

## **REFRESH OR REBRAND? HERSHA HOSPITALITY TRUST'S CADILLAC HOTEL DECISION**

**Victoria Geyfman**  
**Christian Grandzol**  
**Bloomsburg University**

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*Hersha Hospitality Trust was a self-advised real estate investment trust (REIT) in the hospitality sector that owned a portfolio of upscale hotels in a variety of markets. After acquiring the Courtyard Marriott Cadillac Hotel in Miami for \$97 million in 2011 and investing \$25 million more to build an additional tower, Hersha learned in 2017 that it faced a third major investment of \$10 million to bring the hotel into brand compliance. Given the prospects of this pricey “refresh,” Hersha decided it should consider Cadillac Hotel’s positioning to determine if the company should “rebrand” the 1940s hotel into a more upscale experience—a much more expensive proposition that would cost \$45 million. George Malinsky, the Chief Accounting Officer, needs to prepare financial projections for income generation, property value, and capital budgeting to help craft the executive team’s recommendation for an upcoming board meeting.*

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### **INTRODUCTION**

In 2011, Hersha Hospitality Trust (NYSE: HT) acquired the Courtyard Marriott Cadillac Hotel in Miami, Florida for \$97 million. Located on a highly-desirable beachfront parcel, Hersha believed the investment contained significant opportunities for potential value enhancements, such as additional buildable space and a market that might support a more expensive brand. Following the purchase, Hersha invested \$25 million more on the property to build a 10-story oceanfront tower to increase the number of rooms while continuing to operate the hotel under the Courtyard Marriott banner. George Malinsky, Hersha’s Chief Accounting Officer, recounted how successful the new tower had been, but on this hot August day in 2017, there was a new investment decision to make regarding Cadillac. Marriott informed Hersha it would have to complete a “refresh” of Cadillac’s furniture, fixtures, and signage to bring the hotel up to brand standards—an expensive undertaking of approximately \$10 million.

Malinsky and other executives thought this might be the ideal time to consider more earnestly another option they had been mulling since purchasing the hotel: a comprehensive “rebrand” featuring a re-conception of the historic 1940s Cadillac.

As Malinsky noted, “Miami Beach is becoming less of a mid-scale and more of an upscale market—the time might be right to reposition the hotel.” Malinsky’s team constructed the financial projections for the two alternatives and as expected, the rebrand was a heftier capital investment of \$45 million. Malinsky wondered if the income and property value enhancements generated by a rebrand were sufficient to convince Hersha’s board to make yet another substantial investment in Cadillac Hotel.

### **HERSHA HOSPITALITY TRUST**

Hersha was a self-advised real estate investment trust (REIT) in the hospitality sector. A REIT was a corporation that purchased, developed, and financed real estate in sectors including commercial, residential, and industrial (IBISWorld, 2019). Originally, REITs were created as a mutual fund of sorts to give small investors an opportunity to invest in commercial real estate. As organizations that principally invested in real estate and mortgages, REITs qualified for special federal tax treatment if they satisfied specific requirements including “pure play” (75% or more of assets and income arising from real estate), dividend payouts of at least 90%, and an ownership test where no fewer than five individuals could own more than 50% of a REIT’s stock. There were a variety of REIT types, such as mortgage REITs that lent money directly through loans or acquired mortgage-backed securities; equity REITs that owned income-producing real estate; and hybrid REITs that invested in a combination of mortgages and real estate. Please refer to Appendix A for a more detailed description of REITs.

Hersha was founded by Hasu P. Shah when he led the purchase of a hotel in Harrisburg, Pennsylvania in 1984. The Company went public as a REIT in 1998 with Jay H. Shah beginning as CEO in 2006. Hersha owned upscale hotels in urban gateway markets and coastal destinations. As an equity REIT, its performance was based on the perceived future value of the real estate it held and the risk contained in its portfolio. For example, risks were higher if a REIT’s properties were heavily concentrated in areas prone to severe weather events. By August 2017, Hersha’s portfolio consisted of almost 50 hotels in markets such as New York, Boston, Philadelphia, San Diego, and Miami. The company franchised its hotels under leading brands including Marriott International, Hilton Hotels, and Hyatt (Hersha 10-K, 2016). To meet REIT qualifications, Hersha leased hotel operations to subsidiaries or other organizations, including Hersha Hospitality Management, L.P.—a wholly-owned taxable REIT subsidiary (Table 1).

**TABLE 1**  
**Property Management**

	Wholly Owned		Joint Venture		Total	
	Hotels	Rooms	Hotels	Rooms	Hotels	Rooms
	Hersha Hospitality Management, L.P.	39	6,155	7	1,087	46
South Bay Boston Management, Inc.	-	-	2	282	2	282
Marriott Management	2	201	-	-	2	201
<b>Total</b>	<b>41</b>	<b>6,356</b>	<b>9</b>	<b>1,369</b>	<b>50</b>	<b>7,725</b>

Source: Hersha 10-K report (2016).

Hersha's financial statements for the period of 2012 through 2016 can be found in Appendix B. Table 2 presents selected financial data. Overall, Malinsky noted total revenues grew between 2012 and 2015 but then dropped slightly in 2016 due to selling seven hotels from the company's portfolio. Net income increased substantially in 2016, the result of the net gain realized in joint venture transactions and the sales of the hotels.

