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An interview with James M. Seneff, Jr., Chairman of the Board, and Thomas J. Hutchison, III, CEO of CNL Hotels & Resorts, Inc.

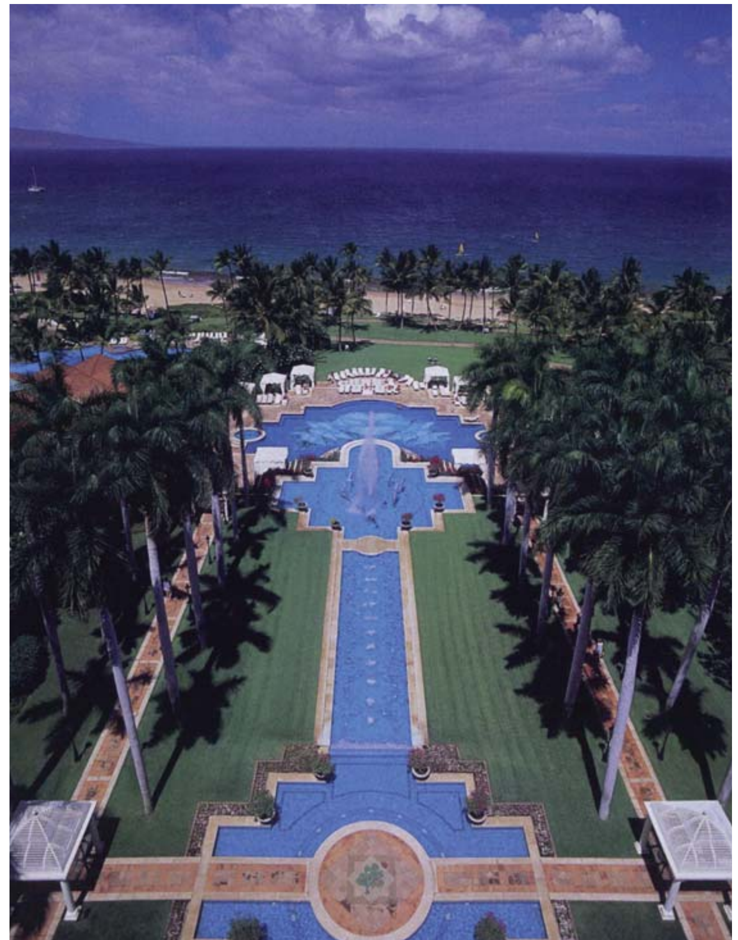
CNL hotels & resorts:

No time to rest in the lodging industry

WITH MORE THAN 130 distinctive properties throughout the United States and Canada, CNL Hotels & Resorts, Inc. (formerly CNL Hospitality Properties) ranks in the top echelon of the nation’s lodging industry REITs (real estate investment trusts).

Since its inception in 1997, the company has worked to develop ongoing relationships with many of the industry’s most recognized operators and managers, including Marriott, Hilton and Hyatt, as well as interests in many of the nation’s most renowned hotel properties.

In the past two years alone, CNL added more than 70 hotels with 14,500 rooms in 15 new markets, including the prestigious Hyatt Regency Montreal in Quebec and the legendary Hotel del Coronado outside San Diego, Calif. With its acquisition of KSL Recreation Corporation in April of 2004, CNL became owner of six of the most recognized resort locations in the world, including the Grand Wailea Resort Hotel & Spa on Maui, Hawaii; the Arizona Biltmore Resort & Spa in Phoenix, Ariz; and the Doral Golf Resort & Spa in Miami, Fla. The $2.6 billion transaction made CNL the second largest hotel REIT measured by total assets.



Recently, PricewaterhouseCoopers Real Estate Partner Steve Walker and Managing Director Christine Hill sat down with James M. Seneff, Jr., chairman of the board of CNL Hotels & Resorts, and Thomas J. Hutchison III, CEO of CNL Hotels & Resorts, to talk about the state of the lodging industry and CNL's plans for the future. Seneff is also chairman of the board and CEO of CNL Financial Group.

James M. Seneff, Jr.,
Chairman of the Board,,
CNL Hotels & Resorts, Inc.

Thomas J. Hutchison, III,
CEO of CNL Hotels & Resorts, Inc.

PwC: To help put things in perspective, maybe you can begin by giving us the broad overview of the CNL Financial Group and how CNL Hotels & Resorts fits into that framework.

