SLAYING THE PIP DRAGON: NAVIGATING BRAND MANDATES WHILE SELLING A HOTEL

By Chris Plasencia
Managing Director
The Plasencia Group

A property improvement plan, or "PIP," is a hotel brand's primary means of reestablishing physical brand standards within a franchised hotel. Generally, hotels are required to replace soft goods every six or seven years, and case goods every fourteen years or so. At the end of these cycles, most hotels are indeed due for much of the requisite work just to stay competitive. Many, if not most, PIPs are ultimately triggered when hotels are sold: the brand franchisor makes the transfer and extension of the hotel's flag contingent on the buyer's execution of the capital initiatives set forth in the PIP. Lately, after years of deferrals attributable to the Covid-19 pandemic, an influx of heavy PIPs are coming due, burdening nearly all sales of branded properties with substantial CapEx obligations.

MITIGATING THE IMPACT OF A PIP

If you are a seller, exiting a property in need of a substantial PIP may have an adverse impact on the price you receive, as the buyer will be saddled with completing brand-mandated capital projects at its own expense post-closing. A buyer's first inclination is to reduce the purchase price by the amount of a property's CapEx needs on a dollar-for-dollar basis (or more in cases where the capital project will be disruptive to ongoing operations). We recommend that sellers consider taking the following steps to mitigate the impact of a PIP on achieving the best price possible.

CONTINUED...

Lately, after years of deferrals attributable to the Covid-19 pandemic, an influx of heavy PIPs are coming due, burdening nearly all sales of branded properties with substantial CapEx obligations.

1. ORDER THE PIP EARLY

We strongly recommend you order a PIP from the brand as soon as possible, and ideally, well before your asset's disposition process is launched. Today, we are seeing it take up to a month for brand representatives to tour a property once the PIP is ordered, and another four to six weeks for a final PIP report to be delivered. Receiving a PIP early gives you ample time for negotiation of the document with the brand before sharing with prospective investors. Finalizing your PIP in the early stages of a marketing process (or ideally, before) also allows prospective investors to digest the document well in advance of a call for offers. Buyers almost never commit to a firm price without a final PIP in hand; delivering a PIP after purchase offers have been submitted opens the door for re-trading of the purchase price.

2. NEGOTIATE THE PIP CREATIVELY

Negotiating a PIP with a brand is more of an art than a science, and it often depends on the relative bargaining power between an owner and its brand. Owners with strong brand relationships and large branded portfolios often do make more headway than owners with limited exposure to a brand. Our Development Management Team brings years of expertise in working with the brands to arrive at reasonable expectations for renovations, both in terms of cost and in the time allowed by the brand to complete the PIP. The negotiation of a PIP can lead to several possible outcomes as to its requirements:

> ***Elimination*** *There may be PIP requirements that a brand, in retrospect after sharing an initial iteration of the PIP, is willing to strike entirely from the document. The rationale for doing so could be updated information (e.g., a PIP requirement to replace mattresses could be eliminated if they had already been replaced a year ago, off-cycle, by ownership due to a pileup of guest complaints) or an appeal to common sense (e.g., a PIP requirement to expand the fitness center to the brand's new standards could be eliminated if the existing setup demonstrably accommodates the needs of the hotel's existing guests). Though elimination of PIP elements is not the most common outcome, it is nevertheless worth making the effort on certain items since it often yields instantaneous cost savings which can be applied directly to price.*
>
> ***Revision*** *Many PIP items can be toned down through negotiation to reduce their cost. As an example, brands often will allow case goods to remain through a cyclical renovation if the furniture is high quality and in good condition and provided it is professionally touched up. In this case, the major cost of replacing furniture is minimized to mere touch up work. Given a hotel's particulars, there are potentially several areas where a brand may be willing to compromise, to the benefit of your sale proceeds.*
>
> ***Deferral*** *If a brand is unwilling to eliminate or substantively revise PIP components, your next best outcome is to delay the deadline for completion. Brands are often willing to push back timing requirements, and depending on when relevant work was last completed, you may be able to push back deadlines two to three years on certain items. Though a delay does not offset price directly, it does allow a buyer to accrue reserves in the intervening years to offset those costs, and the lag in incurring the cost also improves timing-driven IRR-calculations.*
>
> ***Completion*** *It may be possible to address certain (usually minor) PIP requirements in-house prior to sale, allowing for those items to be eliminated from the PIP document. Tasking a hotel's engineering team (or third-party contractors) with straightforward tasks like touching up paint, modernizing public bathrooms, upgrading landscaping, pressure washing, and the like, can help reduce the scope of your PIP. Though you bear the cost, by largely making corrections in-house, you will usually see major cost efficiencies and savings.*

3. PRICE THE PIP THOROUGHLY

Once your PIP has been negotiated and finalized with the brand, we advise getting the PIP fully priced out by a qualified industry resource. In the absence of pricing data from a reputable source, buyers are rightfully conservative in their CapEx assumptions, which has a correspondingly negative impact on pricing. By delivering a fully priced PIP to prospective buyers early in the marketing process, you will undercut any potential pricing disconnect between you and the prospect. It also provides the ultimate buyer with a head start on executing the PIP.

