a single investor. Considering the typical size of most REITs at the time, and the typical minimum investment sizes for large pension funds, such treatment effectively restricted significant investments by pension funds in REITs. RRA 1993 created a "look-through" provision for domestic pension funds whereby for purposes of the 5-or-fewer rule, the beneficiaries of the pension fund were considered to be the investors rather than the pension fund itself (IRC § 856(h)(3)). This change effectively opened a potentially huge source of new investment capital for REITs.

RRA 1993, however, placed a restriction on this provision to prevent pension funds from utilizing REITs for the purposes of avoiding the recognition of unrelated business taxable income (UBTI). Under this reverse-look-through provision, income received by a pension fund from a REIT would be considered UBTI if 5 or fewer pension funds collectively owned more than 50 percent of the REIT's shares, or any one pension fund owned more than 25 percent of the REIT's shares (IRC § 856(h)(3)). In such cases, all income received by the pension fund from the REIT is potentially UBTI if the REIT has utilized debt in financing any of the properties in its portfolio. RRA 1993 did contain certain exceptions to this rule which require fairly specialized structuring of transactions. In general, however, pensions funds must be cautious of their individual as well as collective level of investment in individual REITs.

Appendix E: Hotel REITs & Taxable Hotel Corporations

Public Hotel REITs

Starwood Lodging (HOT) - Starwood Lodging is composed of two separate entities: Starwood Lodging Trust, a self-advised REIT formed in 1969 that owns an interest in 33 hotels with 6,814 rooms, and Starwood Lodging Corporation, a hotel management and operating company. The shares of the two companies are "paired" or "stapled" on a share-for-share basis and trade together as a unit. Starwood Lodging is the only REIT that enjoys a paired or stapled share structure.

RFS Hotel Investors, Inc. (RFSI) - RFS Hotel Investors is a self-advised REIT that owns 47 hotels comprising 6,491 rooms in 22 states. The company's portfolio includes 57 Hampton Inns, 10 Residence Inns, 7 Holiday Inn Expresses, 6 Comfort Inns, and 6 Holiday Inns.

Sunstone Hotel Investors (SSHI) - Sunstone Hotel Investors is a self-advised REIT that owns ten hotels comprising 1,328 rooms in five states. The Company's portfolio includes 5 Hampton Inns, 3 Holiday Inns, a Courtyard by Marriott and a Best Western.

Winston Hotels, Inc. (WINN) - Winston is an externally advised REIT that owns equity interests in 21 hotels containing approximately 2,705 rooms, including 21 Hampton Inns, 8 Comfort Inns and a Quality Suites. The properties are located primarily in Florida, Georgia, North Carolina, and South Carolina.

Patriot American Hospitality, Inc. (PAH) - Patriot American Hospitality, Inc. is a self-advised REIT that owns approximately 20 hotels containing 4,206 rooms. The Company's properties are concentrated in the full-service sector and include 6 Holiday Inns, 3 Radissons, 1 Marriott, 1 Sheraton, 1 Hilton, 4 Hampton Inns, an executive conference center, and 3 independent hotels. The Company is structured as a multi-tenant REIT with an independent lessee.

Equity Inns Inc. (ENNS) - Equity Inns is a self-advised REIT that owns approximately 34 hotels containing approximately 4,018 rooms. The hotels are operated under the Hampton Inn, Residence Inn, Holiday Inn, Holiday Inn Express, and Comfort Inn brands.

FelCor Suite Hotels, Inc. (FCH) - FelCor Suite Hotels is a self-advised REIT that owns approximately 13 hotels located in Arizona, Florida, Georgia, Louisiana, Massachusetts, Oklahoma, Tennessee, Illinois and Texas. All of the hotels are operated as Embassy Suites.

Hospitality Properties Trust (HPT) - Hospitality Properties Trust is a self-advised REIT that owns approximately 37 hotels, all of which are operated under the Courtyard by

Marriott brand name. The Company is structured as a multi-tenant REIT with an independent lessee.

Humphrey Hospitality Trust (HUMP) - Humphrey Hospitality Trust is a self-advised REIT that owns approximately 8 hotels located in Virginia, West Virginia, Maryland, and Tennessee. Seven of the properties are operated as Comfort Inns and one property is operated as a Best Western.