JS: CNL and its affiliates are involved in real estate, development, finance and investments. We have $17 billion in assets; $13 billion is owned by companies that we have either established or acquired; and $4 billion is managed for third party investors.

In terms of our approach, since the early 1990s, our big idea has been to capitalize on the securitization of real estate and financial assets by combining capital markets and real estate expertise. It seems to me that you have to do both if you're going to succeed. Many people over the last 10-15 years who understood real estate, did not understand how to access capital. They were good at the dirt, but they did not know how to get to the capital markets. We worked very hard to combine those skills, because we really believe you have to be good at accessing capital as well as understanding the real estate that you're buying.

One of our affiliates, CNL Hotels & Resorts, is a REIT we started from scratch in 1997. All of our REITs start out externally advised, until it is in the shareholders' best interests to merge in the advisor and become a self-administered REIT. Obviously, in the early years a REIT cannot afford a fully staffed management team. But as the REIT grows, there is a crossover point where it is beneficial to the shareholders to merge the advisor into the REIT.

We access capital from Wall Street, institutional investors and the broker-dealer community, then look for out-of-favor, undercapitalized sectors that have been having trouble accessing capital from Wall Street or other sources. Over the last three or four years, this has been our strategy in both the hospitality and retirement sectors.

We have a long-term perspective and we look for unique assets that we can buy in down or sideways markets. That is the essence of our philosophy. We can access capital anywhere, but we are really looking to access capital when markets are out of favor and take advantage of that. We certainly have done that in the hospitality sector.

PwC: You mentioned the $17 billion in assets. Five years ago, what would that number have been?

TH: I think it was approximately $4 billion as of January 1, 2000, so there has been some significant growth. When the economy was down, we were able to take advantage of being able to grow and acquire properties.

JS: The last time we had growth like this was in the late 1980s or early 1990s, when you had the Resolution Trust Corporation (RTC) taking back assets and we grew from $100 million to $1 billion. For the period after that, we had slower growth. Then our growth increased after the market turned down in 2000 and we saw opportunity in the marketplace that had not been there in prior years.

PwC: The term "relationship-building" is one that comes up fairly frequently at CNL. How important is that element to your overall approach to business?

JS: I think Tom can talk about that on the hospitality side, but it's certainly illustrative of all of our companies. We're very focused on relationships and I think Tom has really done a remarkable job in that regard in hospitality over the last few years.

TH: What our team has tried to focus on continuously over the past few years has been the continuity of doing business. We have done a lot of repetitive business with the same operators — for example in hospitality — Marriott, Hilton, Hyatt, KSL. So rather than having ten different operators, we've chosen to do business with five or six. In doing that, we've created opportunities for repeat business and thereby have strong relationships with various senior people.

I've always believed that it's not enough that Jim or I happen to know Bill Marriott. We have relationships that go all the way from Bill Marriott to their accounting people. In hospitality, we actually match people up at various levels. That way, things happen a lot faster and a lot simpler. If a little problem comes up, it stays a little problem — it doesn't become a big problem. And you have the opportunity for repeat business in the future because there is a certain level of trust and respect that's been developed. That's what we've tried to accomplish for CNL Hotels & Resorts and we've been able to build those kinds of relationships with major companies.

We've also taken that philosophy and developed the same kinds of relationships with our lenders and with our investment bankers. We have a very consistent operating style and work with people in a straight-up, very open fashion. I tell our associates that we have a business way of life in the way we operate as a company. And the most important thing about that is consistency.

PwC: There have been some exceptions in which you've taken some entrepreneur-type risks, but your core business seems to be revolving around very solid, dependable companies. How do you explain your approach?

JS: The few times that we've taken risks — where we didn't have long-term relationships — tended to create more problems than opportunities. So that's taught us to stick with major players.

But if you think about it, if you're in a sector that is having trouble accessing capital, generally what key players are looking for is a financial partner. That's where we come in. That's really what happened in hospitality. There was less capital coming in after the downturn in 2000 and you had key players out there who were looking for a financial partner who could consistently provide them with capital to take advantage of opportunities. So that's really where the match began.

TH: When you think about all the transactions we've done in the last two or three years, one of the most interesting aspects is the high percentage of transactions that we have negotiated with our operating partners — Hilton, Marriott, Hyatt.

PwC: What do you contribute your closure rate to relative to most of the other entities in your sector.

