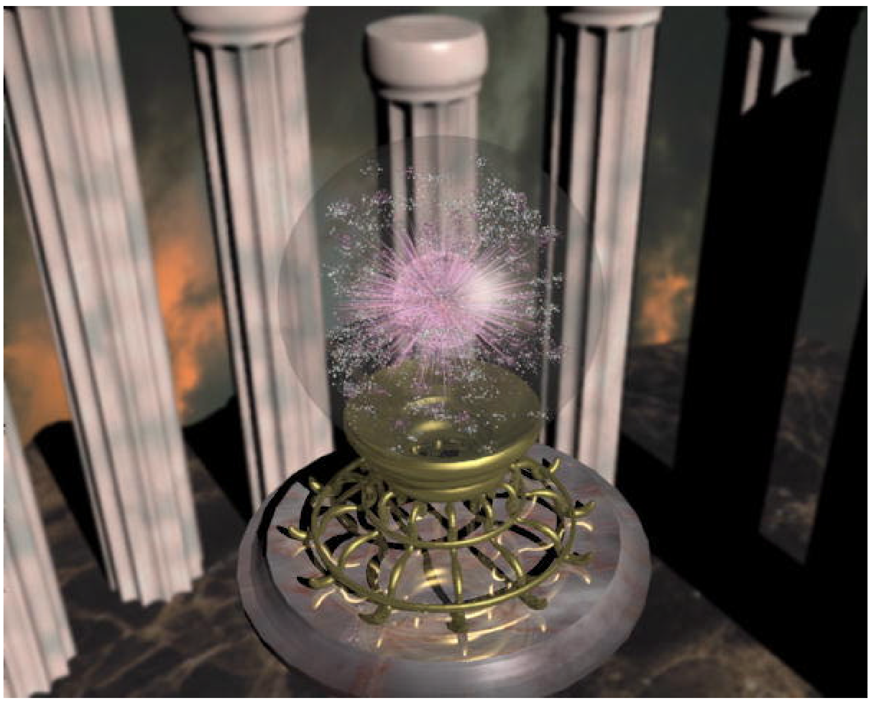
Lodging Industry Investing: What Does The Future Hold?

Spring 2000 Wharton Real Estate Center Seevak Competition

RESEARCH PAPER & PRESENTATION MATERIALS



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Introduction

The lodging industry is a fascinating industry for study. Over the last several years, the economy of the United States, as well as its vaunted stock market, have soared into the stratosphere. The events of April 3 and April 4 of 2000 notwithstanding, stocks on all indices and in all industries have performed phenomenally during the majority of this decade. Even more perplexing, companies with nothing more that a good idea, a series of bloody quarterly losses, and a .com suffix to their corporate moniker are being valued at literally hundreds times next year projected revenues. It seems that a company/industry would literally have had to try in order not to have undergone significant growth and value appreciation during the previous 8 or so years, especially during the last two. Therein lies the mystery of the lodging industry.

It is really counterintuitive. As people become wealthier, they spend more, and take more vacations. As the country prospers, business grows, and consequently, more businesspeople are taking trips and require accommodations. While the growth potential of the industry, which is fairly saturated, clearly does not rival today's Internet darlings, there is no reason to believe that the companies' performance and profits will not continue to grow steadily with the economy. Moreover, within this seemingly growing industry, there are certain players with particularly strong asset portfolios and positioning in lucrative markets. However, even those companies have not escaped the wrath of the public markets of late.

When one digs deeper into the question, explanations are ascertainable. In reality, certain industry fundamentals have combined to restrict the perceived growth prospects for companies in the industry. In addition, certain features unique to the best asset companies in the industry, such as poor management retention or bad internal operational management, have also caused the public markets to forgo these investment opportunities.

In the wake of the disastrous previous two years, though, lies significant opportunity. We will be examining two companies, each of which has performed poorly over the last two bullish years in the market. One of the companies, Starwood Hotels and Resorts Worldwide, Inc., has lagged for reasons ranging from being overly acquisitive to uncertain announcements regarding their strategy in the media. The other, Felcor Lodging Trust, has suffered due to the perception of overcrowding in their core markets and a previously ineffective stock repurchase program. Both companies, however, have pretty strong fundamentals, and at least one seems to be significantly undervalued from an investment standpoint. By analyzing the value drivers in this industry and the macroeconomic forces at play, as well as juxtaposing the fundamental situations and recent woes of these two companies, it is clear that at least one of them represents a solid investment at this stage.

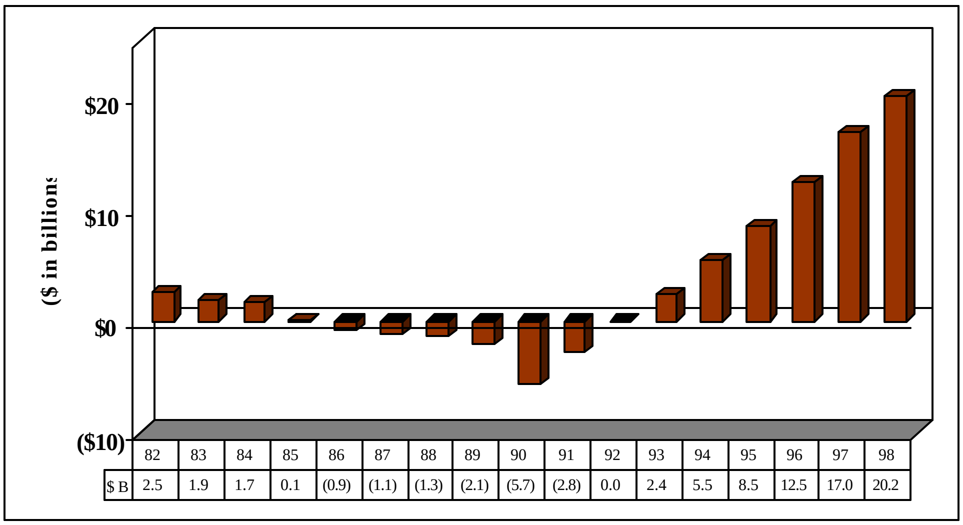
REIT and Lodging Fundamentals and Trends

Demand: Solid Fundamental Growth with a Changing Demand Pattern

Solid Overall Growth

Over the long term, GDP growth has proven to be the primary driver for domestic lodging demand. Based on a 1999 study published by the Hospitality & Leisure Financial Advisory Services Group at PriceWaterhouseCoopers, the coefficient between GDP growth and RevPAR growth in the U.S. lodging industry has been 0.81 for the past four decades, indicating a critical relationship between the health of the overall economy and the demand in the lodging industry. As we are currently experiencing the longest economic expansion in U.S. history with sustained GDP growth and few signs of inflation, the lodging sector has become one of the beneficiaries of this prolonged economic expansion. As the chart shows below, the lodging industry has enjoyed unprecedented prosperity in recent years.

U.S. Lodging Industry Earning before Tax (EBT)



(Smith Travel Outlook: May 1999)

On a regional basis, metropolitan areas that have posted high levels of economic expansion are also the areas that have registered strong lodging gain in recent years. New England (CT, MA, RI, HG, VT, ME) has been the best performing lodging market in the past three years measured by both occupancy and average daily room rate growth. However, considerable softness is observed in certain regions where new supply has outpaced demand, with the cities of Dallas, Houston, and Nashville being prime examples.

Looking ahead, with estimated GDP growth at 3.5% in 2000 and 3.2% in 2001, we expect lodging demand to keep pace with a modest 3%-3.5% growth in the year 2000. Based on preliminary data released by the American Express travel department, the majority of Fortune 500 companies predict their corporate travel budgets to increase 4%-6% in the year 2000. We believe that a favorable macro environment will continue to provide support for near-term lodging demand in the U.S.

Underlying demand patterns

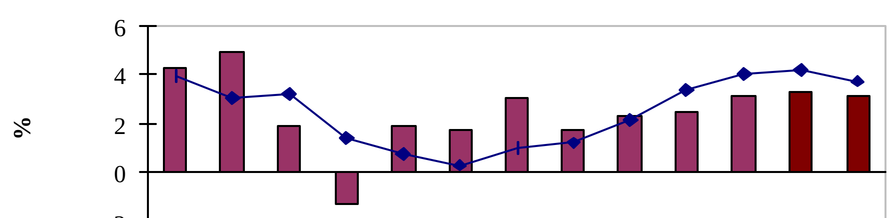
While the demand outlook remains solid, there has been a growing concern among industry observers with respect to the "changing demand patterns" observed in recent quarters. One change involves the increase in conferences and conventions at hotels in business districts. Many hotel operators have reported that more rooms are now being sold to lower-paying conferences, conventions and group attendees rather than the high paying free and independent travelers. The conference and group attendees often spend more on food, beverages and other catering functions that tend to have significantly lower profit margins than nightly room rentals. In addition, hotel operators also observed that conventions and groups consist of a smaller number of people, and the rooms are being booked much later. The shift in revenue mix and customer profile, coupled with a change in booking pattern, results in a reduced gross profit margin for most lodging companies.

