REAL ESTATE INVESTMENT TRUST (REIT) AS AN EXIT STRATEGY FOR INN OWNERS

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The commercial value for Bed and Breakfasts and Country Inns did not kept pace with other lodging establishments. Lodging real estate investment trusts (REITs) grew in the 1990's by acquiring hotels and motels but not the smaller Inns. This study investigated what sale terms and conditions an Inn owner would sell their property to a REIT. The study examined what conditions an innkeeper would manage the property for the REIT once the sale was closed. This study concluded that a REIT was not a feasible exit strategy for Inn owners.

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INTRODUCTION

Statement of Problem

The commercial value (e.g., incoming producing ability) for Bed and Breakfast and Country Inns has not kept pace with other lodging establishments (e.g., hotels, motels, resorts). The lower sale prices reflect this decreased value. Felcor Lodging Trust is the largest non-paired hotel real estate investment trust (REIT) in the country. The REIT is exempt from corporate taxes, provided 75% of its capital is invested in property and it distributes 90% of its profits to shareholders. Felcor owns 195 hotels with 50,000 rooms (Felcor Suites Hotel, 1998). Calculations based on information from the 1997 Felcor Annual Report yield a capitalization rate of 9.2% and a gross rent multiplier of 9.5 (Felcor Suites Hotel, 1998). Proceedings at the March 1998 Professional Association of Innkeepers International (PAII) conference reported that sales of Inns yielded an average capitalization rate of 9.72% to 10.27% and an average gross rent multiplier of 4.19 to 4.78 (Caples, 1998b; Oates, 1998; Yovino-Young, 1998). A higher capitalization rate and lower gross rent multiplier are both indicators of lower sale prices for Inns compared to hotels.

Public lodging REITs are credited with driving up sale prices for hotel properties in the 1990's (Sheridan, 1997). Prior to May of 1994, there were just three public lodging REITs with the largest REIT having a capitalization of $200 million U.S. dollars (Sheridan, 1997). By August 1998, there were 14 public lodging REITs and 27 private lodging real estate investment trusts with a total combined capitalization of $15.4 billion U.S. dollars (Hill et al., 1998). These public REITs use the capital from investors to acquire hotels, motels, and resorts but not the smaller Inns. The primary growth mechanism has been through acquisition because existing properties were priced below replacement costs (Sheridan, 1997). The strong demand resulted in higher hotel sale prices.

Significance of the Study

The PAII Industry Study reveals that 84% of Inn owners are actively involved in operations and 83% live on the premises ("1996 Industry Study," 1997). As such, an ownership change prompts other changes: property management, managerial style, and personality of the inn. These changes add to the startup cost which is reflected by a lower sale price. In addition, there is an implied value associated with the "good will" the owner brings to the Inn. Good will is the favor or prestige created by the innkeeper. Although not quantifiable, an investor may offer a lower sale price to compensate for any degradation in good will lost as a result of the sale or transition.

The buyer must find a qualified property manager or manage the Inn themself. Inn sitters provide a short term solution by managing and operating the property for a time period usually not exceeding two months. The buyer may not be able to afford property management training. It typically takes one full year to fully "season" (e.g., understand operational nuances, adjust efficiencies) the operation (Yovino-Young, 1990). The service quality and sales may suffer during this transition period. It is possible the buyer may not be able to recover or sustain the business resulting in a lower property value.

Market data for similar properties are often difficult to gather due to location (e.g., rural, small village) and uniqueness of the properties (Yovino-Young, 1990). Land values are typically measured by competitive residential site sales rather than commercial values (Yovino-Young, 1990). An estimated 50% of Inns are on local, state or national historic registers (Berman & Lanier, 1993). Since a high percentage of inns are converted residences, a buyer wanting to convert the Inn back into a residence will base their offer price on residential values. The seller may exclude personal property like antique furniture which the buyer must replace. The owner may have intermingled personal finances and items in the Inn's operating statement (Caples, 1998a). These combined factors lower the commercial value of Inns.

The Inn owner (seller) does not receive favorable sale terms and conditions compared to other lodging properties because there are fewer sale channels. Terms are the provisions offered for acceptance that determine the nature and scope of agreement. Conditions are the restrictions or modification factors upon which fulfillment depends.

There is a domino effect when one Inn sells below fair lodging market value or ultimately fails. It affects the entire local marketplace for Inns by lowering commercial values and attractiveness to outside buyers (demand). Operational problems and poor service quality affects the industry's image. The industry's image is based on personalized customer service. The image is what draws most customers to select Inns over other lodging alternatives. Only 10% of Americans have ever stayed at an Inn (Berman & Lanier, 1993). One bad experience will dissuade a guest from ever staying at another Inn. Tarnishing the image directly impacts future sales. Improving the sale terms and conditions while providing a transitional property management strategy will enhance the commercial value for Inns.

Inn owners have limited options when they exit the business. Some discontinue operations either because they want to continue to live in the residence or they can’t sell the business. Inns do not have many employees especially employees with financial means; therefore, an employee buyout is not possible. Giving the property away to a charitable trust doesn’t address who will operate and manage the property in the future. A family succession really doesn’t involve a public sale. A contest or auction is not very common and the data is usually not captured in the real estate databases. According to the PAII Industry Study, 92% of all Inns are structured as proprietorships or in partnership forms (Professional Association of Innkeepers International [PAII], 1997). Applying the law of supply and demand, another sale channel adds more potential buyers. The demand is driven by more buyers which ultimately increases property values.

Purpose of the Study

The purpose of this study was to determine the feasibility of a real estate investment trust (REIT) as an exit strategy for Inn owners. The study determined which predictors best aligned with outcomes that were favorable to both the REIT and Inn owner. The predictors included Inn owner’s perceived satisfaction levels, risk taking attitude, exit horizon, and demographic factors. The outcomes included sale terms and conditions, exit horizon, and property management conditions, fees, and duration.

Limitations

The sample was limited to Inn owners who are members of the Professional Association of Innkeepers International. Aspiring innkeepers and vendors were not sampled. Confidentially of real estate transactions precluded the sampling of former innkeepers.

The real estate investment trust was the only business structure examined. No other exit strategies (e.g., C-corporation) or property management relationships (e.g., hotel operating company like Hilton) were studied.

Assumptions

The researcher assumed the subjects answered truthfully. The persons who filled out the survey were indeed the property owners. The PAII members were representative of the overall population of 15,000 U.S. Inn owners ("Ten years ago," 1999). If the property owner was not involved in daily operations, they at least had the knowledge or consulted their property manager in answering the questions related to property management. The study's demographic factors correlated with the demographic factors in the PAII Industry Study.

Operational Definitions

Average daily rate: The gross room revenues in U.S. dollars (not gross revenues) divided by number of room nights (Professional Association of Innkeepers International [PAII], 1997).

Bed and Breakfast or Country Inn: Inns generally range in size from 1 to 35 guest rooms and provide personalized service ("Ten years ago," 1999). The typical Inn was owned and operated by an individual proprietor or family ("1996 Industry Survey," 1997). They provided lodging in locations where motels and hotels did not find it economically feasible like in rural areas and small resort villages ("Bed and Breakfast," 1995). Nearly 50% of all Inns in the United States were on a local, state or national historic register (Berman & Lanier, 1993). They serve breakfast and may optionally offer lunch or dinner.

Business structure: Common and generally accepted business structures were categorized as one of the following: sole proprietor, S-corporation, general partnership, limited partnership, C-corporation, trust, or limited liability corporation (Professional Association of Innkeepers International [PAII], 1997).

Exit horizon: The number of years the owner expected to own their Inn before selling categorized as follows: less than 1 year, 1 to 3 years, 4 to 6 years, 7 or more years, and no plans.

Geographic region: The United States was divided into four regions: Northeast, Southeast, Midwest, and West (Professional Association of Innkeepers International [PAII], 1997).

Gross revenues: The total revenues (sales) expressed in U.S. dollars from all operations.

Inn size: The number of available guest rooms categorized as follows: 1 to 4 rooms, 5 to 8 rooms, 9 to 12 rooms, 13 to 20 rooms, and 21 or more rooms (Professional Association of Innkeepers International [PAII], 1997).

Investor type: The owner was defined as either an active or a passive investor according to Internal Revenue Service regulations. An active investor was operationally involved in the running of the business while a passive investor provided no operational support.

Job satisfaction: The degree to which survey particpant was satisfied with the property manager role at the Inn.

Location setting: The locations were defined as rural (in the country), urban (cities and suburbs) and village or town (Professional Association of Innkeepers International [PAII], 1997).

Lodging type: The property was defined as either a Bed and Breakfast or Country Inn both of which serve breakfast. A Country Inn served lodging guests and may optionally serve non-guests meals other than breakfast at least somewhat regularly (Professional Association of Innkeepers International [PAII], 1997).

Net operating income (Loss): Income (Loss) expressed in U.S. dollars before mortgage interest, depreciation, income taxes, and owner's draw (Professional Association of Innkeepers International [PAII], 1997).

Occupancy rate: The number of room nights divided by available room nights expressed as a percentage (Professional Association of Innkeepers International [PAII], 1997).

Owner satisfaction: The degree to which the survey participant was satisfied with the ownership role and investment in the Inn property.

Property management duration as condition of sale: The number of years the survey participant would continue to operate (act as property manager) the Inn as a condition of sale categorized as follows: 3 months, 6 months, 1 year, 13 to 24 months, 25 to 60 months, more than 5 years, and never.

Property management duration preference: The number of years the survey participant would prefer to operate (act as property manager) the Inn beyond the sale closing date categorized as follows: 3 months, 6 months, 1 year, 13 to 24 months, 25 to 60 months, more than 5 years, and never.

Property management employment conditions: The employment categories the survey participant would find desirable after the sale closing date categorized as follows: part-time (1 to 30 hours per week), full-time (31 to 40 hours per week), Inn sitter (short term not to exceed 2 months) their property, Inn sitter another property, train new innkeeper, innkeeper in immediate geography, and innkeeper in different geography.

Property management fee: The degree to which the survey participant agreed to refund a proportional amount of the base management fee for not achieving predetermined and mutually agreeable net operating income (NOI) targets during their role as property manager (Hathaway, 1996).