**TABLE 2**  
**Selected Financials**

(In thousands)	2016	2015	2014	2013	2012
<b>Revenue:</b>					
Hotel Operating Revenues	466,370	470,272	417,226	338,064	299,005
Other Revenues	259	113	180	349	2,210
<b>Total Revenue</b>	<b>466,629</b>	<b>470,385</b>	<b>417,406</b>	<b>338,413</b>	<b>301,215</b>
<b>Operating Expenses:</b>					
Hotel Operating Expenses	262,956	254,313	227,324	188,431	161,982
General & Admin and Other Exp	138,151	133,679	122,173	105,292	92,975
<b>Total Operating Expenses</b>	<b>401,107</b>	<b>387,992</b>	<b>349,497</b>	<b>293,723</b>	<b>254,957</b>
<b>Operating Income</b>	<b>65,522</b>	<b>82,393</b>	<b>67,909</b>	<b>44,690</b>	<b>46,258</b>
Interest Income	362	193	805	1,784	1,311
Interest Expense	44,352	43,557	43,357	40,935	38,070
Other Expenses and Losses	18,979	928	1,155	647	3,232
Gain on Hotel Properties and Acquisitions	115,839	0	19,862	12096	0
<b>Income from Unconsolidated Joint Ventures and Discontinued Operations</b>	<b>118,392</b>	<b>38,101</b>	<b>66,558</b>	<b>16,988</b>	<b>6,267</b>
(Loss) Income from Unconsolidated Joint Ventures	(1,823)	965	693	(1835)	(2124)
Income Before Income Taxes	116,569	39,066	67,251	15,153	4,143
Income Tax Benefit	4,888	3,141	2,685	5,600	3,355
<b>Income from Continuing Operations</b>	<b>121,457</b>	<b>42,207</b>	<b>69,936</b>	<b>20,753</b>	<b>7,498</b>
(Loss) Income from Discontinued Operations	-	-	(1,665)	29,195	14,720
<b>Net Income</b>	<b>121,457</b>	<b>42,207</b>	<b>68,271</b>	<b>49,948</b>	<b>22,218</b>

Source: Hersha 10-K report (2016).

Occupancy Rate, Average Daily Rate (ADR), and Revenue per Available Room (RevPAR) were vital metrics for hotel investors. REITs looked for hotels that had a strong combination of these metrics; the best performance came from hotels that were properly positioned for the market. For example, higher-end hotels could charge higher ADR, but might have low occupancy rates if a higher-end hotel was not appropriate for the market. Table 3 depicts Hersha’s performance on these metrics from 2014 to 2016. Although the pace of growth slowed in 2016 due to a softer demand in several markets (Hersha 10-K, 2016), Hersha’s metrics were comparable to that of other hotels in their market areas. Malkinsky knew these metrics would drive the rebrand vs. refresh projections at Cadillac Hotel, so a more complete evaluation is provided later.

**TABLE 3**  
**Occupancy Rate, ADR, and RevPAR**

	<i>(41 hotels in both years)</i>			<i>(46 hotels in both years)</i>		
	<b>Year Ended 2016</b>	<b>Year Ended 2015</b>	<b>2016 vs. 2015 % Variance</b>	<b>Year Ended 2015</b>	<b>Year Ended 2014</b>	<b>2015 vs. 2014 % Variance</b>
Occupancy Rate	82.8%	82.8%	0.0%	83.7%	82.6%	1.1%
ADR	\$ 206.96	\$ 202.62	2.1%	\$ 195.55	\$ 187.21	4.5%
RevPAR	\$ 171.27	\$ 167.68	2.1%	\$ 163.65	\$ 154.71	5.8%

Source: Hersha 10-K report (2016).

Malinsky emphasized the decision on Cadillac Hotel had to synchronize with Hersha’s overall strategy to attract investors by seeking active acquisition opportunities or divesting properties at favorable prices and redeploying capital for more advantageous opportunities (Hersha 10-K, 2016). Table 4 shows that Hersha’s historic market performance lagged the S&P 500 Index, the Russell 2000, and perhaps most importantly, the SNL Hotel REIT Index (2011 serves as a base share price of \$100 for all benchmarks).

**TABLE 4**  
**Market Performance**

	<b>2011</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
Hersha Hospitality Trust	100.00	107.32	124.71	163.90	132.86	137.42
S&P 500	100.00	116.00	153.57	174.60	177.01	198.18
Russell 2000	100.00	116.35	161.52	169.42	161.94	196.45
SNL Hotel REIT Index	100.00	112.80	142.50	188.09	145.50	180.34

Source: Hersha 10-K report (2016).

**REIT OPPORTUNITIES AND CHALLENGES**

Nationally, REITs provided investors regular income streams, diversification, and long-term capital appreciation. Table 5 displays the number of REITs by type and total market value between 2005 and 2017. As seen, there were 197 REITs with the market capitalization of roughly \$331 billion in 2005. By 2017, there were 222 REITs with the market capitalization of \$1.1 trillion. REITs experienced major losses during the 2008-2009 financial crisis as real estate prices plunged and mortgages experienced late payments and defaults. More recently, the industry rebounded with outstanding growth especially among equity REITs. Primary reasons for this turnaround included low interest rates, rising property values, and higher institutional investor demand.

**TABLE 5**  
**Historical Market Capitalization and Number of REITs**

YEAR	ALL REITs		EQUITY		MORTGAGE		HYBRID	
	#	MARKET VALUE (\$mil)	#	MARKET VALUE (\$mil)	#	MARKET VALUE (\$mil)	#	MARKET VALUE (\$mil)
2005	197	330,691.30	152	301,491.00	37	23,393.70	8	5,806.60
2006	183	438,071.10	138	400,741.40	38	29,195.30	7	8,134.30
2007	152	312,009.00	118	288,694.60	29	19,054.10	5	4,260.30
2008	136	191,651.00	113	176,237.70	20	14,280.50	3	1,132.90
2009	142	271,199.20	115	248,355.20	23	22,103.20	4	740.8
2010	153	389,295.40	126	358,908.20	27	30,387.20	--	--
2011	160	450,500.60	130	407,528.90	30	42,971.70	--	--
2012	172	603,415.30	139	544,414.90	33	59,000.30	--	--
2013	202	670,334.10	161	608,276.60	41	62,057.40	--	--
2014	216	907,425.50	177	846,410.30	39	61,017.20	--	--
2015	233	938,852.00	182	886,487.50	41	52,364.60	--	--
2016	224	1,018,729.90	184	960,192.80	40	58,537.10	--	--
2017	222	1,133,697.60	181	1,065,947.70	41	67,749.90	--	--

Source: NAREIT (2018). Hybrid REITs series was discontinued in 2010.