Another trend currently affecting lodging demand is that companies have become increasingly aggressive when trying to secure corporate lodging rates from major hotel companies. Based on the survey of Fortune 500 companies conducted by American Express in July 1999, the largest corporate travel expenditures are airfare (44%), hotels (22%), food (13%) and car rentals (8%). Since the late 1980s, companies have been very successful in negotiating with airlines to achieve reduced corporate fares. American Express confirmed that companies are now beginning to focus on reducing hotel expenditures. If corporations are as successful in negotiating reduced rates with hotel companies as they have been with airlines, RevPAR growth at hotel chains in the Upper Upscale market, which tends to cater to corporate business travelers, will surely be slowed.

Supply: Overbuilding slowing but not completely halted

While a demand outlook remains solid given the expected future economic growth, supply has been the “wild card” when assessing lodging industry fundamentals. Starting in late 1997, supply outpaced demand for the first time in six years (see chart below), resulting in a deceleration of RevPAR across various lodging segments. Since that time, more new supply has been added to the market and hotel companies have reported significantly reduced RevPAR growth. Current data continues to suggest that supply growth will remain abnormally high relative to demand, and it may be another 18-24 months until there is a significant deceleration in the amount of supply added to the major markets.

Supply-Demand Growth in the U.S. Lodging Industry

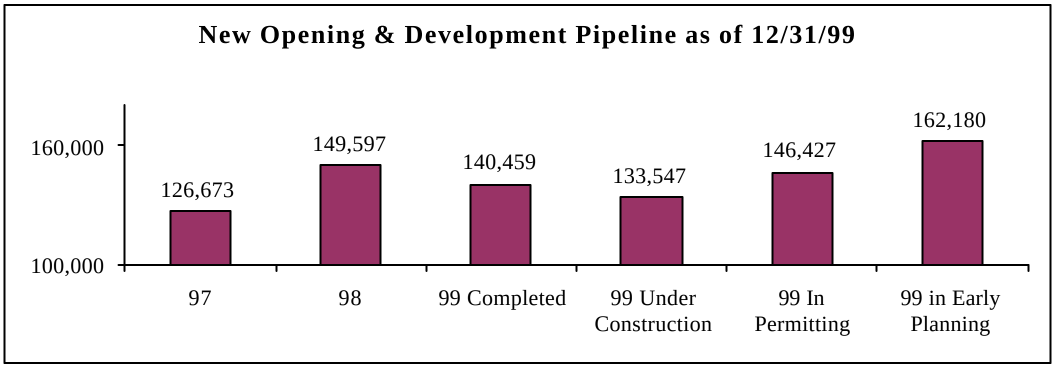


	88	89	90	91	92	93	94	95	96	97	98	99	00E
Chg.Demand %	4.3	4.9	1.9	-1.3	1.9	1.7	3.0	1.7	2.3	2.5	3.1	3.3	3.1
Chg. Supply %	3.9	3.0	3.2	1.4	0.7	0.3	1.0	1.2	2.1	3.4	4.0	4.2	3.7

(Source: Smith Travel Novermber 1999 & Salomon Smith Barney March 2000)

Lodging Econometrics released data in March 2000 showing the pipeline of domestic lodging rooms as of 12/31/99, indicating that the total pipeline of yet-to-open hotels rooms nationally was approximately 442,154 rooms, or 11.5% of the number of existing domestic rooms. Breaking the national pipeline of yet-to-open rooms into their three primary components, *rooms under construction (135,790)*, *permits pending (146,427)*, and *rooms in early planning*

(162,180), the report suggests resurgence in hotel construction activity in late 1999/ early 2000. This resurgence is a reaction to the credit crunch of late 1998 and the first half of 1999 that severely slowed lodging construction. Given the above pipeline and the current supply-demand environment, we believe that the aggregate increase in gross new hotel rooms will be close to 4.2% of the installed base for full-year 1999. The most dramatic change for the December 1999 data is the surge of new construction in the upscale and luxury/first class segments, which in total spiked up 7% as of 12/31/99. The limited service hotel sector continues to suffer from overbuilding, a trend that continues to worsen each quarter.



(Source: Lodging Econometrics March 2000, Deutsche Banc Alex Brown March 2000)

How Severe is the Current Imbalance of Demand and Supply?

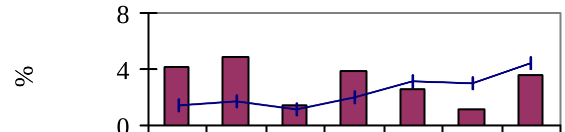
The Time is Different

The current hotel building cycle is different from past ones. In the past, there have been distinct patterns of boom and bust; significant increases in hotel room supply were almost always followed by a complete shutdown in development. This time, there appears to be an extended period of steady supply additions, with the potential for the net build up to be more significant than in previous cycles.

Segment Variation

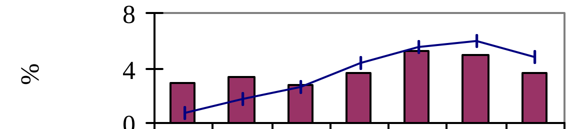
Almost all hotel segments have experienced oversupply in the past two years, with the most substantial increase in the limited service and upscale hotel segments. The exceptional RevPAR growth performance in 1997 and 1998 in the luxury, or upper-upscale, segment has attracted more developers and began to show signs of overbuilding in 1998 and 1999.

Supply & Demand: Luxury Segment



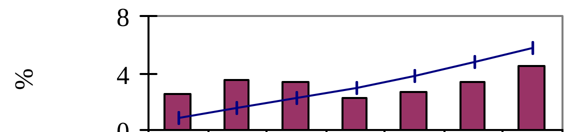
	93	94	95	96	97	98	99
Demand %	4.1	4.8	1.5	3.9	2.6	1.2	3.6
Supply %	1.5	1.7	1.1	2.0	3.1	3.0	4.5

Supply & Demand: Upscale Segment



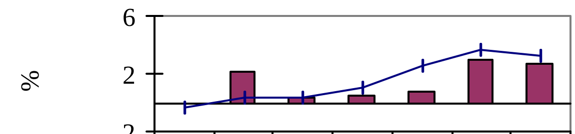
	93	94	95	96	97	98	99
Demand %	2.9	3.4	2.7	3.6	5.2	5.0	3.6
Supply %	0.8	1.7	2.6	4.3	5.5	6.0	4.8

Supply & Demand: Mid-Price Segment



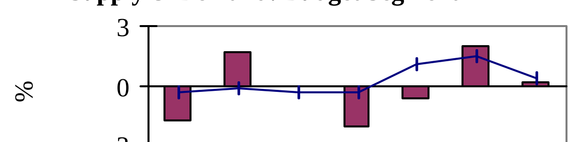
	93	94	95	96	97	98	99
Demand %	2.5	3.5	3.3	2.3	2.7	3.3	4.5
Supply %	0.9	1.5	2.2	3.0	3.8	4.8	5.8

Supply & Demand: Economy Segment



	93	94	95	96	97	98	99
Demand %	-0.1	2.1	0.4	0.5	0.8	2.9	2.7
Supply %	-0.3	0.3	0.3	1.1	2.6	3.7	3.3

Supply & Demand: Budget Segment



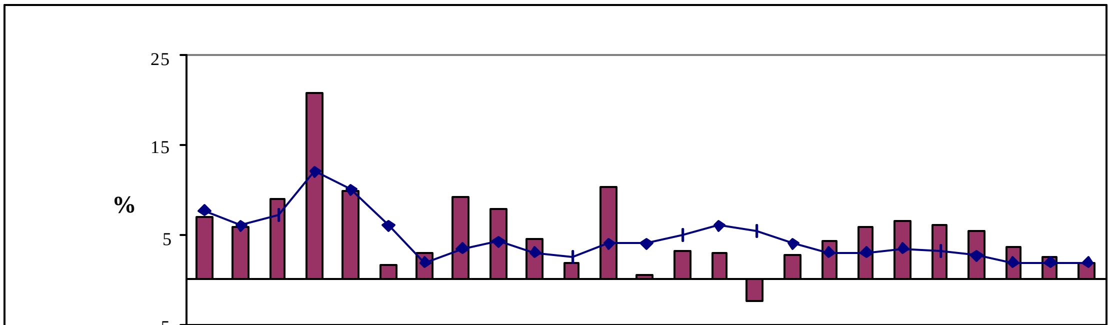
	93	94	95	96	97	98	99
Demand %	-1.8	1.7	0.0	-2.1	-0.7	2.0	0.2
Supply %	-0.4	-0.2	-0.4	-0.4	1.1	1.5	0.4

(Source: Lodging Econometrics March 2000, Deutsche Banc Alex Brown March 2000)

Stagnant RevPAR Growth

The most devastating consequence resulting from a supply-demand imbalance is stagnant RevPAR growth. RevPAR growth, the "same-store sales growth" of the lodging industry, is the most critical determinant of a hotel's operating performance. It is comprised of two figures: occupancy and average daily room rate (ADR). As illustrated in the below chart, RevPAR has showed steady growth since late 1992, but has declined substantially in recent year. RevPAR growth in the luxury segment was only expected to be 3.5% in both 1999 and 2000, but is predicted to increase to 5% in 2001. RevPAR growth in this lucrative segment peaked in 1996 at 10.3%.