Property management incentive based fees: The degree to which the survey participant agreed to each of the following four property manager incentive plans: percent improvement in net operating income (NOI), percent improvement in gross revenues (sales), percent exceeding a preferred return on investment (ROI), and percent exceeding a cumulative cash flow set-aside amount (Hathaway, 1996). While the base management fee was reduced, the incentive plan provided an opportunity to earn more than the typical base fee.

Property manager: Supervised the real estate for an owner to achieve maximum financial return (Dasso, 1995). Inn property managers were responsible for the daily operations which included reservations, guest check-in, housekeeping, meal service, guest services, guest check-out, and settlement of charges. Also known as innkeepers..

Public lodging real estate investment trust (REIT): REITs use capital from investors to acquire real estate properties (e.g., hotels, motels, resorts). Public REIT shares are freely traded and serve much like a mutual fund for real estate. The REIT must pay 90% of its net taxable income to shareholders in the form of dividends. Most REITs do not pay federal or state income taxes thus avoiding double taxation for the shareholders. Unlike a partnership, a REIT cannot pass its tax losses on to its investors. A REIT investor seeks current income distributions, long-term stock appreciation, portfolio diversification, and liquidity. A REIT is suitable for individual IRAs, KEOGH and other pension plans. REITs employ individuals or property managers to professionally operate its lodging properties. Alternatively, the REIT may lease the property to a lodging company who pays a minimum fixed rent plus a percentage of revenue. An umbrella partnership REIT (UPREIT) allows existing partnerships to contribute property in exchange for units in the resulting operating partnership with the REIT. This exchange is tax free. The partners may tender their units over a period of time, thereby spreading out the tax. If the partner holds the units until death, the estate tax rules operate in such a way that allows the beneficiaries to tender units for cash or REIT shares without paying income taxes. The REIT may acquire additional assets without having to tap into capital markets (e.g., issuance of REIT shares, financing).

Risk taking attitude: The degree to which survey participant assessed their own future disposition toward taking financial risks relative to the potential of earning greater rewards.

Sale terms and conditions investment term: The length of time the survey participant would invest in a REIT on a scale ranging from short term to long term.

Sale terms and conditions asset mix: The degree to which the survey participant favored one investment alternative over another for six pairs of investment alternatives. The investment alternatives were the following pairs: income and equity appreciation, annuity and stock, annuity and mutual fund, mutual fund and stock, real estate and stock, and mutual fund and real estate.

Sale terms and conditions investment position hold back: The degree to which the survey participant agreed to withhold a portion of the Inn sale proceeds to be paid out over 3 years as cash flow in each of those subsequent 3 years achieved presale levels (in the 12 months proceeding the closing date).

Sale terms and conditions investment recoup: The degree to which the survey participant agreed to sell their Inn at a purchase price that recouped their equity investment.

Sale terms and conditions investment recoup after 2 years: The degree to which the survey participant agreed to sell and operate their Inn for 2 years in order to recoup their equity investment.

Sale terms and conditions second lien: The degree to which the survey participant agreed to sell their Inn where the profits were in the form of a second lien (mortgage) to the buyer.

Sale terms and conditions ROI target: The rate of return, also known as return on investment (ROI), the survey participant expected to make on the future investment of the Inn sale proceeds expressed as a whole percentage from 0% to 40%.

Sale terms and conditions invest proceeds: All the investment categories the survey participant would invest the majority of their Inn sale proceeds: bonds, certificates of deposit (CDs), commercial real estate, donations and gifts, land, mutual funds, other (respondent given the opportunity to specify investment item), pay off debts, personal property (e.g., boat, car), personal real estate (e.g., house), savings account, and stocks.

Staff size: The number of full-time employees including owners involved in operations. A full-time employee worked 40 hours per week. Part-time employees were expressed as a percentage of full-time employees to one-tenth of a decimal place.

Years in business: The number of years the owner had been in the Inn business according to the following categories: 1 to 3 years (startup period), 4 to 6 years (stabilization period), 7 (Inn is stable) or more years (Professional Association of Innkeepers International [PAII], 1997).

CHAPTER 2

REVIEW OF LITERATURE

Introduction

Limited research has been conducted on the subject of Bed and Breakfasts or Country Inns. This research has generally focused on the guest or customer rather than the Inn owner. Little was known about Inn owner's attitudes toward risk taking, satisfaction levels, exit plans, investment strategies, property management, or sale terms and conditions. Likewise, little was known about hotel, motel, and small business owners with the exception of property management contracts.

The Professional Association of Innkeepers International (PAII) has conducted extensive research since 1988 to understand the operations, marketing, and finance aspects of the Bed and Breakfast industry. Nothing was known about the relationship between the demographics of these PAII members and Inn owner's attitudes toward risk taking, satisfaction levels, exit plans, investment strategies, property management, or sale terms and conditions.

The research concerning real estate investment trusts (REITs) was limited to the analysis of different REIT structures, REIT relationships to other investment alternatives, REIT performance, and the impact of REITs on investors or property owners. The REIT was exempt from corporate taxes, provided 75% of its capital was invested in property and it distributed 90% of its profits to shareholders. REITs were common in the hotel and motel industry but little was known about owner attitudes toward property management or sale terms and conditions. No research had been conducted on the demographics of a REIT investor.

The degree to which a REIT could impact Inn owners depended on a good understanding of the valuation techniques used in the appraisal process. These same techniques were used in evaluating any commercial real estate property.

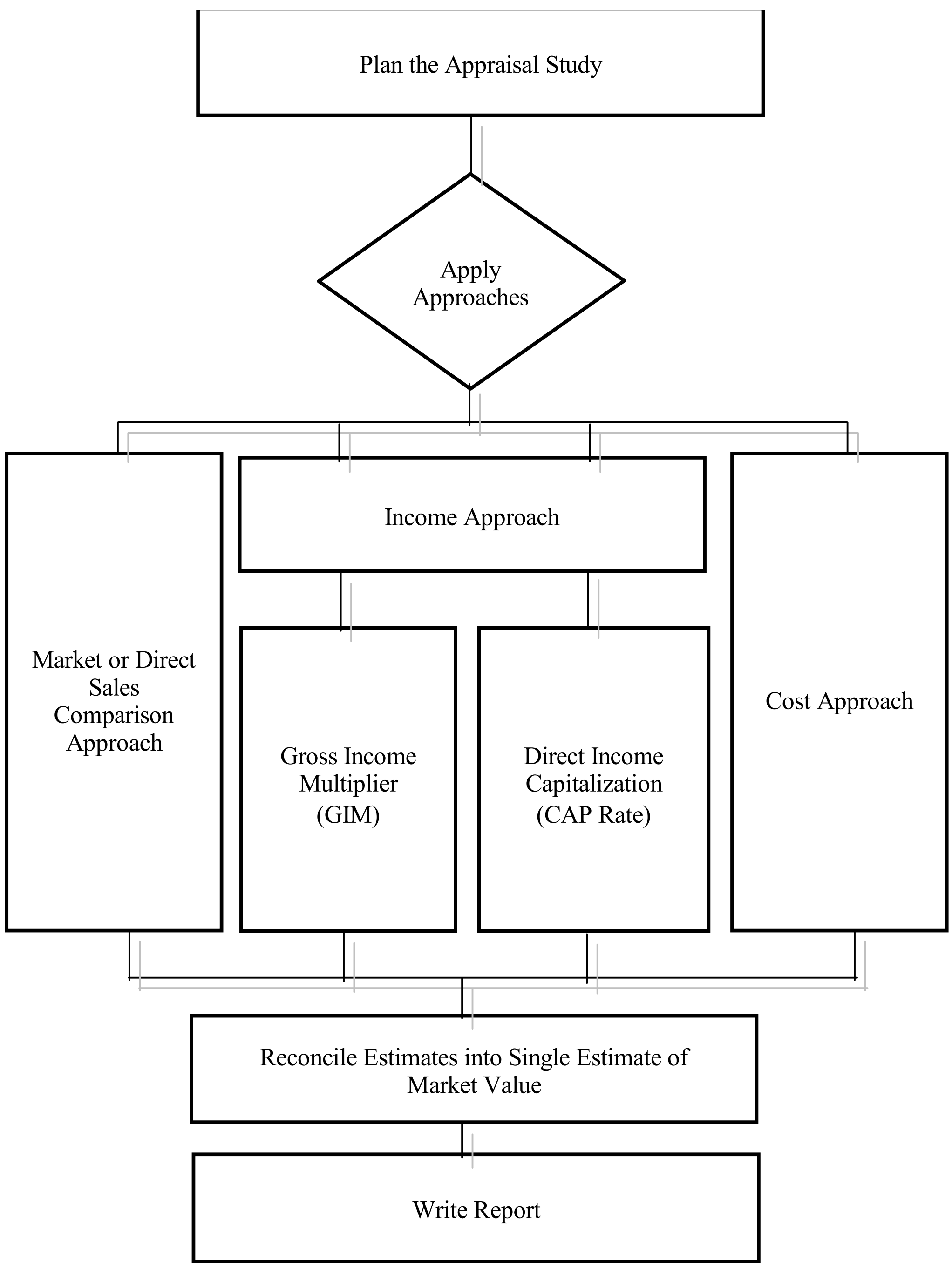
This literature review investigated the real estate appraisal process and its relationship to market value for Inns and real estate investment trusts. The literature review explored Inn owner's attitudes toward owner and job satisfaction levels, exit plans, risk taking, sale terms and conditions, and property management. These owner attitudes indirectly affected market values. The PAII Industry Study data was used during data analysis and will be outlined in this review.

Theoretical Background

Commercial real estate property values were based on well-established valuation techniques used in the appraisal process. The appraisal process framework is represented in Figure 1. Demand for REIT shares was one factor contributing to the increase in commercial prices in the 1990's (Etter, 1998). As prices increased, the price for comparable sales was adjusted upward. This upward adjustment increased the market value estimate for the appraised property. Likewise, the capitalization rate decreased as the price increased. Capitalization rate was calculated by dividing the net operating income (NOI) by the estimated market value (Dasso, Shilling, & Ring, 1995). As comparable sales drove the capitalization rate down, a constant NOI resulted in a higher market value estimate for the appraised property. Also, the higher comparable sales

Figure 1

The Appraisal Process: Steps in Estimating Market Value



improved the gross income multiplier (GIM) ratio. GIM was determined by dividing the sales price by the gross annual income (Dasso et al.). Again, the market value estimate for the appraised property increased as the GIM grew assuming a constant gross annual income. The cost approach was not affected by a REIT. The net effect was that the comparable sales approach and the income approach drove a higher estimated market value for the appraised property.