Malinsky read an industry report, which projected that REITs would achieve an annualized revenue growth rate of about 2.8% through 2024. (IBISWorld, 2019), but this growth would be closely tied to uncertain macroeconomic factors, including federal funds rates, investor sentiment, office vacancy rates, consumer disposable income, stock market performance, and consumer confidence. Additionally, Malinsky’s research indicated the industry was mature with increasing consolidation activity. Hersha was heavily invested in U.S. hotels—a particularly competitive sector where hotels competed ruthlessly for guests on the basis of location, quality of accommodations, convenience, brand affiliation, room

rates, amenities, and level of customer service. New hotels and hotels changing brand positioning were omnipresent threats, especially in “hot” hospitality markets. A relatively new phenomenon, online room sharing services, dramatically amplified the competition for guests (Hersha 10K, 2016). Amidst this backdrop, Malinsky and Hersha executives knew the stakes for the Cadillac Hotel rebrand or refresh decision were very high.

### **CADILLAC HOTEL**

Cadillac Hotel was designed in distinctive Art Deco style by the prominent architect Roy France during a time before Cadillac, the automobile company, owned the exclusive use of the brand. The hotel opened in 1940 with car-like elements infused throughout the property, such as a cantilevered porte cochere, cursive italics signage, a vertical band finial on the exterior’s top, and the Cadillac Coat of Arms in the terraza flooring. The timing of the hotel’s opening coincided with a rise in the post-Great Depression American middle class along with growing popularity of the alluring, yet affordable, Miami Beach as a vacation destination. Two years after opening, Cadillac was used as a processing center for World War II veterans returning from theatre. In 1945 Cadillac returned to hotel operations, reaching its pinnacle during the tourism boom of the 1950s-1960s when distinctive Art Deco hotels captivated travelers—the hotel was even the site for a Frank Sinatra film (Dolven, 2018)!

Cadillac Hotel fell on hard times in the late 1990s amid plummeting Miami Beach tourism. The hotel closed for several years prior to being reopened as Courtyard Miami Beach Oceanfront and earning a spot on the National Registry of Historic Places in 2005. Jay Shah, Hersha’s CEO, saw the property as a potential investment opportunity due to favorable dynamics in mid-Beach Miami including revenue growth, minimal new rooms supply, food and beverage service on the beach, and the prospects for a property comprised of a full city block with a developable parcel in an envious location. He exclaimed, “We fell in love with the heritage and history of Cadillac. We knew the hotel was a gem just waiting to shine again” (Dolven, 2018). Shah believed Cadillac was a “truly unique historic hotel occupying an entire block of oceanfront property. It has the potential to become one of the premier hotel destinations in Miami” (Parikh, 2011).

After purchasing the hotel in November 2011 for \$97 million, Hersha wasted little time adding a new 10-story tower with meeting rooms and underground parking for an additional \$25 million on the developable parcel. The new tower’s design preserved the heritage of the property and brought the total number of rooms to 356 when it opened in 2014, with 263 in the original Cadillac Tower and 93 in the new Ocean Tower. Malinsky informed, “The mid-term plan was to drive more earnings from the same real estate. We did this by adding rooms and by maximizing the

number of ocean-view rooms. We built the tower in a herringbone fashion so every room has an ocean view, which commands a premium rate. We also built the Ocean Tower to meet more demanding specifications and added a second pool with cabanas, giving us the ability to achieve stronger revenue should the hotel upgrade its brand positioning later.” Inclusive of the acquisition and the expansion, total costs were about \$319,000 for each room (“per key” is the industry jargon) with revenue streams originating from room reservations, parking, a Starbucks, meeting facilities, onsite spa services, beach rentals, room service, a Tiki Beach Bar, and a casual dining restaurant leased to Carrabba’s Italian Grill (Parikh, 2011).

### **REFRESH OR REBRAND**

A hotel’s overall revenue potential was maximized if its position was appropriate for the facility and local environment, was appealing to the target market, and was different from the competition (Deuter, 2014). Cadillac operated as a Courtyard under the Marriott banner—operating as a franchised brand allowed the hotel to tap into the brand’s vast sales, marketing, and distribution power. For example, about 60% of Cadillac’s revenue was from guests who chose the hotel because it was Marriott affiliated. In exchange, Hersha paid Marriott a franchise fee of 6% of revenue. Shah shared, “The property performed well as a Courtyard with good cash flows, but this was a forever piece of real estate and a distinctive historic building. Over the long run maybe we would reposition as a higher-end, close to luxury, kind of hotel experience” (Nessler, 2018). A repositioned hotel would also better match the Cadillac name given its association with luxury.

Evaluating the potential rebranding started in earnest in 2015 when Hersha learned it faced a \$10 million brand-required refresh for the 263 rooms in the original Cadillac Tower, an investment of approximately \$38,000 per key. This refresh was mandated by Marriott as part of its brand lifecycle assessment for Cadillac to continue as an upscale, limited-service “select” hotel. Brand refreshes defined by “Property Improvement Plans” or PIPs were commonplace for branded hotels and included a variety of initiatives such as design changes, room renovations, fixture replacement, signage updating, and mechanical systems revisions (Lodging Staff, 2014; Magnuson, 2016). In addition to the direct costs for these changes, Cadillac faced disruption to guests during renovation. It could remain open, but occupancy would drop from 80% to 70%.

Alternatively, if Hersha repositioned Cadillac it might maximize the hotel’s true revenue potential, but a rebrand PIP would cost \$45 million. The location, iconic architecture, and history of Cadillac would likely help qualify it as an upscale, full-service hotel in the Marriott Autograph Collection. Malinsky shared that Autograph Collection was a form of soft branding: “Brands have become less important as consumer demographics have changed. Collections allows you to have an almost-independent hotel where you get to choose the style and level of service so guests

receive a unique experience but within the Marriott system so they get access to things like the rewards program.” The overall concept for Cadillac was to reimagine it as a modern resort with inspiration from the 1940s European Riviera while preserving the Art Deco aesthetic. This vision targeted higher-end guests visiting mid-Beach, the most sophisticated area of Miami Beach, and aligned with key brand pillars imagined for Cadillac: Miami is your oyster, act like you own the place, and unwind in style. Ultimately, a rebranded Cadillac would offer a “curated Miami experience” (Dolven, 2018).