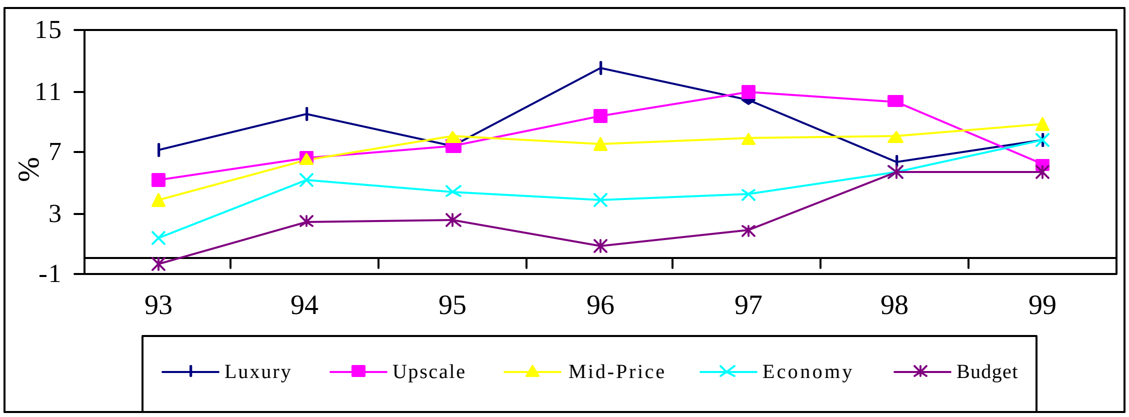
Overall RevPAR Growth



	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99E	00E
RevPAR %	6.9	5.9	9.1	20.8	9.8	1.7	2.9	9.1	7.8	4.5	1.9	10.2	0.5	3.2	2.9	-2.5	2.7	4.2	5.9	6.6	6.2	5.4	3.6	2.4	2.0
Inflation %	7.7	6.0	7.2	12.0	10.0	6.0	2.0	3.5	4.2	3.0	2.5	4.0	4.0	5.0	6.0	5.5	4.0	3.0	3.0	3.5	3.2	2.7	2.0	2.0	2.0

(Smith Travel May 1999)

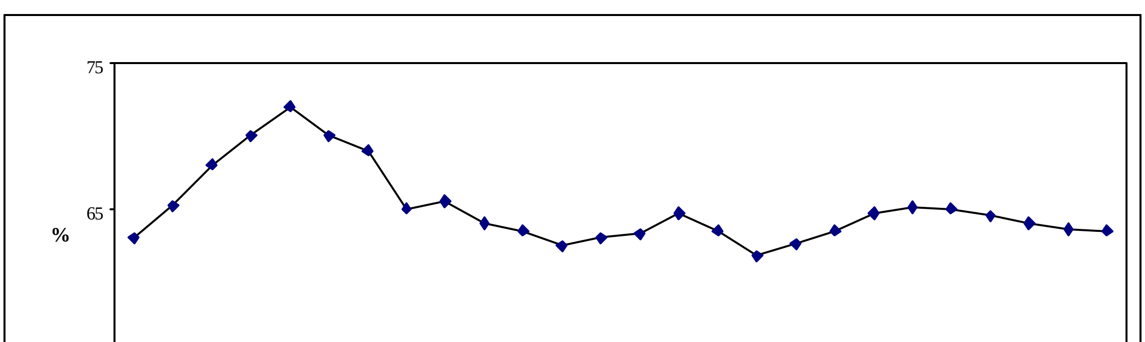
RevPAR Growth By Segment *



(Smith Travel March 2000, Deutsche Banc Alex Brown)
(Data prior to 93 are not available for segmentation analysis.)

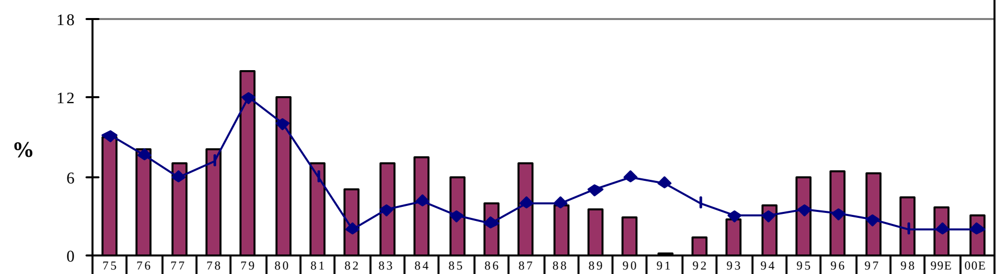
The ultimate result of oversupply is a decrease in overall occupancy, which has occurred over the past two years. As a result of strong economic growth, most hotels were able to raise their average daily room rates to compensate for decreasing occupancy levels and maintain respectable RevPAR growth. However, hotel companies have recently lost a portion of their pricing power due to persistent oversupply pressures. The decline in both room price increases and occupancy levels have drastically affected lodging industry profits.

Occupancy



	75	76	77	78	79	80	81	82	83	84	85	86	87	88	89	90	91	92	93	94	95	96	97	98	99E	00E
%	63.0	65.2	68.0	70.0	72.0	70.0	69.0	65.0	65.5	64.0	63.5	62.5	63.0	63.3	64.7	63.5	61.8	62.6	63.5	64.7	65.1	65.0	64.5	64.0	63.6	63.5

Average Daily Room Rate (ADR)



	75	76	77	78	79	80	81	82	83	84	85	86	87
ADR %	9.0	8.0	7.0	8.0	14.0	12.0	7.0	5.0	7.0	7.4	6.0	4.0	7.0
Inflation %	9.1	7.7	6.0	7.2	12.0	10.0	6.0	2.0	3.5	4.2	3.0	2.5	4.0

	88	89	90	91	92	93	94	95	96	97	98	99E	00E
ADR %	3.8	3.5	2.9	0.2	1.4	2.7	3.8	6.0	6.4	6.2	4.4	3.6	3.0
Inflation %	4.0	5.0	6.0	5.5	4.0	3.0	3.0	3.5	3.2	2.7	2.0	2.0	2.0

(Smith Travel May 1999)

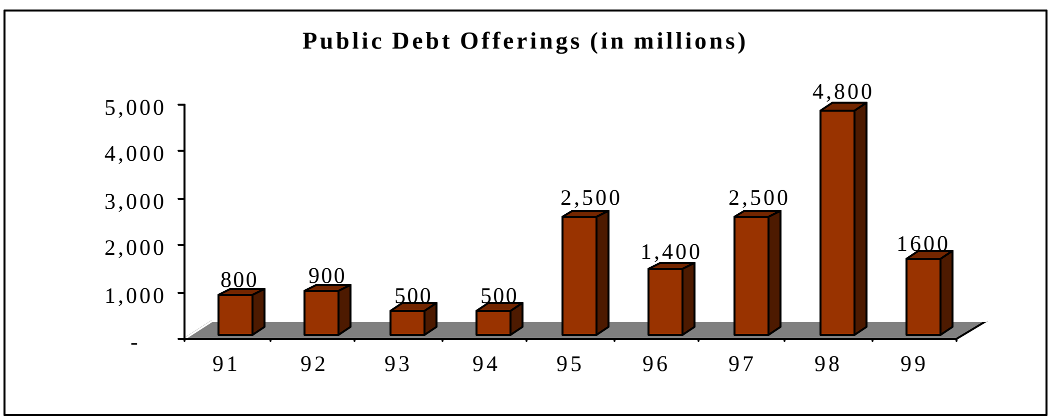
Near-term RevPAR Outlook

Looking forward, RevPAR trends will continue to slow throughout 2000. The deceleration may be more moderate, but the overwhelming impact of increased supply will continue to pressure room rates and occupancy levels. Hotel operators are finding it difficult to implement price increase when competitors continue to saturate regional markets.

While total supply additions in this cycle may be less than additions of the late 1980s and early 1990s, development plans will be well extended in 2000 and early 2001. While supply growth may slow, it will not completely end, since it appears no outside catalyst (i.e. economic recession) will shut down construction completely.