Bed and Breakfast or Country Inns

Most published research on Inns has focused on the sales and marketing (e.g., marketing programs, guest demographics, pricing, economic impact, market segmentation), franchising, and operational (e.g., training, management, financial, regulations) aspects of the industry. The Professional Association of Innkeepers International (PAII) conducted its fifth biennial industry study of Inns in 1996. These biennial surveys revealed important information on operations, marketing and finance including trends since 1988. The survey provided some insight into the work characteristics of innkeepers like how many hours the owners work and what tasks the owners spend the most time on. The Inn owners reported the type of business structure (e.g., partnership, sole proprietor), capital investments, and financing sources. Owners with hospitality experience were more likely to organize as partnerships and corporations (Poorani & Smith, 1995). The survey concluded that the fundamentals of operating an Inn or hotel are quite similar (Professional Association of Innkeepers International [PAII], 1997).

Several articles have been written by Michael Yovino-Young, David Caples, and Lyman S. Robbins about valuation techniques for Inn owner which follow generally accepted commercial real estate appraisal practices (Caples, 1998a; Robbins, 1995; Yovino-Young, 1990). Appraisers and real estate brokers, specializing in the Bed and Breakfast industry, individually assembled comparable sales data for presentation at the March 1996 PAII conference (Caples, 1998b; Oates, 1998; Yovino-Young, 1998). Unfortunately, the data was neither standardized (e.g., different financial ratios, terminology), complete (e.g., sales terms and conditions), nor collected from the same time periods. The confidentiality of real estate transactions presented unique data collection challenges. At the same conference, Bill Oates presented personal and financial considerations for exiting innkeeping. Bill acknowledged that the selling options were limited (Oates, 1998). His presentation focused on getting your financial, business and personal house in order. He spoke about ways to structure the sale and about the importance of strategic planning.

Studies of small business owners and Inn owners determined what owner attributes were required to run a successful business (Kaufman, Poynter, & Weaver, 1996). A strong correlation was found between a successful business and positive beliefs or attitudes about the industry (Kaufman et al.). However, the studies stopped short of measuring owner or job satisfaction. It typically takes 5 to 7 years before a Bed and Breakfast or Country Inn stabilizes and becomes profitable (Withiam, 1997).

Owner and Job Satisfaction

A survey of 403 U.S. Inns in 46 states asked owners if they would choose innkeeping, if given a second chance. Owners selected the profession again 99% of the time for small operations (1 to 3 rooms), 92% for mid-sized inns (4 to 8 rooms), and 87% for large inns with 9 or more rooms (Poorani & Smith, 1995). The innkeepers ranked meeting people and entertaining and professional independence as the top two reasons for choosing the profession (Poorani & Smith). It should be noted that innkeepers who had exited the business were not surveyed. Therefore, the survey results couldn't be generalized for the entire Inn owner population. Meeting people and entertaining were probably an indication of high job satisfaction while professional independence could be related to either owner satisfaction or job satisfaction. Unfortunately, the study did not correlate owner satisfaction or job satisfaction with selecting the profession again.

Exit Horizon

The PAII 1996 Industry Study reported how many years innkeepers had been in the business: 58% for 7 or more years, 19% for 4 to 6 years, and 23% for 1 to 3 years (Professional Association of Innkeepers International [PAII], 1997). The years in the business had increased since 1988 even as Inn population grew: 42% for 7 or more years, 35% for 4 to 6 years, and 24% for 1 to 3 years (Professional Association of Innkeepers International [PAII], 1995). The survey did not ask the Inn owners how long they planned to stay in the business either as owners or employees. Former Inn owners were never surveyed on why they exit the business. No studies were found on why or when hotel and motel owners or even small business owners leave the business.

Risk Taking Attitude

In 1983 there were an estimated 3,000 U.S. Inns (Clapp, 1996). This population has grown to more than 15,000 Inns ("Ten years ago," 1999). This cottage industry has grown very quickly. The 1996 PAII Industry Study reported that 59% of the owners were sole proprietors (Professional Association of Innkeepers International [PAII], 1997). A sole proprietorship assumes personal liability for their business (Dasso, Shilling, & Ring, 1995). By definition Inn owners were small business owners. The mix of small business owner, sole proprietor, and cottage industry suggested a level of risk taking higher than the average public. There were no group studies measuring attitudes toward risk.

Sale Terms and Conditions

No published research had been conducted on the subject of sale terms and conditions for Inn owners, small business owners, or hotel owners. The PAII Industry Study reported the business structure used by Inn owners, but it didn't explain why a particular business structure was chosen. Was the business structure chosen or changed to facilitate the future sale? No study reported on what Inn owners did with the sale proceeds. Did they invest in another Inn? Inn owner's preferences or attitudes toward sales terms and conditions or investments was unknown.

Property Management

Hathaway and Sangree's study on trends in hotel management contracts had considerable applicability to property management fees. The study conducted interviews with hotel managers and reviewed actual management contracts. The average management contract duration fell from17 years in the 1980's to 6 years in the 1990's

(1996). Base management fees declined approximately 30% for all hotel types during that same period while incentive fees increased in popularity and amount for full service hotels. Limited service hotels used primarily base management fees in the 4.5% to 5% range. Full service hotels used incentive clauses to align operator goals and owner goals. The base management fee for full service hotels ranged from 2.5% to 3%. The study found the most common incentive plans to be based on: percent improvement in gross operating profit (most common), percentage of net operating income, and percent beyond preferred return. Less common incentive plans were the percentage of gross operating profit that exceeded a base fee amount, the percentage of net operating income over $200,000, and the percent of amount by which cumulative cash flow exceeded cumulative set aside amount. Gross operating profit could include equity payments, but most consider income before fixed charges. The authors of the study anticipated trends toward higher incentive fees based on benchmark profit figures, operator refunds of management fees if predetermined gross operating profit levels were not achieved, shorter management contract terms, and operator contributed equity or loans.

Innkeeper Demographics

The 1996 PAII Industry Study included responses from 386 U.S. Inn owners from a total membership exceeding 2,500 (Professional Association of Innkeepers International [PAII], 1997). The study's demographic information was used during data analysis and is included in Table 1.

Table 1

1996 Inn Owner Demographic Information

Independent variable	Percentage	Attribute
Lodging type	65%	Bed and Breakfast
	35%	Country Inn
Business structure	59%	Sole proprietor
	23%	S-corporation
	5%	General partnership
	5%	Limited partnership
	4%	Regular corporation
	4%	Trust
	0%	Limited Liability corporation
Investor type	84%	Active investor
	16%	Passive investor
Years in business	23%	1 to 3 years
	19%	4 to 6 years
	58%	7 or more years
Location setting	31%	Rural
	18%	Urban
	51%	Village or town

(table continues)

Table 1 (continued)

1996 Inn Demographic Information

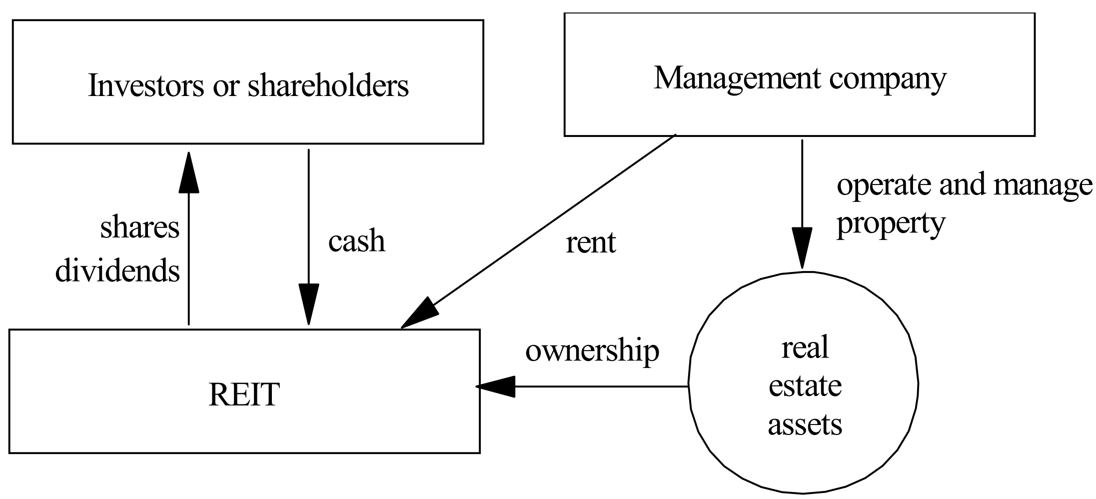
Independent variable	Percentage	Attribute
Inn size	20%	1 to 4 rooms
	46%	5 to 8 rooms
	19%	9 to 12 rooms
	10%	13 to 20 rooms
	5%	21 or more rooms
Geographic region	39%	Northeast
	21%	Southeast
	13%	Midwest
	27%	West
Occupancy rate	53%	
Average daily rate	$107.55	
Gross revenues	$146,045	Bed and Breakfast
	$272,551	Country Inn
Net income	37.4%	Bed and Breakfast
	29.4%	Country Inn
Staff size	4.5	Bed and Breakfast
	6.7	Country Inn

Real Estate Investment Trusts (REITs)

A traditional equity REIT (see Figure 2) purchased a property, financed some debt, and issued shares to raise the remaining equity. Rents were the primary source of income. Shares were freely traded for a public REIT while a private REIT had private investors. The REIT was required to have a minimum of 100 shareholders or investors.