TH: That's primarily because when we go in and make up our minds and tell someone that we're going to do it, we know we can do it. And we do it — again, it's part of being consistent. We don't re-trade, we don't operate in ways some other companies do — and I'm not saying that we're right and they're wrong or vice-versa — we just have a way of operating that people can rely on. People trust us. When we say: "Yes, we're going to do something," we get it done. I think that's been an important aspect of the way we've tried to build this company.

JS: And that's especially true when you are building a company basically from the ground up. You have to build the relationships and earn people's trust, because in many ways you are building relationships that you've never had before. And I think the fact that we have done that is a testament to the team.

PwC: Do you think there is going to be a lot more consolidation in the lodging industry?

JS: Absolutely. There has been a lot of information recently about the average costs companies will incur to comply with Sarbanes-Oxley. How many $500 million listed companies will be able to afford to pay those kinds of dollars to be fully compliant as an independent public company in the future? You just can't do it. So yes, there is going to be a lot of consolidation not only among the smaller companies, but also with the bigger companies.

TH: And there are just too many REITs. You're going to have fewer REITs per sector because of consolidation. Investors are looking for larger, better-capitalized companies to represent the individual sectors.

PwC: What you're doing really isn't buying or consolidating REITs, what you're doing is looking at traditional corporate real estate that has been on the balance sheet and providing a way to monetize it. It seems as though you have quite a pool out there to choose from, going forward, as opposed to the consolidation efforts that you were referring to.

JS: I don't think a lot of companies, especially in hospitality, have as much real estate as they used to. Many major operating companies in the industry have reduced their real estate acquisitions and become primarily or exclusively management companies. The thing that worked for us is that these companies owned very unique assets that were available during that three to four year period after 2000. That availability allowed us to build a distinctive portfolio. Additional hospitality assets may become available, but to be able to do what we did, you would have to be in an out-of-favor period.

TH: We have always tried to stay focused on the top 30 or 40 percent of the quality in each segment. Even in what you would consider the lower end of the lodging scale, we own the top 30 or 40 percent of each segment. In addition, we will limit who operates those hotels to the top 20 or 30 percent of the total

operators in the country today. If you look around, there are literally hundreds of owner-operators of hotel properties around the country that are not operated by the major brands themselves.

Obviously, we do business with Marriott. We do business with Hilton. We do business with Hyatt. We've chosen to do business with very well capitalized companies that you know are going to stand behind their product and their flag and their brands.

PwC: It sounds as though you may be looking abroad for acquisitions that meet those kinds of U.S. criteria. Going forward, does that mean you'll look at Europe, Southeast Asia, or just stay home. Or are you more entrepreneurial when you move into those markets? Do you use the same operators? Different operators?

TH: As you know, we already bought the Wyndham in Montreal in 2003, which we converted into a Hyatt at the end of the year. But looking at Europe, if you consider the economy of Western Europe right now, it's about 18 months to two-and-a-half years behind where the U.S. is today. That's no different from other cycles that have occurred over the past 50 years. And the lodging sector in Western Europe is no different. So if you think about that and you understand that market — and you know that Marriot is one of the biggest operators in Western Europe, and Intercontinental Hotels and Hilton International, both of which we have relationships with — I think it would be natural for us to look at the opportunities that arise.

Will we become a big owner in Europe? No, I don't think we will, but we will look at opportunities as they come up in the future. We have to — that's consistent with our responsibility to our shareholders.

JS: That being said, the U.S. is a terrific place to own assets. I think you'd have to have an awfully good reason to go to other parts of the world.

TH: We have learned what we have to go through as a REIT, from an accounting standpoint, to own a hotel in Montreal, or in Budapest, or London, or somewhere else. It is certainly more challenging than owning U.S.-based properties.

PwC: There's a cost to being a REIT. With the potential changes in the tax law relative to dividend exclusion, are you still happy with the structure that you have, and do you continue to see that as the model going forward?

JS: I think the REIT is a very good structure to own real estate as opposed to the C-Corp. I think the returns that investors are looking for are returns that real estate should provide through the REIT

“Many major operating companies in the industry have reduced their real estate acquisitions and become management companies. The thing that worked for us is that these companies owned very unique assets that were available during that three to four year period after 2000. That availability allowed us to build a distinctive portfolio.”

structure. There are a lot of issues involved with having a C-Corp. that owns real estate. I think all in all, the REIT is a very good structure not only for owning real estate, but it's also good for the shareholders.