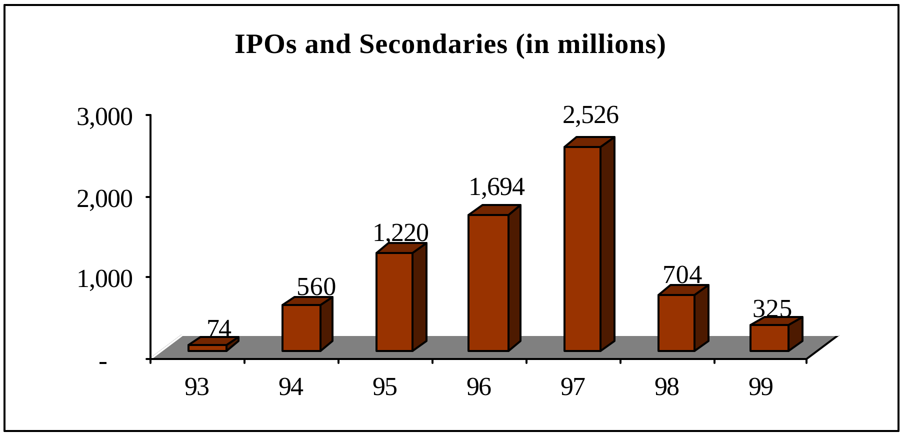
Capital Markets

The lodging sector enjoyed tremendous capital inflow from early 1995 to the first part of 1998. With the rapid development of the debt market for real estate investment, many companies started to borrow aggressively to fund M&A activities.



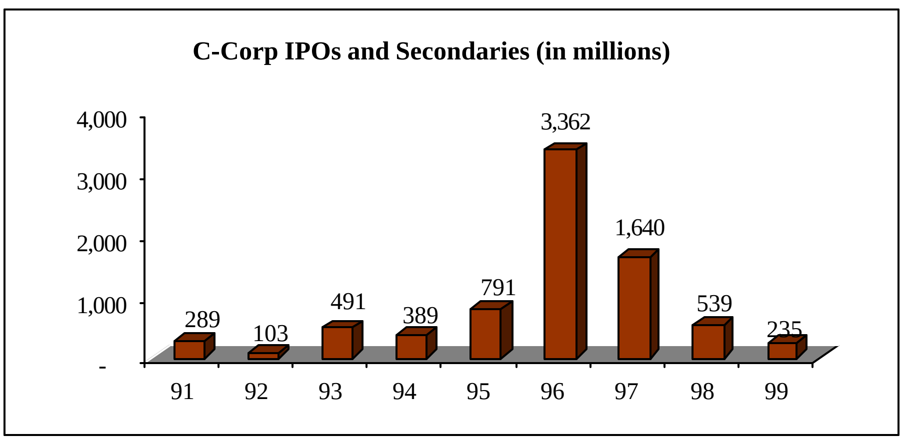
Additionally, the investment community began to embrace the lodging industry as a "high-growth" sector, resulting in a number of extremely high-priced lodging stocks in mid 1990s. For both REITs and C-corps, 1993-1997 represented one of the greatest boom markets for real estate valuation.

REITs



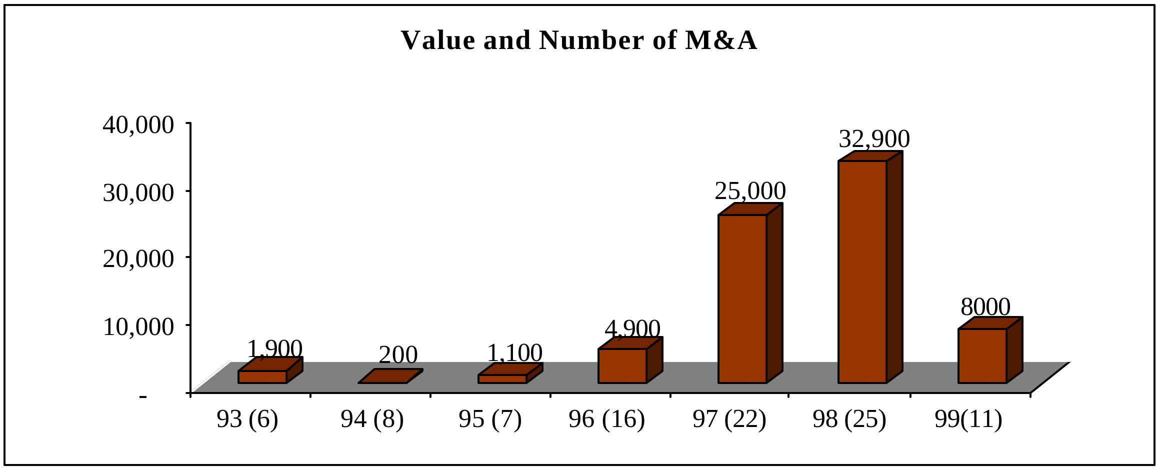
(Source: Lodging Econometrics: 93-98 data, Solomon Smith Barney: 99 data)

C-Corps



(Source: Lodging Econometrics: 93-98 data, Solomon Smith Barney: 99 data)

M&A lodging transactions hit a high in 1998 with regard to both the number and size of deals. The industry average selling price was a record $89,097 per room, a 13% increase over 1997. The 1998 selling price was more than triple the cyclical low established in 1992 ($37,904/ room). The surge of average selling price was most prominent in the luxury segment where average price per room reached $137,081/ room, a 40% increase over 1997.



(Source: Lodging Econometrics: 93-98 data, Solomon Smith Barney: 99 data)

The liquidity crunch stemming from the Asia crisis of 1998 turned investor sentiment against both the REITs and C-corps almost overnight. The markets showed no sign of recovery for most of 1999, and companies were forced to turn to traditional sources for future construction prospects and M&A financing.

Impact of the Internet

Lodging has always been perceived as a low-tech industry. The introduction of 1-800 numbers in early 1980s was a technological innovation that turned out to be an outstanding distribution vehicle for hotels and drastically changed the competitive landscape of the business. The adaptation of the 1-800 system standardized booking procedures and laid the groundwork for the "super reservation system". Even more importantly, it enabled lodging companies to reduce their reliance on travel agents and regain the power that was stripped from them in the 1960s and 1970s.

How are lodging companies to deal with the internet phenomenon of today? Will they be able to duplicate the results of the introduction of the 1-800 number, or will companies fall behind their airline peers in embracing internet as a power tool? While lodging companies have fought hard to maintain control over their own customer base, the “e-middlemen” are rapidly affecting the way consumers book hotel rooms.

Realizing that the internet has emerged as a major player in dealing with both of corporate and retail clients, lodging companies have acted quickly and signed up various marketing agreements with portals such as Yahoo, and popular travel websites such as Expedite, Priceline, and Cheapticket. While these internet alliances are generating hype and gaining recognition for their efforts by Wall Street, most major lodging companies feel uncomfortable giving up direct customer interaction. Many companies are now attempting to develop their own e-booking facilities. It would not be a surprise if a handful of major lodging chains came together and formed an integrated on-line e-booking system, as is currently happening in the on-line music and airline industry.

Starwood Hotels and Resorts Worldwide, Inc.

Starwood Hotels & Resorts

Company Overview

Starwood Hotels and Resorts is one of the world's largest lodging companies, measured by both number of rooms and annual lodging revenue. Starwood operates approximately 700 hotels in 72 countries with over 220,000 rooms. The firm operates these hotels primarily under such brands as Sheraton, Westin, St. Regis/ Luxury Collection, W, and Four Points.

Until January 1999, the company was structured and taxed as a paired share Real Estate Investment Trust (REIT). This advantageous structure provided the firm with added purchasing leverage. This leverage facilitated the purchase of Westin properties in 1997 and proved to be pivotal in allowing the firm to win the highly publicized battle for the lucrative ITT portfolio in 1998. In 1999, Changes in legislation closed the tax loophole that allowed Starwood to remain grandfathered under the paired share REIT structure. As a result of these changes in the code, Starwood decided to deREIT altogether and become a C-Corp in order to be able to retain earnings while managing its own properties and the properties of others.

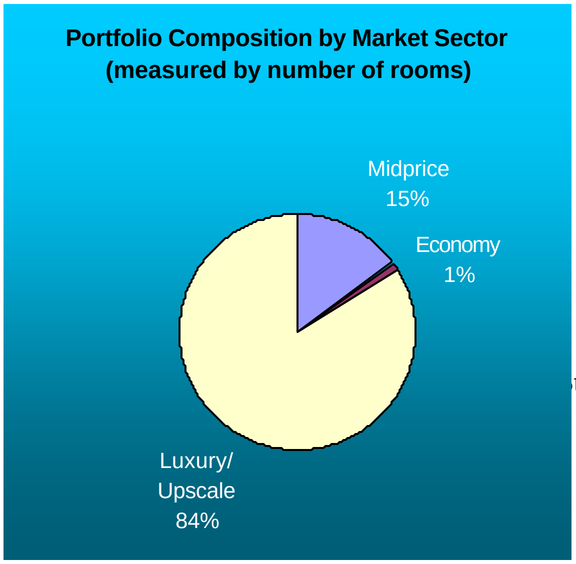
After acquiring ITT's vast portfolio for 14.8 billion dollars, Starwood's intent to concentrate on the lodging business has fueled the sales of ITT's non-core assets. Most notable among these sales are those of Caesars Casinos and minority interests in Madison Square Garden.