Innkeepers USA Trust (NKPR) - Innkeepers USA Trust is a self-advised REIT that owns approximately 18 hotels containing 2,072 rooms. The properties are located in nine states and are operated under the Residence Inn, Hampton Inn, Sheraton, Comfort Inn and Ramada Inn brands.

Jameson Inns (JAMS) - Jameson Inns is an Atlanta-based REIT that develops and owns colonial-styled, limited service motel properties in the southeastern United States. The company currently owns approximately 28 inns containing 1,338 rooms. The company has additional properties under development.

Taxable Hotel Public C-corporations

Prime Hospitality Corporation (PDQ) - Prime Hospitality Corporation is a hotel owner/operator with a portfolio of 95 hotels located primarily in secondary markets in 21 states and the US Virgin Islands. The hotels are operated either under franchise agreements with hotel brands such as Marriott, Radisson, Sheraton, Holiday Inn, Ramada Inn, and Howard Johnson or under the Company's brand names, Amerisuites and Wellesley Inns.

ShoLodge Inc. (LODG) - ShoLodge develops, owns, operates and franchises the 85-unit Shoney's lodging system located in 21 states. The Company owns or manages 35 of the 85 existing Shoney's Inns and Shoney's Inns & Suites, both of which are targeted at the business traveler.

Studio Plus Hotels, Inc. (SPHI) - Studio Plus Hotels, Inc. owns develops and managed StudioPLUS extended stay hotels. these hotels are designed to combine the flexibility of a hotel with many of the amenities found in apartments. The Company operates 26 StudioPLUS properties located in 15 southeastern and midwestern cities.

Extended Stay America, Inc. (STAY) - Extended Stay America, Inc. develops, owns and manages extended-stay lodging facilities. These hotels are designed around customers staying on a weekly basis such as business travelers, people relocating or on temporary assignment away from home.

Doubletree Corporation (TREE) - Doubletree Corporation is a hotel management company. The Company manages contracts for approximately 60 Doubletree full-service hotels, 38 Doubletree Guest Suites, 13 Doubletree Club Hotels and 61 other hotel properties. All Doubletree hotel properties are located throughout the United States.

Suburban Lodges of America, Inc. (SLAM) - Suburban Lodges of America, Inc. develops, owns, manages and franchises "Suburban Lodge" facilities, which are economy extended stay lodging facilities. The Company's guest rooms are similar to studio apartments and include weekly maid service. The Company currently owns and operates eight facilities and franchises six located in four southeastern states.

La Quinta Inns, Inc. (LQI) - La Quinta Inns, Inc. owns, operates and manages over 200 motels under the La Quinta name in 29 states. Operates are concentrated in Texas, California and Florida and are typically located on highways or major roadways. These hotels usually consist of approximately 130 rooms and are managed by a husband and wife team that live on the premises.

Bristol Hotel Company (BH) - Bristol Hotel company owns and operates approximately 38 hotels in the southern United States. The Company's properties are primarily full-

service hotels that operate as Bristol Suites, Harvey Hotel, Harvey Suites, Holiday Inn, Hampton Inn and Marriott.

John Q. Hammons Hotels, Inc. (JQH) - John Q. Hammons Hotels, Inc. along with its general partner, John Q. Hammons Hotels, L.P., owns and manages 31 hotels in 16 states. The Partnership also manages an additional six hotels in four other states. the hotels are all operated under the Embassy Suites and Holiday Inn brand names.

Amerihost Properties, Inc. (HOST) - Amerihost Properties, Inc. is a hotel operations and development company that builds, buys and manages mid-market hotels. The Company manages 58 hotels in 13 states and holds an equity position in 48 of the properties.

Host Marriott Corporation (HMT) - Host Marriott Corporation owns, operates and franchises hotels. The Company owns 45 Marriott hotels, 54 Courtyard hotels, 18 Residence Inns and 4 Fairfield Inns. Also, Host Marriott is a general partner with ownership in approximately 267 hotels. The Hotels are managed by Marriott International. The Company also operates concessions in 74 airports in the United States.