Figure 2

<u>Traditional Equity REIT Structure</u>

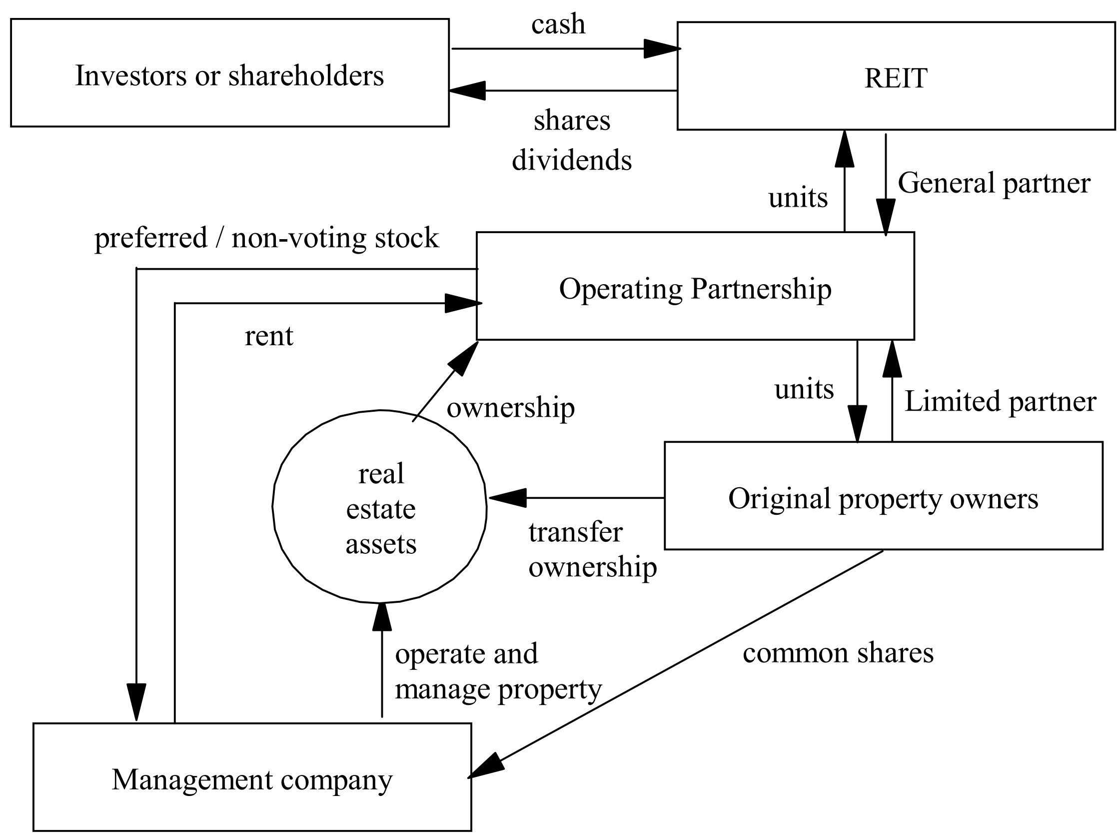


No more than 50% of the REIT shares could be held by five or fewer individuals during the last half of each taxable year. The REIT owned the real estate assets but was prohibited from operating the properties except for four grandfathered paired-share REITs. Another entity had to manage the lodging properties. Some analysts questioned whether REITs made good landlords because their backgrounds were rooted in Wall Street investment markets, not in property management (Garrison, 1998). Unlike a corporation, a REIT could not use retained earnings to grow. Traditional REITs grew by either the issuance of more debt or more shares. A public REIT raised capital at a lower cost than private sources which allowed the REIT to be more competitive during the acquisition phase (Rushmore, 1994). Historically, REITs have maintained low debt-to-equity ratios (Dargatz, 1998).

One REIT variation was the umbrella partnership REIT (UPREIT). Property owners and the REIT became partners in a new partnership called the Operating Partnership (see Figure 3). The property owners contributed equity in the form of real estate while the REIT contributed the cash proceeds from its public offering. In exchange, both partners received units in the Operating Partnership. After 1 year, the partners enjoyed the same liquidity as the REIT shareholders by tendering Operating Partnership units for either cash or REIT shares. The original property owners received the advantages of deferred capital gains tax, a reduction of recapture income, and the ability to tender units in small chunks over an extended period of time (Finn, 1998). Furthermore, upon death of a partner the beneficiaries could tender units without paying income taxes according to estate tax rules (Finn, 1998). The UPREIT was intended for successful owner-operators that were looking to spread out their tax liability who were not necessarily in the market to sell (Muldavin, 1998). The UPREIT grew by exchanging Operating Partnership units for property. The disadvantages of UPREITs were its complex tax and accounting structure and the potential conflicts of interest between the original property owners and the REIT (Finn, 1998). A DOWNREIT was identical to an UPREIT except that the REIT owned the majority of real estate assets rather than the Operating Partnership.

Figure 3

<u>UPREIT Structure</u>



REITs gained popularity in the 1990's because their cash yield was more attractive than certificates of deposits (CDs) and treasury bills (Etter, 1998). Yields on CDs and treasury bills declined as interest rates declined in the 1990's. Equity REITs grew from $16 billion to $140 billion in the past 5 years (Garrison, 1998). The REITs were able to purchase properties at prices below their replacement costs (Etter, 1998). As the economy improved, higher gross incomes increased property values. As a result, REIT share values grew. Over the past decade, 31% of the average total return was generated by share appreciation (Dargatz, 1998). Investors benefited from the share price appreciation improving their overall yield. REITs have outperformed the Standard & Poor 500 Index over the last two decades with a total return of 35.75% compared to 22.96% (Dargatz, 1998). However, REIT share prices were also subject to investor mood swings on Wall Street (Rushmore, 1994). REITs provided investors a means to diversify their investment portfolio with real estate without the illiquidity, large capital outlays, and high transaction costs associated with real estate (Dargatz, 1998). The National Association of Real Estate Investment Trusts (NAREIT) recommended that investors allocate 15% of their portfolio to REITs for long-term safety of principal (Dargatz, 1998).

Wall Street investment bankers were attracted to investments when the critical mass reacheed $150 million (Rushmore, 1994). Since Bed and Breakfast or Country Inn market values generally are less than $2 million dollars per property, a new REIT specializing in Inns would be challenged to attract Wall Street. A secondary challenge facing a REIT would be the human resource issues associated with assimilating these smaller business structures (Muldavin, 1998).

Between 1975 and 1996 the correlation between the NAREIT equity index and small cap stocks was 0.76 (Muldavin, 1998). The correlation drops to 0.52 between 1991 and 1996, and to 0.16 between 1994 and 1996 (Muldavin). Likewise, the correlation between the NAREIT equity index and the Standards & Poors 500 index (large cap stocks) dropped from 0.77 between 1985 and 1987 to 0.40 between 1994 and 1996 (Muldavin). The REIT marketplace was maturing with returns more closely matching private real estate markets.

Summary

The review of literature identified several property management fee structures for use in a REIT specializing in the Bed and Breakfast industry. An understanding of REIT investment characteristics provided a framework for asking owners about their investment attitudes. The appraisal process revealed important linkages between REITs and their impact on sale prices. These valuation techniques revealed the measures to correlate with Inn owner attitudes.

Little was known about Inn owner's attitudes toward risk taking, satisfaction levels, exit plans, investment strategies, property management, or sale terms and conditions. Innkeepers enjoyed their profession but did they enjoy ownership, daily operations, or both. PAII studied operations, marketing and finance for the Bed and Breakfast industry since 1988 but these variables should be correlated to owner attitudes.

CHAPTER 3

METHODS

The purpose of this study was to determine the feasibility of a real estate investment trust (REIT) as an exit strategy for Inn owners. The study determined which predictors best aligned with outcomes that were favorable to both the REIT and Inn owner. This chapter describes the procedures used to complete this investigation. Included are the research objectives, research design, instrument, population and sample, data collection, and data analyses.

Research Objectives

Research was needed to understand Inn owner's attitudes toward different sale terms and conditions, property management structures, and investment alternatives. The following research objectives were used in this study:

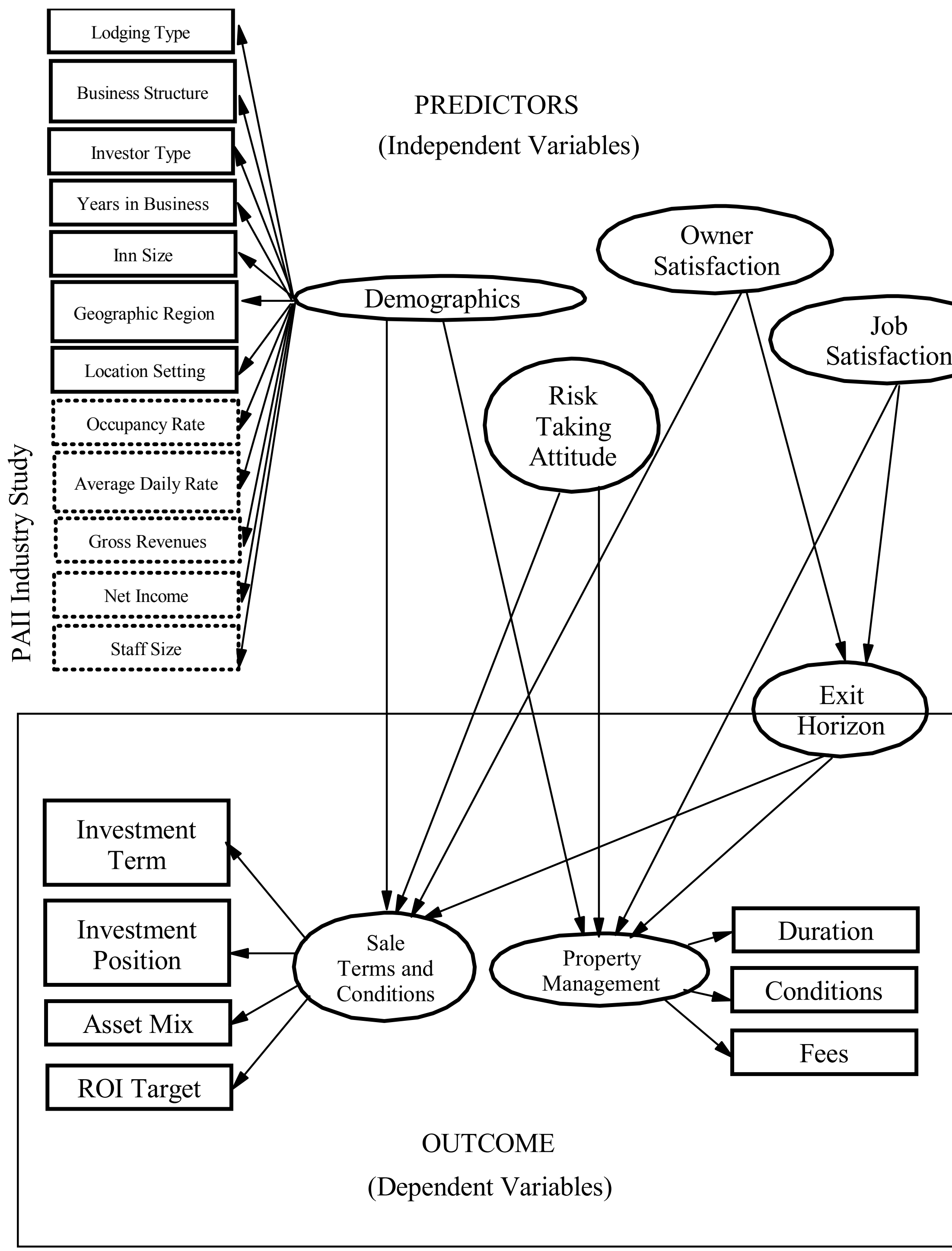
1. to determine under what sale terms and conditions an Inn owner would sell their property to a REIT
2. to determine how long and under what fees and conditions an Inn owner would manage the property for the REIT once the sale was closed.