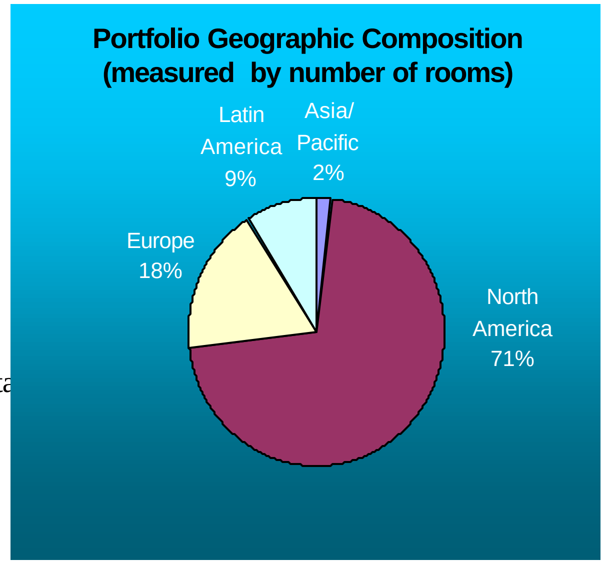
These transactions eliminated Starwood's exposure to highly volatile businesses and resulted in proceeds of more than $3.5 billion that could be used to pay down debt. By reducing its debt, Starwood is able to reduce its borrowing cost, with the hopes of reaching investment grade. Having extra cash form these sales together with the lowering of the cost of raising future capital would allow the firm to accelerate its hotel renovation and re-flagging program.

As of March 31, 1999, the 694 hotels in Starwood's portfolio are divided as follows: approximately 29% are owned/leased, 28% are under management contracts, and 41% are franchised. The three segments are evenly spilt on the basis of total room units. In 1998, owned/leased hotels contributed to over 90% of company's total revenue while the combined revenues of management fees and franchisee fees accounted for 7%.

# of Hotels	Owned/ Leased/ Consolidated	Managed	Franchised	#Hotels/ Concept	# Rooms/ Concept
Sheraton	75	128	158	315	120,881
Westin	36	39	29	113	44,398
Four Points	7	4	90	101	19,522
LuxCol & CIGA	39	16	2	53	14,316
Independent	18	5	13	36	11,806
Other	28	5	---	33	8,469
W	2	---	---	2	991
Total	205	197	292	694	220,388
% Revenue	**90%**	**4%**	**3%**	**98%**	**98%**
% EBITDA	**80%**	**14%**	**2%**	**96%**	**96%**

The portfolio is overweight in the upscale and luxury sectors of the market. It is also geographically diversified with just under a third of its room outside the North American continent.





Source: Company Data

<u>Sheraton:</u> Sheraton is one of the world's most recognized three/four-star full service hotel chains, accounting for 58% of Starwood's portfolio as measured based on number of rooms. Its core customers are nearly evenly divided between business, leisure, and group business. Internationally, Sheraton properties are considered to be of high quality, however, domestically, its reputation for having sub-par and inconsistent quality grew during the ITT period.

In 1998, Sheraton achieved an average occupancy rate of 70.4%, an average daily room rate of \$155.50, and RevPAR of \$109.50 (a 7.2% increase from 1997).

<u>Westin</u>: In the 1997 and 1998 annual survey conducted by Frequent Flyer Magazine and Business Travel News, Westin was ranked first and second, respectively, in the best full-service upscale lodging category. The acquisition of Westin Hotels presented Starwood with an extensive expansion plan and great growth opportunities. Currently the Westin brand composes 21% of Starwood's portfolio.

In 1998, Westin achieved an average occupancy rate of 72.1%, an average daily room rate of \$133.05, and RevPAR of \$95.93 (an 8.4% increase from 1997).

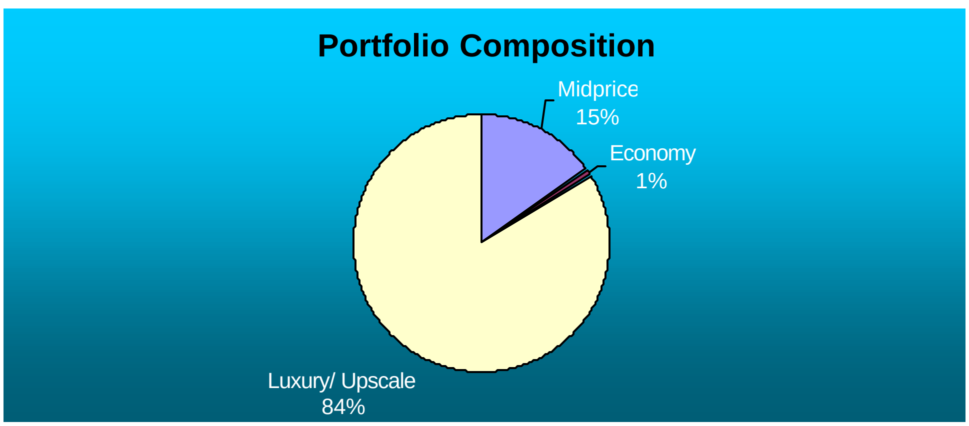
<u>Four Points</u>: During the ITT period, the Four Point concept was introduced to the market as a brand competitive with Marriott Courtyard. Four Points Hotels are full-service, mid-priced properties that Starwood is looking to grow through global franchising. Currently Four points properties make up 7% of Starwood's portfolio.

No occupancy rates, average daily room rates or RevPAR have been released.

St. Regis/ Luxury Collection: Starwood is moving toward establishing St. Regis as its five-star luxury brand and is considering conversion of several Sheraton luxury properties into branded St. Regis Hotels. Starwood currently operates 3 St. Regis hotels with plans to have 5 by the end of the summer and perhaps 20 by the end of 2000. Starwood's goal for St. Regis is to build a brand to compete head to head with Four Seasons and Ritz Carlton in the most lucrative lodging segment. Other luxury properties include those acquired in Europe from Cigna. These properties, most heavily weighted in Italy, are typically of museum quality and have performed exceptionally well in terms of both RevPar and EBITDA growth.

The St. Regis / Luxury collection currently makes up 7% of the Starwood's portfolio. In 1998, the St. Regis/ Luxury Collection achieved an average occupancy rate of 71%, an average daily room rate of $290, and RevPAR of $206.00 (a 17% increase from 1997).

W Hotels: The renovation and conversion of the Doral Inn in NYC to a W Hotel in November 1998 marked the debut of a new four-star, upscale chain for Starwood. Positioned as a "boutique" hotel, W targets business travelers looking for a residential feel. Starwood expects to grow the W chain mainly by refurbishing and converting existing Starwood-owned properties. W Hotels represent one of the fastest-growing revenue streams for the company, and expects to open 12 W Hotels by the second quarter of 2000, adding over 4,000 rooms systemwide. Currently W hotels make up less than 3% of Starwood's portfolio.



Source: Company Data

Current Company Strategies and Opportunities

Starwood controls some of the most attractive assets in the lodging business.
With the acquisition of Westin Hotels (cost = $1.8 billion) and ITT Corporation (cost = $14.8 billion) in 1998, Starwood created the world's sixth largest lodging organization in terms of number of rooms. As of June 30, 1999, Starwood's portfolio of owned, managed, and franchised hotels totaled 695 properties with 213,268 rooms. Most importantly, approximately 84% of Starwood's EBITDA is derived from property positioned in the luxury/upscale segment.

Starwood will realize proceeds of more than $3.5 billion from the sale of its non-core assets.
During Q2:99 Starwood announced the sale of several assets including Caesars (4/99), the Westin Central Park South (7/99), and a stake in Madison Square Garden (4/99). These sales will reduce Starwood's leverage and eliminate earnings volatility associated with gaming operations. In

addition, becoming a pure play in the lodging industry will allow management to focus on Starwood's core lodging business.

Occupancy to benefit from recently launched frequent guest program.
In February Starwood launched a new frequent guest program, Starwood Preferred Guest (SPG), which allows guests to earn points and redeem awards at any hotel within Starwood's portfolio. On June 7th, USA Today published a business traveler survey that ranked Starwood Preferred Guest the No. 1 program for its no-black-out dates and simplicity. To date, enrollment has exceeded 1.4 million members worldwide. Management hopes that the program can help raise its occupancy rates by 2% by the end of 2000.