PwC: What are some of the strategic objectives that you are thinking about for 2005?

TH: We will remain focused on the continued growth of our portfolio, particularly the internal growth. As you know, many of our assets have been repositioned and have new management; we've changed the brand on some of the hotels and so forth — so we believe over 50 percent of the portfolio has opportunity for strong internal growth. We intend to harvest that growth and ensure the rest of the portfolio exceeds 100 percent penetration of the marketplace. In other words, each one of the hotels in its marketplace should sell more than its fair share of room nights during any one period of time. And that's where John Griswold, the company's president, does a great job, because that's his primary background and he has a great staff of asset management veterans.

As you well know, that's what happens when the ADR (Average Daily Rate) of the REVPAR opens up — meaning Revenue Per Available Room on a nightly basis, which is made up of occupancy and the rate of the room. And when the increase in ADR gets to be a bigger percentage of the increase in REVPAR, you have a more substantive amount of flow-through to the bottom line. It just opens up dramatically. So we continually watch and monitor the growth of this portfolio.

We have one of the greatest portfolios in the industry — all we need to do is make sure it performs the way it is capable of performing.

PwC: If you look at the other side of the balance sheet, you have long-term equity there — are you happy with how the debt structure is, or is that also part of the plan for '05 and '06 for longer term financing or fixed financing. What's your debt strategy going forward?

TH: When we bought the KSL portfolio on April 2, we had two financing alternatives. We could either take on $1 billion of bridge debt and assume the existing debt, or we could take on a $1.8 billion bridge loan and pay off the underlying loan. Because of the fees that were involved with the underlying loan, we chose not to pay it off.

As you know, we recently closed a new $1.5 billion CMBS loan with Deutsche Bank, paid out the underlying loan and paid out a big percentage of the bridge loan. We have another loan that we expect to close in the fourth quarter so that will take out the balance of the bridge loan.

If in the future an opportunity arises for us to obtain perpetual preferred debt at a little lower rates than our cost of debt — and in fact those rates have been coming down in the past few weeks — there may be an opportunity to replace some of that secured debt with some unsecured type of preferred debt. We'll continue to look for that kind of opportunity.

PwC: What is your concept of Return on Performance (ROP) and what that means — how you manage through ROP and how you hold people accountable?

JS: Return on Performance is our way to keep a scorecard on our business. Tom has an ROP for CNL Hotels & Resorts that involves a monthly meeting to ensure everyone understands exactly where we are in light of our strategy over the one- and three-year periods. It holds people accountable. It's a very effective process.

PwC: The old story used to be that "deal guys do deals." How do you keep them under control to make the good investments?

JS: I think the real estate industry has been characterized in the past by people who were transaction-oriented. We've taken a different approach and have tried to create best practices based on the way you would manage an industrial company.

I think the Return on Performance methodology is the best way to accomplish that. We review our acquisitions and our policies on acquisitions and we look to see if what we targeted is what we are actually doing. I think the real interesting thing right now, with real estate values starting to come back up, is when do we buy and when do we just hold?

PwC: Do you expect more volatility with regard to cap rates?

TH: I think we're going to see a different kind of market in the future than what we've ever seen before. As Jim mentioned, I think we are going to see more of the European model, where the cap rate is a spread over the debt rate and is more consistent —– not a situation where the price of real estate is going in one direction and the debt going in the other direction. If you look at debt over the last three or four cycles, it doesn't change drastically. It goes up gradually and it comes down gradually. The value of real estate is traded on the more prominent ups and downs.