To achieve this vision, a branding agency would be hired to develop the hotel concept inclusive of interior design and furniture, fixtures, and equipment (FF&E). It would re-concept the hotel lobby and the hard goods (furniture, installations, etc.) and soft goods (drapes, bedspreads, etc.) in the Cadillac Tower’s rooms, corridors, and all public spaces. Hersha’s outlay in the Ocean Tower would be relatively smaller because the tower had been built to higher standards; it would only require new soft goods. In addition to these costs, Hersha would buy out the Carrabba’s Italian Grill lease because casual dining did not align with Autograph Collection’s customer base. Instead, Hersha would develop an upscale food and beverage concept for all outlets. Malinsky informed there would also be a human resources aspect because “hiring and training for execution of a luxury product and service are considerable.” The disruption to guests would be much larger for a rebrand; the hotel would continue operations but likely at only 50% occupancy during renovations.

The benefits of rebranding would materialize from revenue stream enhancements. First, based on a relevant comparison set, Hersha projected ADR would increase by approximately 25%. Second, as a luxury resort the hotel could charge a resort fee. Third, there were opportunities to grow food and beverage revenues and make the restaurant and outdoor bars fixtures for locals as well as travelers. Malinsky informed, “Our restaurant was mid-scale, but the market improved while the long-term lease was fixed. The potential earnings from food and beverage are considerable.” Finally, there would be other incremental income enhancements, such as rental income from corporate meetings and social events.

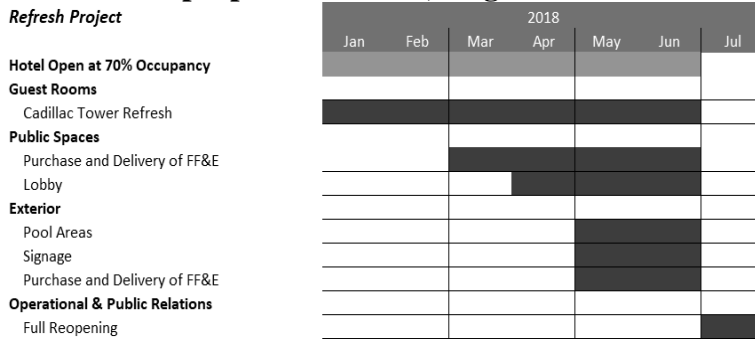
Hersha also had to consider how rebranding of Cadillac Hotel in an Autograph Collection would affect other hotels in its portfolio because the firm already owned two other Autograph Collection hotels within three miles of Cadillac. Hersha believed the properties were located in different submarkets, lowering the risk an Autograph Collection Cadillac would cannibalize its other two properties. Hersha predicted a positive overall outlook for the Miami market. Shah noted, “We think of Miami across a 10- to 15-year horizon as one of the highest growth lodging



markets in the world. The dynamics and fundamentals of this marketplace are really strong for the next decade” (Nessler, 2018).

Project plans for the refresh and the rebrand differed not only in cost, but also in timing. Figure 1 and Figure 2 depict the construction plans for the refresh and the rebrand PIPs. Project visualization, architectural plans, permitting, and brand development would be completed prior to construction. Some material purchases would also occur prior to the plan and would be staged in a local warehouse.

**FIGURE 1**  
**Refresh PIP proposed timeline, August 2017.**



**FIGURE 2**  
**Rebrand PIP proposed timeline, August 2017.**

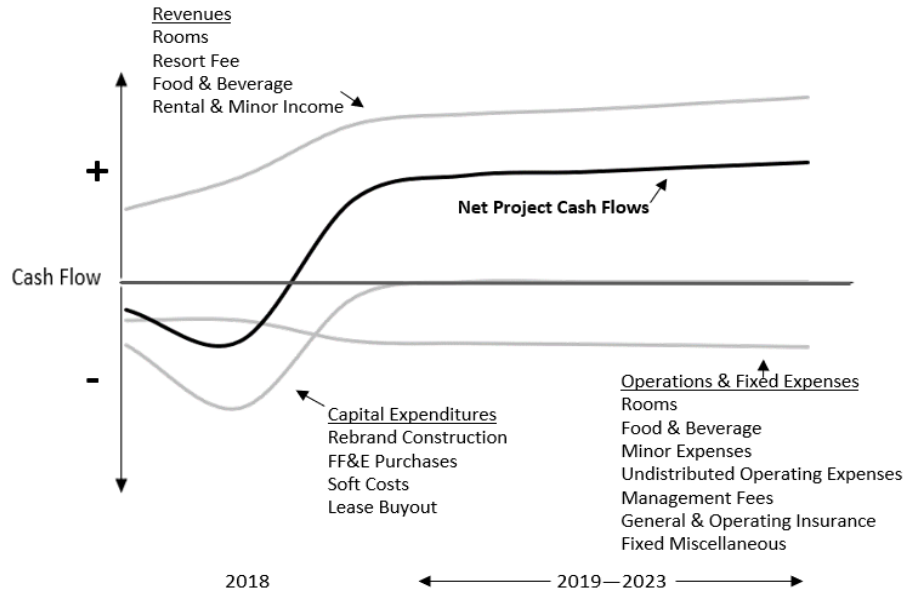


**EARNINGS AND PROPERTY VALUE PROJECTIONS**

Malinsky reported that while Hersha’s vision to rebrand the hotel gained significant support among the leadership team, the company’s board would only approve the rebrand if it were financially prudent. He said, “we prepare pro forma cash flows

and present these opportunities to our board with the incremental investment and the operating results to value the hotel. The board decides whether the investment gets the go ahead.” Multiple factors affected the projects’ revenue potential, operating and fixed costs, and capital investments. Figure 3 depicts these factors for the rebrand PIP and provides relevant project cash flows.