Aggressive internal capital spending program will boost ADR and RevPAR.
Over the next 3 years, Starwood is expected to achieve at least 3% ADR gain, in part, due to its remodeling/reflagging programs. Starwood's owned hotel portfolio has substantial upside potential for ADR growth, given the fact that a number of these properties were inadequately managed when they were owned by ITT during the period from 1995-1997. According to management, the return on investment for a typical remodel averages approximately 20% with a 3-5% boost in RevPAR on an annualized basis.

Starwood should soon realize significant economies of scale by consolidating management and operating activities at the Westin and ITT chains.
Over the next 3 years, we expect EBITDA margins to increase by 150 basis points to 33% for company-owned units. During the Q2:99 conference call, management suggested that its effort to realize vertical integration synergies was only 40-50% completed. We think the potential for merger benefits will enhance earnings prospects for the next 3 years.

Focus on management contracts and franchising should benefit margins.
Third-party management gives Starwood the exclusive right to direct the operations of a property. Sheraton, Westin and Four Points all have well-established management/franchise networks in place. Starwood is aiming to increase its management and franchise fee income in 1999 by $35 million and $65 million, respectively. The incremental revenue increase from its management/ franchise business is favorable to EBITDA growth and margins.

Timeshare business is becoming a new focus point for growth.
Unlike Marriott, Hilton, and Hyatt, which all have meaningful timeshare businesses, Starwood had no material exposure in timeshare or golf resorts until its most recent acquisition of Vistana (VSTN) in July 1999. Starwood is highlighting timeshares and golf resorts as a focal point for growth, and it intends to explore opportunities by capitalizing on its vast resort network and hotel portfolio.

Starwood's strong existing infrastructure should lead to significant international growth opportunities.
We are impressed by Starwood's exposure to international markets, as it possesses some of the most well positioned properties worldwide. In Europe, Starwood has 105 hotels in total, with the biggest exposure in Italy (29 hotels), followed by the UK (7 hotels). In Asia, there are 64 properties in the Starwood portfolio, with the biggest concentration in Australia/ New Zealand (11 properties). Starwood also has 24 properties in Africa, 6 in India, and 15 in the Middle East, which all are under the Sheraton brand. In Latin America, Starwood has 33 hotels, with 70% of its guests in Latin America are from the United States, Europe and Mexico. Starwood's growth in these international markets regions will be primarily due to the expansion of management and franchise contracts.

Current Business Risks and Problems

Thin Management is our primary concern for Starwood.
Starwood has a relatively short corporate history, and the operation of the hotel business relies heavily on a few key people. With the frequent personnel changes at its senior management level for the past two years, we remain cautious on the near term prospect of the company. The most recent resignation of Fred Kleisner, President of North American Operations in July 1999 and Juden Bertul, President of Worldwide Hotel Group in November 1999 fuelled more speculation on the structure of the senior management team. The February 2000 article on Business Week criticizing the lack of independence on Starwood's board further damages Starwood's image as a public company

Integration can be challenging.
Starwood's ability to successfully integrate its owned hotels with the Westin and ITT portfolio remains to be seen. The company has completed a period of major acquisitions and corporate restructuring, so any number of unknown risks exists as the company's management integrates operations under the new C-Corp structure.

Accelerating supply growth affects its RevPAR growth.
According to Smith Travel Research, U.S. hotel supply grew by 4% in the first six months of 1999, adding 138,299 new rooms, well above the historical average of 88,709 rooms per year. Nearly 75% of the new rooms are in the upscale to mid-scale full service segments. Although the construction of new full-service hotels has remained under control in most of Starwood's core markets, accelerated construction have already shown negative affect on the recent performance of Starwood. After posting 6.1% and 7.6% RevPAR growth in 1997 and 1998, Starwood were only able to deliver 3.1% comparable hotels RevPAR growth in 1999.

Recommendations for Starwood to Increase Shareholder Value

Reduce Barry Sternlicht's operational influence, clarify management focus
Starwood CEO Barry Sternlicht has proven to be a great visionary as far as compiling the Starwood portfolio and positioning that portfolio. His lack of ability to retain key talent, his reputation for being difficult to work with, and the replacement of top management has all shaken investor confidence and thus kept Starwood's price depressed. Under the ideal situation Barry Sternlicht would be removed and the leadership of the firm would go to someone who would provide a clearer sign of where management is going and who would place a larger priority on the effective and economically maximizing operation of the firm's portfolio. If this extreme could not be achieved politically within the firm then at the least a redefinition of the roles of senior management with a strong Chief Operating Officer might be the best alternative to remove some of the drag on the firm's stock.

Continue disposition of non-core assets and integrate portfolio while maintaining a focused underlining theme.
The firm should focus on the operation of its valuable portfolio of core assets since even the best assets in the world when mismanaged will not produce economic gains. Efforts to focus the firm's energy's on the proper operation of its assets are aided by the disposition of non-core assets that by definition do not fit within the firm's core competencies.

Starwood should continue non-lodging properties in the manner in which it has, but should also expand its efforts to include the divestiture of the time-share business. While the opportunities in this business appear attractive, investors that want to be exposed to the time-share business would prefer to diversify themselves by investing in a pure lodging play and a pure time-share play with the relative weights they desire. Attempts by Starwood to be everything to everyone are more likely to hold back the stock price than to help it. As such, divesting the time-share business would likely prove to be a boost for the firm's stock.

Integrate Portfolio to achieve synergies.
It is clear that Starwood's portfolio is nowhere near being truly integrated when one learns that given current operations, for example, there is no institutionalized way for a reservations agent for a Sheraton hotel with no available rooms to transfer customers to a Westin hotel in the same city where rooms might be available. Also showing lack of synergistic integration is that these two hotels serve similar market sectors yet use different suppliers to do so. A full integration of the portfolio would do away with this sort of inefficiencies and thus allow for improvements on the revenue side and on the cost side. In both cases the share price would benefit. On the other hand, pursuing too rapid external growth before this integration has taken place only undermines the solidity of the foundation on which future expansions are to be buttressed for which the Street would penalize the firm.

One brand strategy: What is Starwood to consumers?
The firm should concentrate on eliminating disparity across properties and on setting a clear picture to consumers on what they can expect from the different type of Starwood hotels. While admittedly it is strategically useful not to have every hotel positioned in the same manner it would be beneficial to have an underlying level of quality, reliability and customer service that is unmatched within each specific sector. This strategy, coupled with one that makes consumers aware of the vast worldwide scope of Starwood properties, would engender enhanced loyalty not to one specific hotel but to the portfolio. This would be ideal because it would be much easier for the firm to benefit from the loyalty of consumers to the entire Starwood instead of one particular brand since in the case where the loyalty is to the portfolio Starwood would be able to cross-sell across different geographic markets and different price points.

Expand Commitment to Internet Strategy
A commitment to a comprehensive internet strategy benefits Starwood at many levels and the firm has already shown significant commitment to its internet strategy. Leveraging the internet helps the firm to implement a one brand strategy. Starwood.com makes it easy for customers to see the firm's entire portfolio of assets and gain an understanding and develop a loyalty to the brand if they are served well by it. Customer loyalty can also be enhanced as customers use Starwood loyalty points to make reservations at any hotel in the portfolio. Amplifying the incentives provided to customers to make reservations online will reduce Starwood's cost structure since current studies show that reservations made on the internet only cost a few cents,

while those made through an agent cost several dollars. As more consumers adopt the internet to make reservations, the firm's margins would undoubtedly improve. Another way in which the internet can reduce the firm's costs is by making relationships with hospitality product B-to-B suppliers such as ehospitality.com. On the revenue side, specifically in terms of generating ancillary revenue, Starwood would also find benefit in integrating the internet to offer business services in the hotels to its prominent business class of customers.

FelCor Lodging Trust

In analyzing Felcor, it is important to note that fundamentally, they are a good company with considerable potential. Unfortunately, like many other quality REITs today, Felcor has not received full valuation credit for the quality of its core attributes in the public market. To achieve a better understanding of Felcor, we will first look at an overview of the company and its financial state; thereafter, we will examine the core assets in the Felcor portfolio, the strategic approach that they have been taking, the core problems facing the company of late, and our recommendations for what steps the company can take to improve their strategic positioning in the market and their perception among investors.

Overview and Financials

Felcor is one of the nation's largest hotel REITs. Their portfolio is primarily concentrated in the upscale and full-service segments, with 188 hotels and nearly 50,000 rooms located in 34 states and Canada. Felcor hotels include some of the best-known brands to consumers, and some of the brands most appreciated by business travelers. Today, Felcor has a market capitalization in excess of $1.2 billion.

Felcor's beginnings were as a private company owning a few properties in the Southern United States. Since their public offering in 1994, the company has looked to acquire hotels at below replacement cost when possible, and renovating these properties to improve their REVPAR. By expanding and developing key brands, as well as re-branding and refurbishing under-performing properties, Felcor has built a strong portfolio in a number of high growth markets.