Research Design

Figure 4 identifies the concepts and variables studied and how they relate to each other within the context of a model or conceptual framework.

Figure 4

Research Model



Dependent Variables

The dependent variables were property management, sale terms and conditions, and exit horizon. Property management included duration, conditions, and fees. Duration measured how long the innkeeper would manage the property after the sale as both a condition of sale and as a preference. Conditions recorded the employment categories the innkeeper would agree to after the sale. Fees examined the incentive and base property management fees that were agreeable to the innkeeper. The study determined property management's relationship with demographic factors, risk taking attitude, job satisfaction level, and exit horizon.

Sale terms and conditions included investment term, investment position, asset mix, and return on investment target. Investment term determined the owner's interest in long or short term investing. Investment position measured the owner's attitude toward four different investment scenarios. Asset mix asked the owner to assess six pairs of investment alternatives to determine which were more favorable to them. The owner was asked to specify the rate of return (known as return on investment or ROI) they expected to make on future investments of their sale proceeds. The study determined the relationships between sale terms and conditions and demographic factors, risk taking attitude, owner satisfaction level, and exit horizon.

Exit horizon served as both a dependent variable to satisfaction levels and as an independent variable to property management and sale terms and conditions. The owner was asked about their plans to sell the Inn.

Independent Variables

Inn owner's satisfaction levels, risk taking attitude, exit horizon, and demographic factors were the independent variables. Satisfaction levels were included for both owner (owner satisfaction) and property manager (job satisfaction) roles. Risk taking attitude measured the owner's attitude toward greater investment risks for greater rewards. The demographic factors consisted of two sets: those included in this research survey and those gathered from the PAII Industry Study. The first set of demographic factors were based on the same units of measurement utilized in the PAII Industry Study: lodging type, business structure, investor type, years in business, Inn size, geographic region, and location setting (Professional Association of Innkeepers International [PAII], 1997). As such, these demographic factors associate directly with the demographic factors in the PAII Industry Study: occupancy rates, average daily rate, gross revenues, net operating income, and staff size.

Instrument

A questionnaire (see Appendix B) was developed by the researcher to investigate the two research objectives. The questionnaire contained all closed-ended questions with nominal, ordinal, and interval levels of measurement except for one open-ended question with a ratio level of measurement.

The questionnaire contained six sections. Section one asked participants to describe Inn ownership and management attitudes. Section two included questions regarding participant's intentions or preferences for continued involvement in the industry. Property management attitudes toward fees were gathered in section three.

Participant's attitudes toward sale terms and conditions was the subject of section four. Section five examined attitudes toward investments. Finally, section six asked descriptive questions. Optionally, the participant could provide their name, Inn name, e-mail address, and comments.

Content validity was tested by sending the questionnaire to six Denton Area Bed and Breakfast Inn owners. The questionnaire was administered through the mail in a manner similar to the final questionnaire with the exception of a request for feedback about the instrument itself. Three responses were received. From this feedback, the instrument was adjusted in order to clarify and refine the questions and instructions. Additional content validity was conducted by reviewing the instrument with Pat Hardy, Co-Executive Director Professional Association of Innkeepers International, a professional organization for the Bed and Breakfast Inn industry.

No reliability testing was included due to the difficulty in creating multiple questions or instruments that measured the same characteristic. Time constraints did not permit test-retest reliability.

Five independent measures (occupancy rate, average daily rate, gross revenues, net income, staff size) were calculated for each participant using data from the 1996 PAII Industry Study and specific questionnaire responses. The lodging type from the returned survey determined which section (Bed and Breakfast or Country Inn) was consulted in the PAII Industry Study. The PAII Industry Study broke down each independent measure by different categories; for example, occupancy rate was categorized by the number of rooms, number of years in business, region, and location (Professional Association of

Innkeepers International [PAII], 1997). The questionnaire responses determined the appropriate categories to use. Equal weighting was given to each category in determining the value for the independent measure. The calculations were easy and consistent since both the independent measures and input variables were ratio data.

If the participant answered both instrument items 1 and 3, then the participant was deemed an active investor type. Otherwise, the participant was coded a passive investor type. Staff size was based on a forty hour week for the total hours worked by all owners and employees. A summary of dependent measures are included in Table 2 while a summary of independent measures are included in Table 3. The attributes for each measure are defined in Table 4 and in the operational definitions included in Chapter 1.

Table 2

<u>Dependent Measures</u>

Measure	Instrument item(s)	How measured	Scale
PM duration as condition of sale	5	Ordered categories	Ordinal
PM duration preference	6	Ordered categories	Ordinal
PM employment condition	7	Categories	Nominal
PM NOI incentive fee	10	7-point Likert scale	Interval
PM sales incentive fee	11	7-point Likert scale	Interval
PM ROI incentive fee	12	7-point Likert scale	Interval
PM cash flow incentive fee	13	7-point Likert scale	Interval

(table continues)

Table 2 (continued)

Dependent Measures

Measure	Instrument item(s)	How measured	Scale
PM management fee	14	7-point Liker scale	Interval
STC investment term	25	Semantic Differential scale	Interval
STC asset mixes: income-equity appreciation, mutual fund-stock, mutual fund-real estate, real estate-stock, annuity-mutual fund, annuity-stock	19, 20, 21, 22, 23, 24	Semantic Differential scale	Interval
STC investment position hold back	18	7-point Likert scale	Interval
STC second lien	17	7-point Liker scale	Interval
STC investment recoup after 2 years	16	7-point Likert scale	Interval
STC investment recoup	15	7-point Likert scale	Interval
STC ROI target	8	Fill in the blank	Ratio
STC invest proceeds	9	Categories	Nominal
Exit horizon	4	Ordinal scale	Ordinal

Note. PM = property management; STC = sale terms and conditions.

Table 3

Independent Measures

Measure	Instrument item(s)	How measured	Scale
Lodging type	27	Categories	Nominal
Business structure	31	Categories	Nominal
Investor type	1, 3	Categories	Nominal
Years in business	26	Ordered categories	Ordinal
Inn size	30	Ordered categories	Ordinal
Geographic region	28	Categories	Nominal
Location setting	29	Categories	Nominal
Occupancy rate	PAII Study	Inn type by number of rooms, years in business, region, and location	Ratio
Average daily rate	PAII Study	Inn type by number of rooms, years in business, region, and location	Ratio
Gross revenues	PAII Study	Inn type by number of rooms, years in business, region, and location	Ratio
Net operating income	PAII Study	Inn type by number of rooms, years in business, region, and location	Ratio
Staff size	PAII Study	Inn type by rooms and years in business	Ratio

(table continues)

Table 3 (continued)

Independent Measures

Measure	Instrument item(s)	How measured	Scale
Owner satisfaction	1	7-point Likert scale	Interval
Risk taking attitude	2	7-point Likert scale	Interval
Job satisfaction	3	7-point Likert scale	Interval
Exit horizon	4	Ordinal scale	Ordinal

Table 4

Variable Attributes Summary

Measure	Attributes	Categorization
Lodging type	Bed and Breakfast	
	Country Inn	
Years in business	1 to 3 years	Young
	4 to 6 years	Stable
	7 or more years	Mature
Geographic region	Northeast	
	Southeast	
	Midwest	
	West	

(table continues)

Table 4 (continued)

Variable Attributes Summary

Measure	Attributes	Categorization
Inn size	1 to 4 rooms	Small
	5 to 8 rooms	Small
	9 to 12 rooms	Medium
	13 to 20 rooms	Medium
	21 or more rooms	Large
Business structure	Sole proprietor	
	S-corporation	
	General partnership	
	Limited partnership	
	C-corporation	
	Trust	
	Limited Liability corporation	
Investor type	Active investor	
	Passive investor	
Location setting	Rural (in the country)	
	Urban (cities and suburbs)	
	Village (town)	
Occupancy rate	U.S. dollars	calculation

(table continues)

Table 4 (continued)

Variable Attributes Summary

Measure	Attributes	Categorization
Average daily rate	U.S. dollars	calculation
Gross revenues	U.S. dollars	calculation
Net operating income	U.S. dollars	calculation
Staff size	Number with 1 decimal place	calculation
Owner satisfaction	1 or 2	Dissatisfied
	3 to 5	Neutral
	6 or 7	Satisfied
Job satisfaction	1 or 2	Dissatisfied
	3 to 5	Neutral
	6 or 7	Satisfied
Exit horizon	Less than 1 year	Imminent
	1 to 3 years	Transition stage
	4 to 6 years	Long range plan
	7 or more years	Not likely
	No plans	No plans
Risk taking attitude	1 or 2	Risk adverse
	3 to 5	Neutral
	6 or 7	Risk taker

(table continues)

Table 4 (continued)

