Hotel Acquisition Standard Due Diligence Procedures

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With record levels of hotel transaction activity, hospitality professionals have been busy assisting prospective buyers in performing due diligence procedures for target hotel properties or hotel companies. Due diligence is a process through which a buyer performs a thorough investigation of a hotel property from both financial and non-financial perspectives.

Due diligence is usually conducted by an appointed team who would address such areas as analysis of historical financial statements and budgets, operations, comparison of the property to its competitive market, engineering and environmental surveys, and a review of legal and other exposures. The purpose of due diligence is to allow a prospective buyer to determine the market value of the property and therefore determine what price he is willing to pay. Market value calculations are generally based on historical results as well as comps and future profit potential. The results of due diligence will also provide the buyer with potential changes to the asking price or points of negotiation, as well as an understanding of what changes may need to be implemented in management, strategy, or capital expenditure requirements after acquisition.

For the larger hotel chains, due diligence is performed in-house by teams of experienced operations people, general managers, and valuers. Smaller hotel companies and individual owners that do not have the expertise or time to conduct due diligence hire third parties to perform the due diligence.

The following provides a high level summary of some of the key areas and documents one might expect a financial due diligence team to include:

The team will review management's budgets and the underlying assumptions, as well as reviewing past budget versus actual performance to determine the reasonableness of the budgeting process.

A market analysis of the property with comparison of key statistics to competitive properties in the area and assessment of guest profiles, future trends in local demand and supply, review of local economic activity, estimate of future market share, and cash flows.

Most recent independent audit reports, as well as access to audit firm work papers and any control letters issued.

Quality of historically reported earnings, with a view to determining if past results can be repeated and whether there are any extraordinary items that caused historical results to be distorted and therefore not representative of potential future results.

Verification of assets and liabilities.

Quality of management and financial controls with respect to running the business and reliability of financial information.

Search for unrecorded liabilities such as contingent management or franchise fees, legal exposures, contract commitments, etc. The team would most likely communicate with outside legal counsel and insurance administrators to determine estimates of insured and uninsured losses and contingencies.

Federal, state, and local tax status and review of tax consequences of the acquisition. The team would likely review recent federal, state, and local tax returns and correspondence, including real estate taxes and sales and occupancy taxes, to determine whether there is any delinquency in filing or payment to which the potential buyer could be exposed. The potential buyer often seeks indemnification from the seller for pre-acquisition tax liabilities.

Employee matters such as bonus plan documents and calculations, understanding union labor contracts, reviewing union correspondence, employee benefit plan terms and funding status of defined benefit retirement plans, and terms of executive employment contracts.

Review of existing management and franchise agreements and search for any deferred or contingent liabilities related to these. The potential buyer will need to decide whether or not to make any changes to these upon acquisition.

Review of contracts and capital and operating leases for key financial terms.

An historical analysis of capital expenditures and tour of the property to determine what capital expenditures and renovations may be required shortly after acquisition

Computer systems assessments and determination of Y2K compliance.

Insurance review, including coverages, deductibles, and caps.

As indicated by the above, the due diligence process involves a substantial amount of time and expertise in a wide variety of professional fields. Although time consuming, due diligence is nevertheless essential to a successful acquisition to protect the interests of the buyer and company shareholders, particularly if combined with a well-drafted purchase and sale agreement. The purchase and sale agreement should give significant consideration to the facts, issues, and exposures that were identified during due diligence. In fact, an element of due diligence and a progression from the findings may also be that the due diligence team assists in the drafting of the purchase and sale agreement with regard to the terms of the apportionments of certain working capital balances and revenues and expenses at the closing of the transaction. ▪

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