Because of their REIT status, Felcor is not able to both own and manage its properties. In response to this, Felcor has effectively built one of the most effective asset management teams in the industry, creating strong strategic relationships with the most respected names in the game, including Hilton, Bass, Bristol, and Promus. The strong relationships have allowed Felcor to maximize value in their diverse asset portfolio.

In addition to these strategic factors, Felcor also has an auspicious financial condition. The company has nearly $4.5 billion in assets, and their leverage ratios are relatively low, always adhering to a self imposed 40% cap on their indebtedness to total hotel asset value ratio. From a credit perspective, Felcor's EBITDA interest coverage ratio is a solid 3.5x, and their fixed charge coverage ratio nearly 3.0x. Felcor's long-term liability to book capital ratio is still only 50%, very solid by industry standards. Moreover, their access to capital is strong, as they recently secured a $1.1 billion credit facility to finance projects going forward.

The company increased FFO by 30% in the last year, and revenues by almost 50%. Although their growth on a per share basis has been less dramatic, the company's strategic and financial growth have continued jointly. Another boon to shareholders has been Felcor's aggressive dividend policy, with a yield approaching 14%. This steady performance, along with projected growth in CAPEX and appropriate measures to maintain the financial structure of the company, should keep Felcor healthy well into the future.

Brands and Relationships

Felcor, in the process of buying undervalued properties and repositioning them to increase their value, has developed a number of key brands whose name and reputation alone can improve the value of an existing asset. These brands include Embassy Suites, Doubletree, Holiday Inn, and

Crowne Plaza. These hotel brands all lie in the upscale and traditional full service segments, from which Felcor derives 95% of its revenues. Geographically, though Felcor does cover 34 states and Canada, the majority of its properties are in the high growth states of Florida, Texas, California, and Georgia.

Felcor's strategic relationships are a key to its success, as the ability to generate revenue and extract value from its strong asset portfolio is a function of its managers' abilities to optimize performance. Its biggest relationship is with Hilton (post Promus merger), who is recognized internationally as one of the preeminent hospitality companies. Similarly, their relationship with Bass links them with the top hospitality manager in the United Kingdom. Their relationship with Bristol, resulting from the 1998 merger of the companies, has led to a joint effort to acquire hotels under the Bass brand. Other key Brand Owner/Manager relationships have been established with Starwood (through the Sheraton and Westin brands).

Overall Strategy

Felcor has employed multiple strategies in an attempt to increase shareholder value, but a few of their strategies stand out as essential to any future efforts to bolster the flagging stock price. The key strategies have been refocusing on internal brand management and key brands, focusing on core assets and disposing of non-core ones, and continuously maintaining and improving their capital structure through debt and share repurchases.

Felcor has built its impressive portfolio of assets by a series of large external acquisitions
Most notably, they recently acquired the real estate assets of Bristol, which brought them several valuable properties as well as their strategic relationship with Bass. At present, Felcor has a renewed focus on developing their brands internally to increase the value proposition through renovation and repositioning. Hopefully, this strategy will help Felcor to, among other things, boost ADR and occupancy in many of its chains. The company has spent $340 million on this in the last few years, with another $40 million budgeted in this year to finish the job.

The reality of this trend can be seen in the below chart listing the net hotel acquisitions by Felcor in the last few years:

Acquired (Disposed) hotels

1994	7
1995	13
1996	23
1997	30
1998	120
1999	-6
Total	187

Focusing on core brand names is essential.
The two brands Felcor currently emphasizes are Embassy Suites (37% of rental revenue) and Crowne Plaza (33% of rental revenue). These two brands have always been received positively by business and individual travelers, and Felcor has searched through its myriad of brands to determine that these two have the greatest chances of success in the middle to luxury segment.

Disposition of non-core assets must occur to keep the bottom line from eroding.
Related to the aforementioned strategy is the initiative to dispose of non-core hotel assets. Felcor has attempted to trim down its portfolio to increase its own efficiency, as well as to modify its exposure to markets where it may be overexposed. Felcor is heavily concentrated in certain markets, and is currently taking the strategic view that it may generate more value out of those markets by reducing its holdings therein somewhat. Nearly $100 million in assets are slated for sale in 2000.

Recent stock buyback initiatives
The company is aggressively buying back shares and managing its debt levels with excess cash flow. The share buybacks are an attempt to increase value for shareholders because Felcor management feels that its shares are undervalued. Morevoer, this strategy allows the company to maintain an attractive dividend yield. Its $2.20 dividend implies an annual yield of 13%, albeit at a very conservative FFO payout ratio of 58%. In addition, Felcor has been attempting to manage its debt levels in order to maintain the perception of a conservative capital structure. Felcor received confirmation of the importance of a conservative capital structure when it recently contemplated a debt for equity swap, and the public markets and investment houses promptly downgraded its stock.

Unfortunately, the public markets have withheld credit for these strategies, and the company trades at a real discount to NAV. Management estimates that the company's NAV is in the $30 area, translating into $100,000 per room valuation for its properties. Currently, FCH's stock price ($18.7/ share) implies a value of roughly $70,000/room. (The book basis of FCH's assets is approximately 4.5 billion, significantly less than its current enterprise value of 2.9 billion). While asset prices have come down significantly over the past two years, there is still a disconnect between the market value of the company's assets and public equity valuation

Business Risks

Given the strong asset portfolio and good strategy employed by Felcor management, clearly certain problems must exist to keep Felcor's stock price down and damage their perception in the eyes of the public and the investment houses.

The first major problem is the well documented exposure to oversupplied markets. The hot markets of yesterday are the crowded markets of tomorrow, and Felcor, though having enjoyed profitability in those markets for some time, now faces a supply glut and declining margins. This is particularly poignant in Texas, which contains 23% of Felcor's portfolio, and featured flat Revpar growth last year. Until Felcor management completes an effort to reduce exposure to overcrowded markets and seek opportunity in untapped areas, the market will not give them full credit for their portfolio.

Beyond being located in crowded markets, the company is positioned in a less attractive segment. The upscale segment is considered to be the most attractive with the best margins, and Felcor has very little exposure to the segment. The market will likely give more credit if they perceive Felcor to be repositioning into the higher end segment (the current plan is to convert several of the Holiday Inn flags into Crowne Plaza labels). In their current lower service middle segment, in which Felcor has nearly half of their portfolio, there are lower barriers to entry, and margins are projected to drop even further in the coming years.

Third, the company has faced an actual internal problem, and not merely one of perception, from the recent merger of Promus and Hilton Properties. By getting less attention from their property managers, Felcor will be seeing lower returns on their assets, and may face a distraction from locating new, more dedicated managers for key properties. This is important as Felcor has nearly 40% of their portfolio under Promus management, and had planned an ambitious marketing campaign for the Promus brands this year.

Another problem for Felcor has been recent inability to generate significant RevPAR growth. Although they claimed that they are comfortable with estimates of 3%-4% RevPAR growth, the consensus appears to believe that a 1% total portfolio RevPAR growth is more realistic in 2000. While U.S. hotel construction starts have declined 13% year to date through September 1999, Felcor's markets will continue to be susceptible to overbuilding due to lower barriers to entry in these markets. If the company misses its RevPAR guidance, there will be further downward pressure on its stock price.

One final problem that was discussed earlier involves public market perception of Felcor financial management. The market drastically penalized Felcor for its attempt at a debt for equity swap (proposed share repurchase). If Felcor can credibly indicate a reversal in policy and a focus on keeping leverage low and buying back shares when strategic and appropriate, the market would likely regain considerable confidence in the team and reward them with a richer valuation.

Recommendations

There are certain steps and decisions that we feel Felcor should make to improve its strategic positioning and its perception in the public markets. Some of these recommendations may not be possible, but over the intermediate term, should improve positioning and value. First, the company should decrease its exposure to fast growing but oversupplied markets. The key for the company will be locating the hot markets of tomorrow, as many of todays have seen overbuilding and now face a glut in supply of rooms in all segments. Second, the company should attempt to reposition some brands into the high luxury segment. This is obviously the highest margin and the greatest opportunity segment, and Felcor's brands currently languish in less sexy market areas. Repositioning and upgrading might generate increased returns. Finally, the company should continue to focus on its highest value added strategic relationships, and should recognize when some of its partners, such as Promus, may have distractions preventing them from allocating sufficient time to the Felcor portfolio assets.

From a financial structure perspective, we have two recommendations. First, the company should scrap any plans to buy back stock with straight debt funding. The markets and the investment houses may like stock buybacks with excess cash flow but hate straight debt for equity swaps, and all such plans should be abandoned (Moody's downgraded them immediately upon the announcement, for example). At present, their conservative balance sheet allows a debt service coverage ratio of 3.3x and a total debt to EBITDA of 4.5x.