Variable Attributes Summary

Measure	Attributes	Categorization
PM duration preference	3 to 6 months	Short term
	1 to 2 years	Transition phase
	25 to 60 months	Long term
	More than 5 years	Career
	Never	Never
PM employment conditions	Part-time	1 to 30 hours weekly
	Full-time	31 to 40 hours weekly
	Train new Innkeeper	
	Inn sitter their property	Less than 2 months
	Innkeeper in immediate geography	At another Inn
	Innkeeper in different geography	At another Inn
	Inn sitter another property	At another Inn
PM management fee	1 or 2	Disagree
	3 to 5	Neutral
	6 or 7	Agree

(table continues)

Table 4 (continued)

Variable Attributes Summary

Measure	Attributes	Categorization
PM incentive based fees	1 or 2	Disagree
	3 to 5	Neutral
	6 or 7	Agree
PM duration as condition of sale	3 to 6 months	Short term
	1 to 2 years	Transition phase
	25 to 60 months	Long term
	More than 5 years	Career
	Never	Never
STC investment term	1 or 2	Short term
	3 to 5	Mid term
	6 or 7	Long term
STC investment position hold back	1 or 2	Disagree
	3 to 5	Neutral
	6 or 7	Agree
STC investment recoup	1 or 2	Disagree
	3 to 5	Neutral
	6 or 7	Agree

(table continues)

Table 4 (continued)

Variable Attributes Summary

Measure	Attributes	Categorization
STC investment recoup after	1 or 2	Disagree
2 years	3 to 5	Neutral
	6 or 7	Agree
STC asset mix (income-	1 or 2	Income
equity)	3 to 5	Neutral
	6 or 7	Equity
STC asset mix (mutual fund-	1 or 2	Mutual fund
stock)	3 to 5	Neutral
	6 or 7	Stock
STC asset mix (mutual fund-	1 or 2	Mutual fund
real estate)	3 to 5	Neutral
	6 or 7	Real estate
STC asset mix (real estate-	1 or 2	Real estate
stock)	3 to 5	Neutral
	6 or 7	Stock
STC asset mix (annuity-	1 or 2	Annuity
mutual fund)	3 to 5	Neutral
	6 or 7	Mutual fund

(table continues)

Table 4 (continued)

Variable Attributes Summary

Measure	Attributes	Categorization
STC asset mix (annuity-stock)	1 or 2	Annuity
	3 to 5	Neutral
	6 or 7	Stock
STC second lien	1 or 2	Disagree
	3 to 5	Neutral
	6 or 7	Agree
STC ROI target	0% to 40% in whole numbers	
STC invest proceeds	Bonds, CDs, commercial real estate, donations and gifts, land, mutual funds, other, pay off debts, personal property, personal real estate, savings account, and stocks	

Note. PM = property management; STC = sale terms and conditions.

Population and Sample

The population of professionally run American Inns was estimated at 15,000 ("Ten years ago," 1999). The Professional Association of Innkeepers International (PAII) was the only organization dedicated to the advancement of the industry. As of January 1999, PAII's membership included 3,500 innkeepers, vendors and aspiring innkeepers

("Ten years ago," 1999). PAII's 2,500 innkeepers represented approximately 17% of the total Inn population. The sample included 1,300 American innkeepers who were members of PAII. The mailing list was contained on a computer diskette in ASCII file format and was alphabetized by Inn name. The mailing list was imported into a database from which mailing labels were printed. The mailing labels for all 2,500 PAII innkeepers were affixed to envelopes by four individuals in random order. A student assistant randomly selected 1,300 of the 2,500 envelopes to mail.

Data Collection

Approval to use human subjects was approved by the University of North Texas Institutional Review Board for Human Subjects Research. A cover letter (see Appendix A) and self-administered questionnaire (see Appendix B) were mailed to the sample population on November 9, 1999. The cover letter explained the purpose of the study, the confidentiality and privacy of participation, and how participants could obtain a summary of the findings. A November 30th return date was requested. A return envelope with prepaid postage was included. The innkeepers also had the option of faxing their completed questionnaire. The Professional Association of Innkeepers International (PAII) ran a three month series on exiting innkeeping in their monthly newsletter beginning in October 1999. The anticipated return rate was 15%.

Data Analysis

Upon receipt of the completed questionnaires, the questionnaires were examined for completeness, consistency, and legibility. Nine questionnaires were undeliverable and 203 surveys were returned. Of those returned, four were unusable. Three completed surveys from the Denton Area Bed and Breakfast Inn owners together with the 203 returned surveys resulted in a sample of 206 respondents for a response rate of 15.6%. The usable questionnaires were coded and the data compiled into Statistical Program for Social Sciences (SPSS) for analysis. Descriptive statistical tests were conducted to determine frequencies (all data), means (interval and ratio data), mean standard error (interval and ratio data), medians (ordinal data), modes (ordinal data), and standard deviations (interval and ratio data). A summary of relationship tests are listed in Table 5.

Ordinal data was categorized (see Table 4) into nominal data so that Chi Square contingency coefficient tests could identify relationships between these data measures and nominal data measures as well as different ordinal data measures. The same held true for comparing interval data (see Table 4) with nominal and ordinal data measures. Chi Square contingency coefficient tests were also used to determine the relationships between different nominal data measures. Spearman rank order correlation coefficient test measured the association between selected ordinal data measures. Pearson product-moment correlation coefficient test determined whether a linear relationship existed between interval data measures and other interval data measures and ratio data measures. A Simple Regression test was run to determine whether ratio data measures could predict return on investment (ROI) targets. All statistics were tested at a .05 level of significance.

Table 5

Summary of Relationship Tests used for Analysis

Independent variables	Dependent variables	Statistical tests
Nominal data	Nominal data and ordinal data (categorized)	C
Ordinal data (categorized) except exit horizon	Nominal data and ordinal data (categorized)	C
Ordinal data except exit horizon	Ordinal data	r_s
Interval data (categorized)	Nominal data and ordinal data (categorized)	C
Nominal data	Interval data (categorized)	C
Ordinal data (categorized)	Interval data (categorized)	C
Interval data	Interval data	r
Interval data	Ratio data	r
Ratio data	Ratio data	r and Simple regression

Note. C = Chi Square contingency coefficient - cross tabulation; r_s = Spearman rank correlation coefficient; r = Pearson product-moment correlation.

CHAPTER 4

RESULTS AND DISCUSSION

Introduction

This study examined the feasibility of a real estate investment trust (REIT) as an exit strategy for Bed and Breakfast Inn owners. The study investigated what sale terms and conditions an Inn owner would sell their property to a REIT and under what conditions an innkeeper would manage the property for the REIT once the sale was closed. A mail survey was developed to understand the innkeeper's attitudes toward these research objectives. The survey data was analyzed using the Statistical Package for the Social Sciences (SPSS). This chapter describes the characteristics of the sample and reviews the statistical analysis of the survey data as it pertains to the two research objectives.

Characteristics of Participants

The 202 participants were characterized by demographic factors and by their state of mind at the time of the survey. The demographic factors included lodging type, investor type, location setting, geographic region, business structure, years in the business, and Inn size. The participant's states of mind were captured in the form of their owner statisfaction, job satisfaction, risk taking attitude, and when they planned to exit the business.

The 202 participants had demographic characteristics similar to those who responded to the 1996 PAII Industry Study. A comparison of the demographic factors between the two surveys is included in Table 6. The participants were primarily owner operated (95.5%) Bed and Breakfast owners (84.2%). The PAII Industry Study consisted of 65% Bed and Breakfast owners and 84% owner operated businesses (Professional Association of Innkeepers International [PAII], 1997). The larger Bed and Breakfast percentage explain the higher percentage of owner-operated properties. A village (47.5%) was the most common location setting while the West (33.2%) and the Northeast (32.2%) were the most common geographic regions. The lack of motels or hotels in small towns allowed Inns to flourish in villages and to a lesser extent in rural locations (30.2%). The growing popularity of Inns probably led to the increase in the urban areas (22.3%). The distributions across geographic regions mirror the PAII membership which has 31.6% in the West and 32.1% in the Northeast (PAII Membership List, 1999). The village (51%) was the predominant location setting while the West (27%) and the Northeast (39%) were the most common regions for the PAII Industry Study (PAII, 1997). In fact, the ranking order for both location setting and geographic regions were identical between the two surveys.

The two most common business structures were the same in both surveys: 46.8% sole proprietor and 29.9% S-Corporation versus 59% and 23%, respectively, in the PAII Industry Study (Professional Association of Innkeepers International [PAII], 1997). The growth of Limited Liability corporations from 0% in the PAII Industry Study to 11.4% in 1999 was the only significant difference (PAII, 1997).

Table 6

Survey Comparison

Demographic factor	Participants (1999)	1996 PAII Industry Study
Sample size N	202	386
Lodging type	84.2% B&B	65% B&B
	15.8% Country Inn	35% Country Inn
Investor type	95.5% Active	84% Active
	4.5% Passive	16% Passive
Location setting	47.5% Village	51% Village
	30.2% Rural	31% Rural
	22.3% Urban	18% Urban
Geographic region	33.2% West	27% West
	32.2% Northeast	39% Northeast
	19.3% Southeast	21% Southeast
	15.3% Midwest	13% Midwest
Inn size	41.6% 5 to 8 rooms	46% 5 to 8 rooms
	22.8% 1 to 4 rooms	20% 1 to 4 rooms
	18.3% 9 to 12 rooms	19% 9 to 12 rooms
	11.4% 13 to 20 rooms	10% 13 to 20 rooms
	5.9% 21 or more rooms	5% 21 or more rooms
Occupancy rate	51%	51%

(table continues)

Table 6 (continued)

Survey Comparison

Demographic factor	Participants (1999)	1996 PAII Industry Study
Years in business	45% 7 or more years	58% 7 or more years
	32.2% 4 to 6 years	19% 4 to 6 years
	22.8% 1 to 3 years	23% 1 to 3 years
Business structure	46.8% Sole proprietor	59% Sole proprietor
	29.9% S-corporation	23% S-corporation
	11.4% LLC	0% LLC
	6% General partnership	5% General partnership
	3.5% C-corporation	4% C-corporation
	1.5% mix of 2 structures	
	1% Limited partnership	5% Limited partnership
	0% Trust	4% Trust
Average daily rate	$105.12	$106.72
Gross revenues	$169,815	$189,972
Net operating income	$59,421	$63,471
Staff size	4.9	5.3

Innkeepers with 7 or more years in the business represented 45% of the responses while those with 3 years or less in the business represented 22.8% of the total response rate. The PAII Industry Study had a higher response rate from those with more than 7 years experience at 58% and a lower response rate from those with 4 to 6 years experience at 19% (PAII, 1997). The response rate from those with less than 3 years experience was identical. The response rate across Inn sizes was very similar between the two surveys; for example, Inns with 5 to 8 rooms represented 41.6% of the responses compared to 46% in the PAII Industry Study (PAII, 1997). The Inn size was normally distributed (negative 0.174 kurtosis) with a positive 0.736 skewness. Inns with from 1 to 4 rooms and 9 to 12 rooms constituted 22.8% and 18.3% of the responses, respectively, while those with 13 to 20 rooms represented 11.4% of the total response rate.