Promus Hotel Corporation (PRH) - Promus Hotel Corporation owns, operates and franchises approximately 650 hotel properties containing approximately 85,000 rooms. The Company is the franchisor and operator of the Embassy Suites, Hampton Inn, Hampton Inn & Suites and Homewood suites hotel brands.

Red Lion Hotels, Inc. (RL) - Red Lion Hotels, Inc. operates approximately 53 hotels containing approximately 14,000 rooms in the United States. The Company owns or leases approximately 38 of the 53 hotels it operates.

Servico Hotels & Resorts (SER) - Servico owns or manages 59 hotels with over 11,000 rooms in the United States. These hotels are affiliated with franchises such as Omni, Radisson, Holiday Inns, Howard Johnson, Days Inn, Comfort Inn, Quality Inn, Hilton, Best Western, Clarion, Crowne Plaza, Embassy Suites, Hampton Inn and Westin.

Renaissance Hotel Group N.V. (RHG) - Renaissance Hotel Group is one of the world's leading hotel management companies, offering lodging products under the Renaissance, New World and Ramada brand names in 35 countries on five continents. The Company currently manages approximately 107 hotels, containing 37,900 rooms, and has franchise agreements for an additional 30 hotels containing 6,900 rooms.

Wyndham Hotel Corporation (WYN) - Wyndham Hotel Corporation is a national hotel company operating upscale hotels primarily under the Wyndham brand name. The company operates approximately 65 hotels located in 22 states and four Caribbean Islands. The hotels are operated under the Wyndham Hotels, Wyndham Garden Hotels, and Wyndham Resorts brand names.

Red Roof Inns (RRI) - Red Roof Inns, Inc. is an economy lodging chain. The Company owns and operates 235 properties in 33 states primarily located in the Midwest, East, South and Gulf Coast regions.

Works Cited

Anonymous, 1990. "Investment Session Experts Paint a Bleak Picture." April 9, 1990. Hotel & Motel Management, pp2.

Berg, P. and R. French. 1995. "CapEx in the '90s". Lodging, April 1995, pp.103-106.

Burgess, Robert, "RFSI Hotel Hires Morgan Keegan to Help Finance Growth Plans," *Bloomberg Business News*, November 22, 1994.

Burritt, M.C. 1994. "Structuring a lodging REIT". Kenneth Leventhal & Company, Resort Forum IV Report. pp 3.

Channing, "Federal Taxation of Real Estate Investment Companies", *Taxes* 36 (1958)

Clifton, R. Brent, "Checking into Hotel REITs", *REIT Review,* Winter 94-95, pp 1-6.

Commerce Clearing House. 1996. Capital Changes Reporter. Commerce Clearing House, Chicago, Illinois. 1996 serial edition. 7 volumes; see "hotel ...".

Coopers & Lybrand, 1995. "Capital Investment in the Lodging Industry Climbs in 1994". Hospitality Directions. pp. 25-26.

DiPasquale, D. and W. C. Wheaton. 1995. The Economics of Real Estate Markets. Prentice Hall, Englewood Cliffs, New Jersey, 378 p.

Dittmer, P.R. and G.C. Griffin. 1993. The Dimensions of Hospitality. Van Nostrand Reinhold, 550 p.

DLJ, 1996. "Presentation to N.Y. U. Hospitality Industry Investment Conference, June 3, 1996". Donaldson, Lufkin & Jenrette. 61490010.DOC (DLJNY01), 14p.

Ford, P. H. 1996a. "Who has money?". Lodging Hospitality, May 1996. pp. 30-32.

Ford, P. H. 1996b. "Real Estate In Transition", Lodging, May 1996 pp. 53-60.

George, Christopher C., "Hotel REITs: There's Still Time to Check In," *Bear Stearns Equity Research*, December 1995.

Giliberto, S.Michael., and Sidoroff, Fredrika N.., "Real Estate Stock Indexes", *Real Estate Finance*, Winter 1996, pp 56-62.

Gorham, John, "Doubletree Completes Purchase of RFS, Inc. for $74.9 Million," *Bloomberg Business News,* February 28, 1996.