**FIGURE 3**  
**Rebrand PIP Visualization.**



Source: adapted from Westney (2011)

The board primarily used two perspectives to value projects: ability to generate income and property value. For income, Hersha projected Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA) during project activity (2018) and for five full years after project’s completion through the end of 2023. Considering the refresh as mandatory, Malinsky’s team used the Courtyard refresh project as a baseline; it constructed an incremental EBITDA analysis to compare the Autograph Collection rebrand versus this baseline. Malinsky shared that, rather than a typical Net Present Value (NPV) analysis, Hersha’s board preferred to use metrics typical for commercial real estate investments: Cash-on-Cash Return of incremental EBITDA (calculated as a year’s incremental EBITDA divided by the incremental capital investment) and Internal Rate of Return (IRR). These metrics measured the rebrand investment’s ability to generate income over the refresh baseline.

For the board’s second perspective, property value, Malinsky’s team projected two metrics. First, was Residual Value, the predicted value of the property in 2023 as both an Autograph Collection and a Courtyard. It then calculated the incremental Residual Value and compared it to the incremental investment. Second, the team analyzed the total invested into the hotel on a per-key basis with sales price per-key of comparable hotels. This analysis added nuance to property value relative to total investment.

**REVENUE**

Malinsky’s team analyzed each of the factors contained in Figure 3 to construct pro forma financial projections. Figure 4 displays the format used for these projections, which was completed first for the refresh PIP (remain as Courtyard) PIP and then completed for the rebrand PIP (convert to Autograph Collection).

**FIGURE 4**  
**Example Pro Forma Format.**

	2018	2019	2020	2021	2022	2023
<b>Revenue</b>						
Room						
Resort Fee						
Food & Beverage						
Rental & Minor						
<i>Gross Revenue</i>						
<b>Expenses</b>						
Rooms						
Food & Beverage						
Minor Expenses						
Undistributed						
<i>Total Expenses</i>						
<b>Gross Operating Profit</b>						
<b>Fixed Expenses</b>						
Management Fee						
General & Ops Insurance						
Fixed Miscellaneous						
<i>Total Fixed Expenses</i>						
<b>EBITDA</b>						

The team began by projecting room revenue using ADR. For the refresh, ADR would be \$200 in 2018 and 2019. If rebranded, ADR would increase to \$255 in 2019. ADR was not sufficient to project revenue because rooms were not always occupied. Thus, the team multiplied ADR by occupancy rate (percent of rooms typically occupied each night) to calculate Revenue per Available Room or RevPAR. Post modifications, refresh occupancy rate was expected to be 80%; post renovations, rebrand occupancy rate was expected to be 75% because competition for the target market was more aggressive. RevPAR was then multiplied by available rooms (356) and available nights (365) to generate annual room revenue. Forecasts indicated a strengthening market over time that would reflect in a

combination of higher ADR or occupancy rate. Malinsky's team used this market insight to project 2.5% annual RevPAR increases for the refresh and 3% annual RevPAR increases for the rebrand, both starting in 2020, so Autograph RevPAR in 2023 would be almost \$39 higher than the Courtyard's 2023 RevPAR of \$176.61. Malinsky's team kept in mind that 2018's room revenue would be more complicated to calculate due to the disruption brought by renovations. The team used the occupancy rates and number of months contained in Figure 1 and Figure 2 when calculating 2018 room revenue.

For the second revenue source, Malinsky shared that no resort fees were charged as a Courtyard, but as an Autograph Collection Hotel, Cadillac could charge a resort fee. Resort fees generated additional revenues above room rates and were used to cover a range of resort amenities. Hersha expected to add a \$30 per occupied room, per night resort fee if it rebranded starting in 2019, but some guests would not pay the resort fee due to negotiating the fee off their bill or the fee not being collected through a third-party reservation service. Malinsky expected a capture rate (a percent of guests paying resort fee) of 70% and projected the fee would stay fixed at \$30 through 2023. The team projected resort fees would contribute slightly more than \$2 million a year.

The next revenue item was food and beverage, a revenue stream Hersha saw as a significant contributor to earnings if the property were rebranded, but the revenue would be classified differently. As a Courtyard, Cadillac generated food and beverage income through the lobby bar, room service, and banquets/catering. This total income was projected to be \$1.3 million in 2018 with an annual growth rate of 2%. It also received fixed lease income from Carrabba's for the restaurant, income classified as rental and minor income. If the property were rebranded, Malinsky shared "we want to focus on rooms only so we would find a third party to manage all of the food operations." Thus, food and beverage income would be \$0 starting in 2019 for an Autograph Collections hotel—the entire stream would be captured in the next revenue item, rental and minor income.

As a Courtyard, Cadillac expected to generate income of \$1.5 million in 2018 from conference room and equipment rentals, a parking lot lease, the Carrabba's lease, and a car rental lease. This revenue stream was projected to grow at a 2% annual rate. As an Autograph Collections hotel, Cadillac could generate substantially more revenue in this category because it would be more attractive for business conferences and its rentals would be more desirable. Most influentially, it would negotiate a new lease agreement to fully manage food and beverage operations. Other Hersha properties used leases featuring 5-year terms with fixed and variable components. Conservative projections for all food and beverage on the property (restaurants, lobby bar, room service, and banquets/catering), based on comparable

hotels’ food and beverage revenue per key, were for total income of nearly \$10 million. This food and beverage revenue would generate a much more profitable lease than the existing fixed-rate Carrabba’s lease. Malinsky’s team expected rental and minor income, inclusive of a new food and beverage lease, to be \$3.9 million beginning in 2019, with a 3% annual growth rate through 2023.

**OPERATING AND FIXED EXPENSES**

Estimating operating and fixed expenses was relatively straightforward given Hersha’s extensive experience operating similarly-situated hotels. Malinsky’s team identified stable patterns for expense categories expressed as a percentage of gross revenue (see Table 6). Short descriptions for each expense category are provided below.