4. TELL THE PIP STORY

Conveying the financial upside achievable through completion of the PIP is incredibly important. The infusion of capital into a hotel should have a significant positive impact on its performance, and the need to illustrate to prospective investors the upside that is likely attainable through completion of the PIP is fundamental. In fact, if a purchaser buys into the "story," there's a great chance they'll get comfortable paying more than the current operating performance metrics warrant, by placing additional weight on the upside potential of the asset. There are several ways for you to tell the PIP story, including:

> ***Projecting Increases in RevPAR Penetration*** *A refreshed hotel will perform better against its peers post-renovation, and projecting improved topline performance relative to a competitive set is expected. The extent to which this improvement takes place depends on the magnitude of the work done and the makeup of a hotel's competitive set; for example, in a relatively commoditized market, a hotel running 85% RevPAR Index pre-renovation could potentially see its RevPAR penetration hit or exceed 100% following a comprehensive renovation, while a hotel already running at 110% RevPAR Index is unlikely to see much improved penetration following replacement of soft goods. Often this growth is driven primarily by ADR, as guests are willing to pay more for a refreshed hotel room.*
>
> ***Upgrading the Comp Set*** *Sometimes, a renovation is substantially meaningful to justify ordering a new competitive set altogether. This allows a complete resetting of property benchmarking. Ordering a custom STR Trend Report to provide a comparison to a better-performing competitive set is absolutely worthwhile when, post-renovation, a hotel will have a completely new business plan or expects to tap into a new, higher-rated segment of demand. Selecting a rational yet aspirational comp set for this new comparison will help you prove out that it is feasible for an upgraded hotel to attain its fair share of the higher caliber of business that exists in the market.*
>
> ***Modeling Specific Improvements*** *Certain upgrades at hotels deserve to be discussed in detail to convey upside. For example, where a PIP calls for reconcepting your hotel's restaurant, building out an analysis that shows improved revenues offsetting the capital expense can soften the blow, especially when corroborating data on comparable restaurants revenues is available. The goal here is to present a clear case that the investment in a particular aspect of your hotel (e.g., a restaurant, pool deck, meeting space, or elsewhere) will generate a meaningful return by attaining a higher level of business than was previously attainable.*

TURNING A CHALLENGE INTO AN OPPORTUNITY

Today, PIPs handed down from brands are as onerous as they have ever been, especially since many assets forewent renovations during the pandemic. That said, a bit of forethought and legwork in advance of a sale process will help you blunt any negative impact on pricing, and in fact, turn a challenge into an opportunity by offering a path to the creation of additional value if handled in a thoughtful manner.

For over thirty years, The Plasencia Group has been serving our clients, and the broader hospitality industry, by sharing our experience across all aspects of the asset ownership lifecycle. Our vast consulting expertise spans the entire ownership experience, from acquisitions and new development to dispositions, renovations, capital investment and strategic planning, to a whole host of owner representation and asset management services. If we can be of assistance by helping you to navigate your PIP plan, or any other detail of your hotel, resort, or property portfolio investment, please call us directly at (813) 932-1234 to start the discussion.

Today, PIPs handed down from brands are as onerous as they have ever been, especially since many assets forewent renovations during the pandemic.

For more valuable hospitality industry news and market analysis, visit us online and opt-in to our communications list at tpghotels.com/company-news

About The Plasencia Group

In 1993, The Plasencia Group was formed to provide hotel and resort owners investment advisory services at a personal level. Thirty years and hundreds of engagements later, we still have the privilege of making our clients successful with the passion, access, and certainty they've come to expect. Our firm offers investment sales, asset management, development and renovation management, debt and equity sourcing, and advisory services to hotel and resort owners throughout North America.

Contact us today if our experienced advisory team can assist you in evaluating your current portfolio and strategizing for the weeks and months ahead. We look forward to the opportunity to serve you.

(813) 932-1234
info@tpghotels.com
tpghotels.com