Gottschalk, E. C. "Partnerships in Hotels Lure Many Investors", Wall Street Journal, August 3, 1987 p.19.

Halpern, "Real Estate Investment Trusts and the Tax Reform Act of 1976," *Tax Law* 31 (1978): pp. 329-331.

Homer, S. and R. Sylla . 1991. A History of Interest Rates. Rutger University Press; 662p.

Hsieh, J. 1996. "Lodging Stocks: Trends and Investors". presentation at the Eleventh Annual Hotel Industry Investment Conference; January 26-28, 1996, Los Angeles, California. F18G\109009\1-23-96\2:36P; 12p.

Jarchow, S.P. 1988. Real Estate Syndication. John Wiley & Sons, New York. 995 p.

Kaplan, L. and Stern, C. 1994. "REITs and UPREITs: Characteristics, Requirements, and Taxation.", *The Real Estate Tax Digest*, 1994.

Lapin, J., Chief Executive Officer, Hotel Investors Trust, Los Angeles, California.

Lehman Brothers, 1996. 1996 - Annual Review and Outlook for REITs. Lehman Brothers, Inc. New York, NY. 183 p.

Lloyd-Jones, A. and Rushmore, S. 1996. "Recent Trends in Hotel Management Contracts", Real Estate Finance Journal, Summer 1996.

Lynn, T. A. and Bloomfield, M., 1995. *Real Estate Investment Trusts,* Warren;, Gorham & Lamont, publishers.

Mahone, N. 7/17/96. Robert A. Stanger Company, Shrewsbury, New Jersey; personal communication.

NAREIT, 1995a. "NAREIT White Paper on Funds From Operations"; March 1995. National Association of Real Estate Investment Trusts (NAREIT); Washington, D.C.

NAREIT, 1995b. REIT Handbook, 1995. National Association of Real Estate Investment Trusts (NAREIT); Washington, D.C. 970p.

NAREIT, 1977. "REIT Factbook, 1977". National Association of Real Estate Investment Trusts (NAREIT); Washington, DC. 83p.

New York Times, November 25, 1960, p. 46, col 1.

Pacelle, M. 1996. "Heard on the Street: Red Roof Inns Initial Public Offering May Set Stage For the Sale of Stake by Morgan Stanley Fund". Wall Street Journal, January 24, 1996. pp. C2.

Pacelle, M. 1993. "Distressed Real Estate Lures Wall Street Powerhouses". Wall Street Journal. May 24, 1993. pp. C1.

PaineWebber Incorporated, Patriot American Hospitality, Inc. Initial Public Offering Prospectus, September 27, 1995.

Rohs, J. J. and Pinsk, S. M., 1995. "Morning Meeting Highlights: Doubletree", Schroder Wertheim & Company, Inc., December 20, 1995.

Rosenberg, 1986. "REITs Emerge as Sources of Real Estate Finance and Investment," *Real Estate Review* 16 (1986): pp. 41-43.

Rossof, L. D. 1995. "The U.S. Lodging Industry: an econometric analysis". unpublished Master's Thesis. Center for Real Estate, Massachusetts Institute of Technology. 99 p.

Rushmore, S. 1992. Hotel Investments. Warren, Gorham, Lamont; 21 chapters, appendices.

Sandler L. and M. Pacelle. 1996. "Heard on the Street: Hotels thrive as rooms fill and rates rise, but pricey shares are keeping investors home". Wall Street Journal. June 17, 1996.

Sasser, W.E. and R. L. Banks. 1976. "Lender Attitudes Toward Hotel Financing". Cornell HRA Quarterly, Vol.16 No. 4. February 1976. pp 29-43.

Standard & Poor's 1996a. "Security Price Index Record". Standard & Poor's Statistical Service, 1996 edition. Standard & Poors, New York. 339 p.

Starwood Lodging Trust and Starwood Lodging Corporation, December 31, 1995 10-K Filing.

Webster, D. and B. Garrison. 1995. "Patriot American Hospitality". unpublished lodging industry manuscript. October 23, 1995. Paine Webber Inc, New York.