**TABLE 6**  
**Operating and Fixed Expenses as a Percentage of Gross Revenue**

<u>Expense Category</u>		<u>% of Revenue as Courtyard</u>	<u>% of Revenue as</u> <u>Autograph</u>
<i>Operations</i>	Rooms	20%	20%
	Food & Beverage	4.5%	0%
	Minor	4.2%	4.2%
	Undistributed	25%	25%
<i>Fixed</i>	Management Fee	3%	3%
	Insurance	1.1%	1.1%
	Fixed Miscellaneous	5.1%	3.9%

Rooms expenses consisted of all costs incurred to service rooms and guests. Food and beverage included expenses related to providing room service, lobby bar, and banquets/catering. Minor expenses included costs associated with parking, laundry, retail operations, and the like. Undistributed operating expenses included aspects such as utilities, sales and marketing, franchise fees, credit card commissions, and IT systems. Malinsky noted that if Cadillac were converted to an Autograph Collections Hotel, the 2018 percentage of revenue metrics in the Rooms and Undistributed categories would be unreliable due to lower occupancy rates. To compensate, he added \$1.1 million to the Room expenses calculated using the percentage of revenue. He set the undistributed category to \$5.4 million for 2018.

Fixed expenses included Management Fees. Hotel management was organized in a variety of ways. For example, a few Hersha hotels used the franchise’s management group (Marriott) and paid them a percentage of revenue. There were also typically incentive fees to encourage profitability, but the thresholds were often difficult to reach, so management focused almost exclusively on revenue, even if decisions were not profitable. Malinsky said, “We use our own management group, a taxable subsidiary, at Cadillac. Thus, we have higher margins than our peers because our

management group focuses more on profitability.” Malinsky used 3% of revenue to estimate Management Fees. The next fixed expense was General and Operating Insurance to cover property, business disruptions, and other categories. Finally, Fixed Miscellaneous included a variety of expenses, such as real estate taxes, personal property taxes, and any other business improvement taxes levied by the local municipality. Unlike federal, state, and local income taxes that are subtracted from EBITDA, the taxes contained in Fixed Miscellaneous are based on the value of the property and thus are more fixed in nature. Malinsky expected these taxes would be lower as a percentage of revenue come 2019 if Cadillac were rebranded as an Autograph Collection because gross revenue would be higher while these specific taxes would be relatively fixed.

### **CAPITAL INVESTMENTS**

Malinsky’s team continued its analysis with capital investments, which they projected at \$10 million for the refresh and \$45 million for the rebrand. As shown in Figure 1, the refresh investment would fund a variety of items, such as soft goods in the Cadillac Tower, new signage, and new furniture. Figure 2 shows how the rebrand investment would be spent. Total construction costs were expected to be \$15 million with FF&E adding another \$8 million. Soft costs, such as design, architectural, and legal costs, were estimated at \$4.5 million while signage, murals, and incidentals would be \$0.5 million. The largest capital investment was expected to be the Carrabba’s lease buyout. Malinsky confided, “The lease was signed years ago when mid-beach was a no man’s land. The market has improved considerably since, but the lease is fixed and has many years remaining on it—it is extremely profitable for them, but not so much for us. Plus, they know we have to buy them out to make a rebrand work.” Hersha estimated it would cost \$17 million to buyout the lease.

With the 2018 through 2023 cash flows constructed for both the refresh and the rebrand, Malinsky’s team calculated incremental EBITDA for the rebrand compared to the refresh using the format displayed in Figure 5. Malinsky was pleased to note that incremental EBITDA grew to over \$5 million by 2023 after a hefty loss of almost \$5 million in 2018 due to renovation disruptions. The team then added the incremental investment for the rebrand over the refresh to these EBITDA streams to calculate incremental total cash flows. They computed Cash on Cash Return by dividing total cash flow annually from 2019 to 2023 by the incremental capital spending of 2018; it averaged the five percentages together for a summary metric called Average Cash on Cash Return. Finally, the team needed to compute Internal Rate of Return (IRR) to gauge the profitability of rebranding compared to refreshing, but it had to wait until the Residual Value in 2023 was computed.

**FIGURE 5**  
**Example Incremental EBITDA Format.**

Incremental (Autograph - Courtyard)	2018	2019	2020	2021	2022	2023
Gross Revenue						
Expenses						
Fixed Expenses						
<b>EBITDA Impact</b>						
Incremental Capital Spending						
Incremental Residual Value at 6.5% Cap Rate						
<b>Total Incremental Cash Flow</b>						
Cash on Cash Return (capital spending)						
Average Cash on Cash Return (capital spending)						
IRR						

**PROPERTY VALUE**

The second board perspective was to ensure the investment created higher intrinsic property value. Investors were primarily interested in a property’s income stream. Thus, the larger the income stream, the higher the property value for the investor. A typical way to value a property based on its income potential was to use capitalization of income, or Cap Rate, a percentage articulating an investor’s desired rate of return. With a Cap Rate projection, an investor could value a property at a future point by dividing a future income level by the Cap Rate. The higher the Cap Rate, the lower the value of the property. Hersha used a seemingly-low Cap Rate projection of 6.5% due to industry expectations and the projected market for other investment opportunities. With the Cap Rate assumption set, valuing the property was a simple division of the 2023 EBITDA by the Cap Rate to calculate Residual Value in 2023. Malinsky’s team projected the Residual Value for the property as a Courtyard and the property as an Autograph. It found the incremental Residual Value of the hotel as an Autograph and compared it to the incremental capital investment. With Residual Value now computed and added to incremental EBITDA in 2023, the team computed IRR.

If it were to rebrand, the board expected to learn how its total investment in the property compared to selling prices of comparable hotels. Table 7 displays the sales of hotels in Miami Beach similar to a rebranded Cadillac. Malinsky’s team computed Sales Price Per Key (rooms) and then Total Capital Investment Per Key for a rebranded Cadillac Hotel inclusive of acquisition, Ocean Tower project, and rebrand project. The board would likely only consider the rebrand option if comparable Sales Price Per Key were higher than Total Capital Investment Per Key. Malinsky also multiplied the Average Sales Price Per Key by Cadillac Hotel’s number of rooms as a feasibility check on the rebrand 2023 Residual Value projection.