The financial ratio data was comparable between the two studies. The occupancy rate had identical means of 51% for the two studies (Professional Association of Innkeepers International [PAII], 1997). The mean for average daily rate (ADR) varied by $1.60 with the PAII Industry Study slightly larger at $106.72 (PAII, 1997). The standard deviation was 3.33% for the occupancy rate and $4.10 for the ADR. Consequently, the higher room rate drove larger gross revenues and net operating income for the PAII Industry Study participants. The calculations yielded a gross revenue of $169,815 and a net operating income of $59,421 for the returned questionnaires. The participant's staffing needs (M = 4.9, SD = 2.1) were slightly less than the PAII Industry Study's (M = 5.3) requirements (PAII, 1997).

Each participant assessed their satisfaction level with property ownership and property management. On a 7-point Likert scale the participants assessed their level of satisfaction from 1 (very dissatisfied) to 7 (very satisfied). As expected, the innkeepers were satisfied with both ownership (M = 5.78, SD = 1.35, mode = 7 with 37.1% of the responses) and property management (M = 5.55, SD = 1.45, mode = 6 with 31.1% of the responses). Owner-operated lodging businesses merge the ownership aspects with property management which partly explain why the satisfaction levels were so similar. The innkeepers viewed themselves as slight risk takers on a 7-point Likert scale (M = 4.65, Mdn = 5, SD = 1.94, mode = 5). Each participant estimated when they planned or expected to sell their property: 11.4% within 1 year, 24.3% in 1 to 3 years, 21.3% in 4 to 6 years, 15.3% in 7 or more years, and 27.7% had no plans to sell. Since 77.2% of the participants had been in business more than 4 years, the exit horizon for most innkeepers was far into the future. The positive state of mind suggested by the high owner and job satisfaction levels supports this long tenure.

Statistical Analysis

Three different relationship tests were used in the analysis: Chi Square contingency coefficient C, Spearman rank order correlation coefficient r_s, and Pearson product-moment correlation coefficient r. Significant correlation coefficients are summarized in Table 7.

No relationships were found between when a participant expects to sell their business (exit horizon) and the research study's dependent variables. However, a moderate degree of association was discovered between the exit horizon and both owner satisfaction (C = 0.397 at .05% level) and job satisfaction (C = 0.432 at .01% level). The results also revealed a moderate relationship between the geographic region and the exit horizon (C = 0.326 at .05% level).

Table 7

Significant Correlation Coefficients

Independent variable	Dependent variable	C	r_s	r
Owner satisfaction	Investment recoup	0.461 *	-0.170 *	
	Investment recoup in 2 years	0.474 *		
	Second lien	0.480 *		
	Invest proceeds stocks	0.247 *		
	Invest proceeds pay off debts	0.263 *		
	Annuity-mutual fund		0.161 *	
	NOI incentive fee	0.510 **		
	Sales incentive fee	0.545 **		0.165 *
	Base management fee	0.557 **		
	Exit horizon	0.397 *		
Job satisfaction	Investment position hold back	0.469 *		
	Mutual fund-real estate	0.488 *		
	Management fee	0.494 *	-0.216 **	
	Exit horizon	0.432 **		
Risk taking attitude	Second lien	0.458 *		
	Invest proceeds commercial real estate	0.245 *		
	Real estate-stock	0.501 *		

(table continues)

Table 7 (continued)

Significant Correlation Coefficients

Independent variable	Dependent variable	C	r_s	r
Risk taking attitude	Investment term		0.198 *	0.158 *
	NOI incentive fee	0.485 *		
	Sales incentive fee	0.501 **		
	Mutual fund-real estate		0.155 *	0.154 *
	Annuity-stock	0.508 **	0.201 **	0.185 *
	Annuity-mutual fund		0.224 **	0.195 **
	Mutual fund-stock	0.481 *		
Lodging type	Invest proceeds stocks	0.139 *		
	Part-time employment	0.150 *		
	ROI incentive fee	0.285 *		
Business structure	Investment recoup	0.492 **		
	Invest proceeds pay off debts	0.326 **		
	Invest proceeds donations	0.292 **		
Investor type	Investment position hold back	0.263 *		
Years in business	Invest proceeds stocks	0.188 *		
	Invest proceeds donations	0.218 **		
Inn size	Invest proceeds stocks	0.231 *		
	Invest proceeds donations	0.276 **		

(table continues)

Table 7 (continued)

Significant Correlation Coefficients

Independent variable	Dependent variable	C	r_s	r
Inn size	Invest proceeds commercial real estate	0.270 **		
	Inn sitter another property	0.245 *		
Geographic region	Invest proceeds pay off debts	0.219 *		
	Exit horizon	0.326 *		
Location setting	Invest proceeds donations	0.204 *		
Occupancy rate	Management fee		0.150 *	0.183 *
Gross revenues	Investment recoup		-0.151 *	-0.145 *
	Management fee		0.149 *	
Net operating income	Investment recoup		-0.164 *	-0.166 *
Staff size	Investment recoup		-0.168 *	
	Annuity-stock		0.174 *	
	Management fee		0.172 *	

* $p < .05$. ** $p < .01$.

Research Objective 1

One-third of the questions in section II and all the survey questions in section IV and V dealt with the sale terms and conditions an Inn owner would sell their property to a REIT. Each Inn owner was presented with four different sale scenarios and asked to assess each one individually on a 7-point Likert scale. The participants were asked to indicate their level of agreement or disagreement with the sale scenario from 1 (strongly disagree) to 7 (strongly agree). The Inn owners didn't like any of the four sale scenarios. The strongest opposition came from the sale scenario (investment recouped after 2 years) asking them to operate the Inn for 2 years in order to recoup their equity in the property (M = 1.84, SD = 1.42, mode = 1 with 63.6% of the responses). The second least attractive sale scenario (investment position hold back) withheld a portion of the sales price in a fund to be paid out over 3 years as cash flow in each of those subsequent years achieved presale levels (M = 2.47, SD = 1.72, mode = 1 with 45.3% of the responses). The Inn owners slightly disagreed with the remaining two sale scenarios: sale price recouped equity (M = 3.26, SD = 2.25, mode = 1 with 38.3% of the responses) and recoup profits through a second lien or mortgage (M = 3.17, SD = 1.93, mode = 1 with 30.3% of the responses).

Varying degrees of association were found between these four sale scenarios and owner satisfaction, job satisfaction, investor type, risk taking, and business structure. There was a moderate relationship (Cs = 0.461 to 0.480) at the .05 significance level between owner satisfaction and all the sale scenarios except the one tied to cash flow (investment position hold back). The Spearman rank order correlation coefficient indicated there was a small inverse relationship (r_s = -0.170 at .05% level) between owner satisfaction and the sale scenario where the sale price recouped their equity (investment recoup). There was a moderate relationship (C = 0.469 at .05% level) between job satisfaction and the sale scenario tied to cash flow (investment position hold back). A small relationship (C = 0.263 at .05% level) existed between the investor type (active or passive) and the sale scenario tied to cash flow (investment position hold back). The sale scenario that recouped profits through a second lien had a moderate relationship ($\underline{C}$ = 0.458 at .05% level) with risk taking. The business structure produced a moderate relationship ($\underline{C}$ = 0.492 at .01% level) with the sale scenario asking the innkeeper to operate the Inn for 2 years to recoup their equity (investment recoup after 2 years). Lastly, the sale scenario that recouped their equity (investment recoup) had a small inverse relationship at .05% significance level with gross revenue ($\underline{r}_s$ = -0.151), net operating income ($\underline{r}_s$ = -0.164), and staff size ($\underline{r}_s$ = -0.168).

The Inn owners were asked where they would invest the majority of their property sale proceeds. The top five investment choices were personal real estate (59.9%), mutual funds (54.5%), stocks (49.5%), pay off debts (34.7%), and commercial real estate (29.7%). The next tier of most desirable investment alternatives were land (21.8%), certificates of deposit (19.8%), savings account (18.8%), and bonds (14.4%). The least desirable alternatives were personal property like automobiles or boats (6.9%), donations and gifts (6.9%), and other like collectibles (6.4%). Contingency coefficients were calculated for these investment alternatives against each independent variable. A moderate relationship ($\underline{C}$ = 0.326 at .01% level) was seen between paying off debts and business structure. Paying off debts had small correlations with owner satisfaction ($\underline{C}$ = 0.263 at .05% level) and geographic regions ($\underline{C}$ = 0.219 at .05% level). Small relationships were found between donations or gifts and these independent variables: Inn size ($\underline{C}$ = 0.276 at .01% level), business structure ($\underline{C}$ = 0.292 at .01% level), years in the business ($\underline{C}$ = 0.218 at .01% level), and location setting ($\underline{C}$ = 0.204 at .05% level).

Likewise, small relationships were established between stocks and these variables: Inn size (C = 0.231 at .05% level), years in the business (C = 0.188 at .05% level), lodging type (C = 0.139 at .05% level), and owner satisfaction (C = 0.247 at .05% level). Commercial real estate had a small association with Inn size (C = 0.270 at .01% level) and risk taking (C = 0.245 at .05% level). Unfortunately, the tests did not reveal the direction of the associations (positive or inverse).

The participants were requested to assess six pairs of investment alternatives and determine the degree to which they favored one investment alternative over the other (assset mix) using a 7-point Likert scale. Overall the participants were mostly neutral toward any given investment alternative except annuities (e.g., variable annuity, 401K) although approximately 13% failed to answer these questions. Several write-in comments indicated some confusion over how to answer these questions.