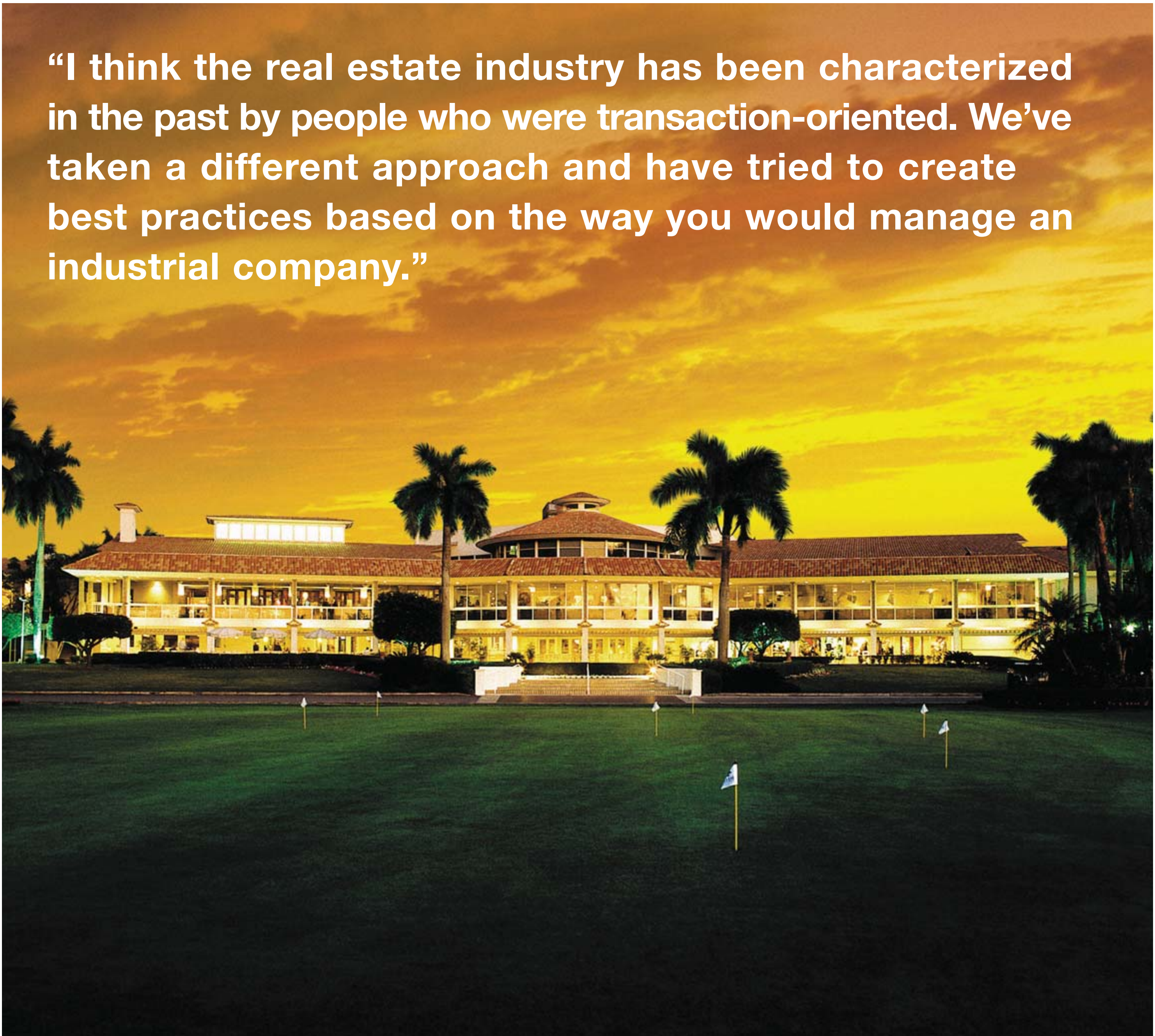
JS: Another thing is — if you take the total value of all the real estate that is owned by REITs, it is smaller than the market cap of GE. So you have a number of people now who want to invest in real estate; it's easier to do because it's more efficient and I think that has had an impact on price and on cap rates. And I think that is something we are going to see continue in the future.

PwC: In terms of competition, who do you see as being your main competitors in this industry? Anyone in particular?

TH: I don't think that we have any one type of competition; I think there is a combination. Plain and simple, there is more inflow of capi-

tal into the real estate segment. It dried up for a very short period over the summer, then there was an outflow for about three weeks. Today there is an inflow again into the real estate sector. There is a broader base of people looking at the lodging sector than there was a year or two ago. There are also more opportunity funds looking at acquisitions, as well as REITs. Two years ago, the lodging REITs were addressing challenges such as their leverage and debt covenants more than they were considering acquisitions. Now all of a sudden, the REITs are back in, and new REITs are looking at acquisitions. So I don't think there is a simple answer in terms of competition due to a much broader interest.

JS: There is a point that needs to be made here — it's not as easy to buy assets when they are out of favor. When you are buying assets at a time when all the news is negative about the hospitality industry, you need to have a long-term strategy and the understanding that this is how you make money. You make money when you buy the assets at a time when there are fewer people competing for them. And that's when you get unique assets. It's a very important point.



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