**TABLE 7**  
**Comparable Hotel Sales in Miami Beach in Past Five Years**

<u>Hotel</u>	<u>Keys</u>	<u>Sales Price (Million)</u>
The Sagamore Hotel	93	\$63
Confidante Hotel	380	\$235
SLS South Beach	142	\$125
The James Royal Palm	393	\$278
Dream South Beach	108	\$70
The Raleigh Hotel	105	\$69
Shore Club South Beach	309	\$175

Source: sales prices reported in <https://therealdeal.com/>

### CONCLUSION

George Malinsky reviewed his team's projections and presentation materials one last time before heading to the board meeting. He was confident in the team's analysis and was ready to pitch the recommendation and request board approval. He knew the board was under pressure from investors to deliver better results. Malinsky must be prepared for tough, discerning questions about the pro forma analysis, the property valuation, and the overall recommendation.

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## **APPENDIX A: TECHNICAL NOTE ON REITS**

Created in 1960 by U.S. Congress, the REIT Act created a “mutual fund” type vehicle to allow small investors to invest in commercial real estate. The major products/services were equity REITs, mortgage REITs, hybrid REITs, and other. Equity REITs predominantly owned and operated income-producing real estate, and accounted for about 73% of industry revenues. Mortgage REITs, (mREITs) accounting for 6.3% of total REIT revenues, lent money to real estate owners and operators (either directly through mortgages and loans or indirectly through the acquisition of mortgage-backed securities). The market value of mREITs was inversely related to changes in interest rate movements (Madura, 2018). As rates rose, the market value of mortgages declined and the demand for mREITs declined. Mortgage REITs were also influenced by credit risk since mortgages were subject to possible default. Some REITs were publicly traded and regulated by the SEC; public non-listed entities were registered with the SEC but not traded on national stock exchanges; the remaining private REITs were exempt from SEC registration and not listed on national stock exchanges (<https://www.reit.com/what-reit/reit-basics>).

To qualify as a REIT, a company had to comply with specific provisions in the Internal Revenue Code (IRC). The major constraints were: 1) Assets test or real estate “pure play,” where 75% or more of the REIT’s total assets must be real estate, mortgages, cash, or federal government securities. 2) Income test – 75% or more of the REIT’s yearly gross income must be derived directly or indirectly from real property, including mortgages/real property rents, interest on mortgages financing the real property, or from sales of real estate, partnerships and other REITs. 3) REITs must derive their income from primarily long-term passive sources, such as rents and mortgage interest, as opposed to short-term trading or sale of property assets. They could not use their federal tax-exempt tax status to shield non-real-estate income from corporate taxation. A REIT was subject to a tax of 100% on net income from “prohibited transactions,” such as the sale or other disposition of property held primarily for sale in the ordinary course of its trade or business. 4) Earnings payout requirement – 90% or more of the REIT’s annual taxable income must be distributed to shareholders as dividends each year; a REIT could not retain more than 10% of its earnings. Shareholders paid ordinary income tax on earnings in their personal taxes. 5) Ownership test – a REIT could not be a closely-held corporation. No five or fewer individuals could own more than 50% of the REIT’s stock (5/50 rule), and there had to be at least 100 shareholders after its first year of existence.

Some of the requirements were relaxed over time. For example, prior to 1999 REITs were primarily passive owners of real estate. In 1999, Congress enacted the

taxable REIT subsidiary (TRS) provision to allow REITs to engage in non-customary type activity via TRS, in which the subsidiary was subject to corporate income tax. A TRS was a corporation in which the REIT owns stock, typically 100%. As a result, a REIT was subject to a 100% penalty tax on any amount from its TRS that exceeds what an unrelated party would have paid in an arm's length transaction. This was designed to prevent a REIT from engaging in tax arbitrage, i.e., non-taxable REIT receives payments from a TRS, which reduces taxable income of the TRS and increases the non-taxable income to the REIT. The IRS developed various methods to test for arm's length pricing.

**Appendix B: Financial Statements of Hersha Hospitality Trust, 2012-2016**

*Consolidated Balance Sheets (in \$000)*

Balance Sheet as of:	Dec-31-2012	Dec-31-2013	Dec-31-2014	Dec-31-2015	Dec-31-2016
	USD	USD	USD	USD	USD
<b>Currency</b>					
<b>ASSETS</b>					
Gross Property, Plant & Equipment	1,732.6	1,796.0	2,067.7	2,227.0	2,087.9
Accumulated Depreciation	(265.9)	(260.1)	(322.2)	(395.8)	(320.3)
<b>Net Property, Plant &amp; Equipment</b>	<b>1,466.7</b>	<b>1,535.8</b>	<b>1,745.5</b>	<b>1,831.1</b>	<b>1,767.6</b>
<b>Total Real Estate Assets</b>	<b>1,466.7</b>	<b>1,535.8</b>	<b>1,745.5</b>	<b>1,831.1</b>	<b>1,767.6</b>
Cash And Equivalents	69.1	36.2	21.7	28.0	185.6
Accounts Receivable	11.5	9.1	9.4	9.5	8.8
Other Receivables	12.4	12.8	6.6	6.2	18.3
Goodwill	-	-	-	-	-
Other Intangibles	8.7	7.6	7.3	13.4	16.9
Mortgage Loans	28.4	-	-	-	-
Other Current Assets	35.4	91.8	24.8	33.6	120.0
Trading Asset Securities	-	-	-	-	1.8
Deferred Tax Assets, LT	3.4	8.8	11.4	14.6	16.2
Deferred Charges, LT	12.2	7.7	8.6	-	1.4
Other Long-Term Assets	59.9	38.2	20.2	26.3	18.8
<b>Total Assets</b>	<b>1,707.7</b>	<b>1,748.1</b>	<b>1,855.5</b>	<b>1,962.6</b>	<b>2,155.5</b>
<b>LIABILITIES</b>					
Curr. Port. of LT Debt	-	-	0.2	-	0.0
Long-Term Debt	794.9	774.3	919.3	1,170.2	1,051.9
Accounts Payable	31.6	40.0	53.5	59.0	65.1
Accrued Exp.	4.4	4.8	7.2	8.8	-
Other Current Liabilities	15.6	16.0	17.9	16.5	77.5
Unearned Revenue, Non-Current	-	-	-	-	81.3
Other Non-Current Liabilities	0.0	45.8	0.0	0.0	0.0
<b>Total Liabilities</b>	<b>846.6</b>	<b>881.0</b>	<b>998.2</b>	<b>1,254.5</b>	<b>1,275.8</b>
Pref. Stock, Convertible	0.1	0.1	0.1	0.1	0.1
<b>Total Pref. Equity</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>	<b>0.1</b>
Common Stock	2.0	2.0	0.5	0.4	0.4
Additional Paid In Capital	1,178.3	1,200.8	1,194.5	1,086.3	1,198.3
Retained Earnings	-	-	-	-	-
Distributions In Excess Of Earnings	(348.7)	(364.6)	(365.4)	(408.3)	(364.8)
Treasury Stock	-	-	-	-	-
Comprehensive Inc. and Other	(1.8)	(0.4)	(0.4)	(0.5)	1.4
<b>Total Common Equity</b>	<b>829.8</b>	<b>837.9</b>	<b>829.3</b>	<b>678.0</b>	<b>835.3</b>
Minority Interest	31.3	29.2	28.0	30.1	44.3
<b>Total Equity</b>	<b>861.1</b>	<b>867.1</b>	<b>857.4</b>	<b>708.2</b>	<b>879.7</b>
<b>Total Liabilities And Equity</b>	<b>1,707.7</b>	<b>1,748.1</b>	<b>1,855.5</b>	<b>1,962.6</b>	<b>2,155.5</b>