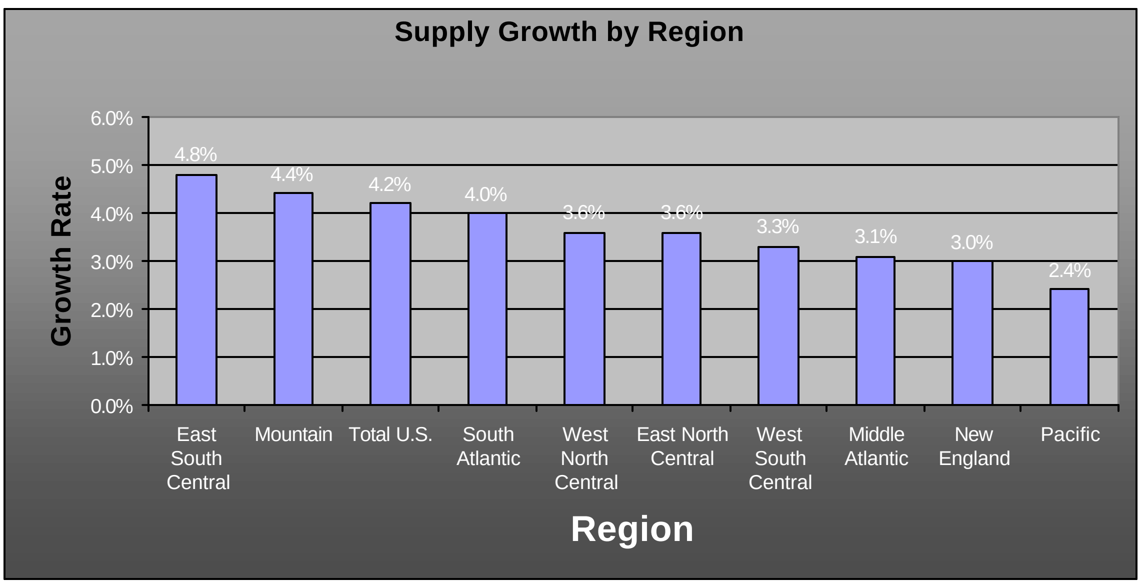
Second, the company should reduce its use of floating rate debt, even repurchasing some. The company currently has $884 million in floating rate debt, representing 48% of its outstanding debt. This debt infuses unnecessary uncertainty into the capital structure, and with Chairman Greenspan's stated proclivity towards rate hikes, might infuse costs as well.

Investment Recommendations

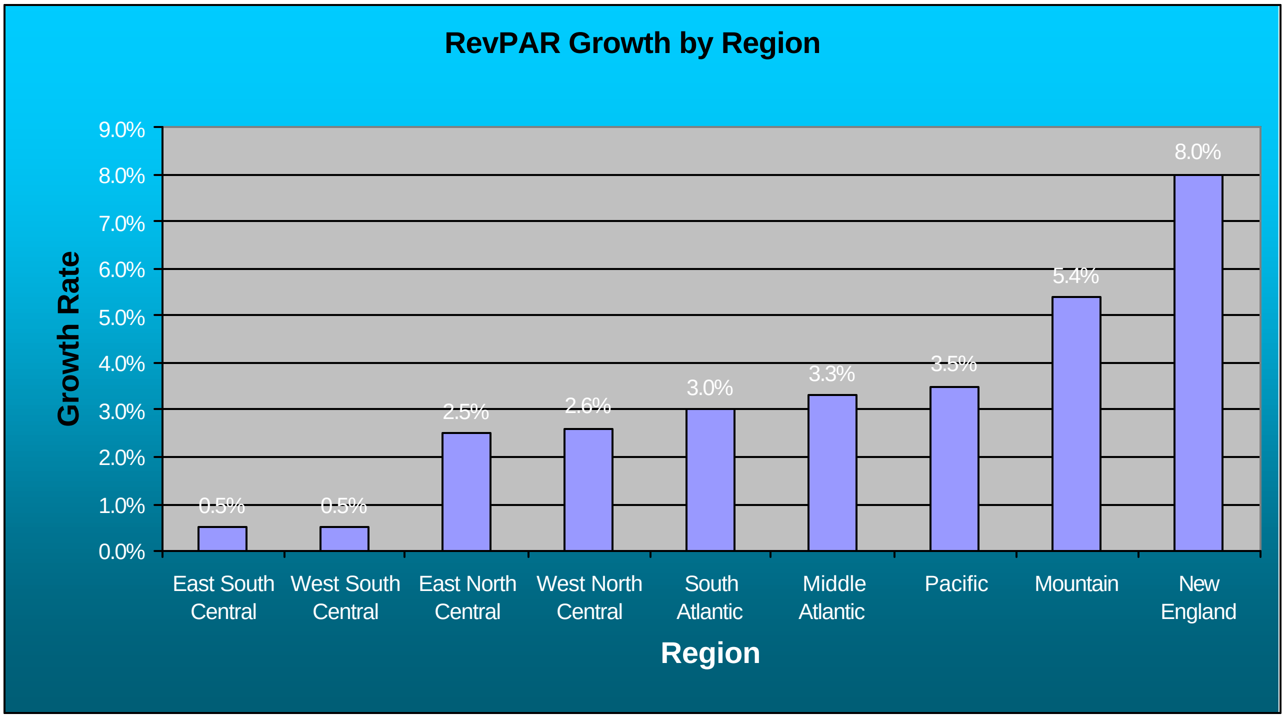
Based on the environment that we foresee for the next 2-5 years, which company is best positioned to generate the greatest economic value for investors? As the growth story in the industry the answer to this question is Starwood. The reasons for this decision are enumerated below.

Strongest Portfolio of Assets

The firm's portfolio is composed of excellent properties that have strong brands attached to them. At the same time the portfolio is well diversified. But most important of all is that the portfolio is overweight were it needs to be. The Starwood portfolio is overweight in the upscale and upper upscale market sector and, above all as seen in the charts below, it portfolio is overweight in key geographic areas in such a way that makes the portfolio minimally exposed to the oversupply trends mentioned earlier. Starwood obtains over 7-% of its EBITDA from the four regions with the highest RevPAR growth and over 60% of EBITDA from the regions with the lowest supply growth. By minimizing exposure to oversupply Starwood is best positioned to take the most advantage of the positive macroeconomic environment that we foresee in order to generate the most RevPAR growth through the better ADR trends and occupancy trends that are associated with regions where supply is under control. Given constant margins, the growth in RevPAR is likely to directly filter down to EBITDA thus generating true economic value for shareholders.



Source: Smith Travel Research



Source: Company Data

Potential RevPAR growth likely to be accompanied by margin improvements as portfolio becomes more integrated.
Further boosting the strong EBITDA prospects for the Starwood portfolio is the fact the firm still has significant upside in terms of the level of synergistic cost cutting that can result from better integrating the firm's properties. As outlined in the recommendations section, the firm can further consolidate suppliers and institutionalize ways to integrate reservation systems in order to reduce cost per customer. As the portfolio becomes more fully integrated it is likely that the firm's EBITDA will grow more quickly than that of competitors not only, as mentioned earlier, because of more robust RevPAR trends due to the portfolio's favorable positioning but also because the firm will be able to keep more of that RevPAR by taking advantage of synergistic cost cutting.

Internet Strategy likely to help with RevPAR and Costs.
As highlighted in the recommendations section, a solid internet strategy helps to boost revenues while reducing costs. Starwood has already put its internet initiatives higher on its agenda than the majority of the industry. For example the firm has already developed important relationships such as that with Microsoft's Expedia in order to increase the number of online reservations and the firm's own site allows preferred guest to make reservations online. As the firm continues to expand its leverage of internet technologies EBITDA will see upward pressure as the firm capitalizes on its opportunities to boost RevPAR and reduce costs via the use of technology.

Upside potential buttressed by an underlying conservative capital structure.
Starwood's capital structure has remained conservative with a debt to value ratio of only 40% vs. the industry average of about 60%. Furthermore, the majority of the debt the firm does have is fixed rate debt. The conservative combination of the low leverage percentage and the way the firm's debt is structured minimizes the firm's interest expenses and the variability of these expenses allowing the firm to retain more of the EBITDA it achieves to fund future growth opportunities in a cost effective manner.

Starwood's Potential not Recognized by the Street.
Perhaps the most important factor, from an investor's perspective, is that Starwood's upside potential has not been priced into the firm's stock. All the potential in the world would not justify an investment in a firm that has a stock price that has already been adjusted for all of its potential. In Starwood's case; however, this is far from being true since the firm's equity is currently trading at a 30% to 45% discount to NAV depending on the modeling followed. This heavy discount together with the fact that Starwood stock has historically enjoyed solid institutional support at the low 20s price level means that there is great potential and limited downside for investors that get involved in Starwood stock.