Source: S&P Capital IQ

Consolidated Income Statement, 2012-2016 (\$000)

For the Fiscal Period Ending	Dec-31-2012	Dec-31-2013	Dec-31-2014	Dec-31-2015	Dec-31-2016
Currency	USD	USD	USD	USD	USD
Rental Revenue	-	-	-	424.5	408.8
Tenant Reimbursements	-	-	-	-	-
Interest and Invest. Income, Total (Rev)	2.0	0.2	-	-	-
Other Revenue	299.0	338.2	418.1	46.9	56.0
<b>Total Revenue</b>	<b>301.0</b>	<b>338.4</b>	<b>418.1</b>	<b>471.4</b>	<b>464.8</b>
Property Exp.	183.3	214.5	260.1	292.0	298.7
Selling General & Admin Exp.	23.4	23.9	20.4	20.5	24.4
Depreciation & Amort.	48.2	55.8	69.2	74.4	75.4
Amort. of Goodwill and Intangibles	-	-	-	-	-
Other Operating Exp.	-	-	-	-	-
<b>Total Operating Exp.</b>	<b>255.0</b>	<b>294.1</b>	<b>349.6</b>	<b>386.9</b>	<b>398.5</b>
<b>Operating Income</b>	<b>46.0</b>	<b>44.3</b>	<b>68.5</b>	<b>84.5</b>	<b>66.3</b>
Interest Expense, Total	(38.1)	(40.9)	(43.4)	(43.6)	(44.4)
Interest and Invest. Income	1.3	1.8	0.8	0.2	0.4
<b>Net Interest Exp.</b>	<b>(36.8)</b>	<b>(39.2)</b>	<b>(42.6)</b>	<b>(43.4)</b>	<b>(44.0)</b>
Other Non-Operating Inc. (Exp.)	0	(0.1)	(0.5)	(0.4)	(17.8)
<b>EBT Excl. Unusual Items</b>	<b>9.2</b>	<b>5.0</b>	<b>25.4</b>	<b>40.7</b>	<b>4.5</b>
Total Merger & Rel. Restruct. Charges	-	-	(2.5)	(1.1)	(2.6)
Impairment of Goodwill	-	12.1	12.7	-	-
Gain (Loss) on Sale of Invest.	(1.9)	(1.8)	-	-	-
Gain (Loss) On Sale Of Assets	-	-	7.2	-	115.8
Total Insurance Settlements	-	0.4	4.6	-	-
Other Unusual Items	(3.2)	(0.5)	19.8	(0.6)	(1.2)
<b>EBT Incl. Unusual Items</b>	<b>4.1</b>	<b>15.2</b>	<b>67.3</b>	<b>39.1</b>	<b>116.6</b>
Income Tax Expense	(3.4)	(5.6)	(2.7)	(3.1)	(4.9)
<b>Earnings from Cont. Ops.</b>	<b>7.5</b>	<b>20.8</b>	<b>69.9</b>	<b>42.2</b>	<b>121.5</b>
Earnings of Discontinued Ops.	14.7	29.2	(1.7)	-	-
Extraord. Item & Account. Change	-	-	-	-	-
<b>Net Income to Company</b>	<b>22.2</b>	<b>49.9</b>	<b>68.3</b>	<b>42.2</b>	<b>121.5</b>
Minority Int. in Earnings	0.2	(0.3)	(1.0)	(0.4)	(4.5)
<b>Net Income</b>	<b>22.4</b>	<b>49.6</b>	<b>67.3</b>	<b>41.8</b>	<b>117.0</b>
Pref. Dividends and Other Adj.	14.5	17.7	14.9	14.8	21.9
<b>NI to Common Incl Extra Items</b>	<b>7.9</b>	<b>31.9</b>	<b>52.4</b>	<b>27.0</b>	<b>95.1</b>
<b>NI to Common Excl. Extra Items</b>	<b>(6.8)</b>	<b>2.8</b>	<b>54.0</b>	<b>27.0</b>	<b>95.1</b>
<b>Per Share Items</b>					
Basic EPS	\$0.17	\$0.64	\$1.05	\$0.56	\$2.21
Basic EPS Excl. Extra Items	(0.15)	0.06	1.09	0.56	2.21
Weighted Avg. Basic Shares Out.	46.9	49.6	49.8	47.8	43.0

Source: S&P Capital IQ.