The participants slightly favored mutual funds (M = 5.24, SD = 1.78) and stocks (M = 4.90, SD = 1.92) over annuities where 1 on the scale represented a strong preference for an annuity while 7 represented a strong favor toward mutual funds or stocks. Marginally, the participants preferred an equity position to an income position in order of preference starting with real estate, then mutual funds and stocks, and ending with annuities. The Inn owners marginally selected equity appreciation over income (M = 4.07, SD = 1.97) to confirm this preference. The income position was more conservative than the equity position as it tried to preserve the initial capital. The equity position took some risks to improve the potential for higher rewards. The participant's risk taking attitude had a relationship with all but one investment pair: annuity-mutual fund, annuity-stock, mutual fund-stock ($\underline{C}$ = 0.481 at .05% level), real estate-stock ($\underline{C}$ = 0.501 at .05% level), and mutual fund-real estate. A small positive linear relationship existed in three of these cases: annuity-mutual fund ($\underline{r}$ = 0.195 at .01% level), annuity-stock ($\underline{r}$ = 0.185 at .05% level), and mutual fund-real estate ($\underline{r}$ = 0.154 at .05% level). Therefore, the participant's risk taking attitude increased as they moved away from investments in annuities or as they moved away from mutual funds toward real estate. Owner satisifaction also improved as the investment moved from annuities toward mutual funds ($\underline{r}_s$ = 0.161 at .05% level).

The survey determined how long a participant would invest in a real estate investment trust (REIT). This question yielded the highest non-response rate in the survey (20.8%). The researcher believes a lack of understanding concerning REITs was responsible for the high non-response rate because respondents wrote question marks next to the question. The responses to the REIT investment term question indicated a very slight preference for short term investing ($\underline{M}$ = 3.62, $\underline{SD}$ = 1.89, mode = 4 with 17.8% of the total responses). A Pearson product-moment correlation coefficient of 0.158 at the .05 significance level indicated a small positive linear relationship between the REIT investment term and the participant's risk taking attitude. The Spearman rank order correlation coefficient of 0.198 at the .05 significance level confirmed a small association that as the REIT investment term lengthened the risk taking attitude increased.

The Inn owners supplied a rate of return (ROI target) they expected to earn on the sale proceeds from their property. Eighteen participants left this question blank. The answers ranged from a low of 5% to a high of 40% with a mean of 14.38% (mode = 10%, Mdn = 12.5%, SD = 6.53%). The majority of the responses (68.4%) fell from 10% to 15%. The most common responses were 10%, 15%, and 20% with response rates of 27.7%, 20.7%, and 12% respectively. Six owners felt they could earn 40% while 8 expected 25% and 1 expected 30%. Sixteen individuals expected rate of returns in the range from 5% to 9%. A simple linear regression test (R = 0.138, Adjusted R^2 = -0.009) revealed that the rate of return could not be predicted by occupancy rate, average daily rate, gross revenues, net operating income, or staff size. There were no significant linear associations between the rate of return and the previously stated independent variables. Likewise, no relationship was found between rate of return and exit horizon.

Research Objective 2

All the survey questions in section III and half the questions in section II investigated what it would take to get the innkeeper to continue property management for the REIT once the sale was closed. The innkeepers agreed to manage and operate the Inn for 3 to 6 months past the sale closing date for a fee as a condition of the sale (duration as condition of sale). The innkeepers still agreed to manage and operate the Inn for 3 to 6 months past the sale closing date for a fee when the condition was removed (duration preference); however, more innkeepers (46% versus 27.2%) would never manage and operate the Inn if given the option. Only 10.9% of the innkeepers would manage and operate the Inn more than 1 year if required to or 8% if given the option. As a condition of sale, 61.2% of the innkeepers would manage and operate the Inn up to 1 year while 44.6% would if given the option. A summary showing how long innkeepers would manage and operate the Inn after the sale closing date as a condition of sale and as a preference are listed in Table 8. There were no correlations between these two property management duration variables and any independent variables.

Table 8

Property Management After Sale Closing Date

Duration	Condition of sale n	Condition of sale P	Preference n	Preference P
Never	55	27.2%	93	46.0%
3 months	50	24.8%	37	18.3%
6 months	36	17.8%	30	14.9%
1 year	16	18.8%	24	11.9%
13 to 24 months	4	7.9%	9	4.5%
25 to 60 months	2	2.0%	3	1.5%
More than 5 years	2	1.0%	4	2.0%
No response	1	0.5%	2	1.0%

The survey determined what employment categories the participants found desirable whether at their property or another property (employment conditions). Very few participants wanted full-time employment (9%) or part-time employment (20.1%) at their property. Inn sitting at their property (37.7%) or another property (40.6%) was desirable over innkeeping at another property (12.6% same geography, 16.6% different geography). Inn sitting was defined as short term employment not to exceed 2 months while innkeeping was defined as exceeding 2 months. The participants (57.4%) agreed to train the new innkeeper. There was a small correlation ($\underline{C}$ = 0.150 at .05% level) between the desire for part-time employment and the lodging type (Bed and Breakfast or Country Inn). Also, there was a small correlation (C = 0.245 at .05% level) between Inn sitting at another property and Inn size. There were no correlations between employment categories and the respondent's satisfaction levels, exit horizon, or risk taking attitude.

Section III determined whether innkeepers would agree to manage and operate someone else's Inn when offered one of four incentive plans or one disincentive plan. A 7-point Likert scale captured the participant's attitude toward property management fees from 1 (strongly disagree to the plan) to 7 (strongly agree to the plan). Approximately 14% of the participants failed to answer these questions. There were many write-in comments that the participant would never agree to manage a property for someone else under any circumstance. These five questions were not dependent on any property sale and as such don't affect owner satisfaction or exit horizon.

The four incentive plans were based on improving net operating income (NOI), improving gross revenues (sales), exceeding a return on investment (ROI) target, and exceeding a cumulative cash flow target. The participants preferred the incentive fee based on improving gross revenues or sales (M = 5.15 slightly agree to plan, mode = 6 agree to plan, SD = 1.74). The participants slightly disagreed to the other three incentive plans (ROI M = 3.47, cumulative cash flow M = 3.54, NOI M = 3.88). A mode of 4 (neutral) supported the indifference for these three incentive plans. Targets based on ROI and cumulative cash flow were the least desired. The participants disagreed to refunding a proportional amount of the base management fee for not achieving predetermined and mutually acceptable net operating income targets ($\underline{M}$ = 2.09, $\underline{SD}$ = 1.45, mode = 1 with 49.4% of the responses).

The gross revenue incentive fee had a small positive linear relationship ($\underline{r}$ = 0.165 at .05% level) with owner satisifaction. As the innkeeper grew happier (owner satisfaction), the gross revenue incentive fee was favored. A moderate relationship existed ($\underline{C}$ = 0.545 at .01% level) between the gross revenue incentive fee and owner satisfaction. There was a moderate relationship between the gross sales incentive fee and the participant's risk taking attitude ($\underline{C}$ = 0.501 at .01% level). Similarily, the net operating income (NOI) incentive fee had a moderate relationship with the respondent's risk taking attitude ($\underline{C}$ = 0.485 C at .05% level) and a moderate relationship with owner satisfaction ($\underline{C}$ = 0.510 at .01% level). Finally, the incentive fee based on a return on investment (ROI) target had a small degree of association ($\underline{C}$ = 0.285 at .05% level) with the lodging type (Bed and Breakfast or Country Inn). Ironically, the incentive fees had no association with job satisfaction even though both the fees and innkeeping job role were directly related to property management. As expected, the incentive fees had no association with the Inn owner's exit horizon since the fees concerned property management rather than ownership.

The disincentive plan, called for the participant to refund a portion of the base management fee for not achieving net operating income targets (management fee), had relationships to five independent variables. As the level of agreement with the management fee increased, the participant's job satisfaction decreased ($\underline{r}_s$ = -0.216 at .01% level). A moderate degree of association existed between the management fee and owner satisfaction ($\underline{C}$ = 0.551 at .01% level). Agreement to the management fee improved linearly as the Inn's occupancy rate increased ($\underline{r}$ = 0.183 at .05% level). Positive agreement to the management fee improved as gross revenues ($\underline{r}_s$ = 0.149 at .05% level) and staff size ($\underline{r}_s$ = 0.172 at .05% level) grew. A successful business, as measured by higher occupancy rates and gross revenues, was more likely to agree to the financial targets necessary to retain their full management fee. As expected, the management fee had no association with the Inn owner's exit horizon since was a post sale event.

The 1996 PAII Industry Study reported that properties with a small number of rooms lose money (1997). The financial figures in the 1996 PAII Industry Study provided evidence that economies of scale were at work. The fixed cost structure was the same regardless of the number of rooms. As the number of rooms increased, the cost structure allocated to each room decreased. Unit variable costs decreased as volume increased due to volume purchase discounts. As revenues increased, a lower expense ratio yielded higher net operating incomes. An improvement in net operating incomes (NOI) also improved the return on investment (ROI). The inability of small properties to make money would cause them to miss any NOI or ROI incentive fees and result in the refund of management fees based on NOI. The expectation was that small properties (Inn size) would not favor incentive plans based on NOI or ROI. However, the participants indicated no relationship between Inn size and these incentive plans based on NOI or ROI.

CHAPTER 5

SUMMARY, CONCLUSIONS, AND RECOMMENDATIONS

Summary

This study examined the feasibility of a real estate investment trust (REIT) as an exit strategy for Bed and Breakfast Inn owners. The study investigated what sale terms and conditions an Inn owner would sell their property to a REIT and under what conditions an innkeeper would manage the property for the REIT once the sale was closed. This chapter summarizes and concludes how well the respondents' attitudes match up with the attributes that would make a REIT feasible.

The REIT needs to have ready and able investors who own profitable and sustainable lodging properties. The typical investor should have a reasonable return on investment target and expect to withdraw their equity and profits over an extended period of time. The ideal REIT investor owns the property but has someone else manage and operate the property (known as a passive investor). In this case the investor exchanges the equity in their property for shares in the REIT without any interruption to the operations. This survey confirmed that most Inn owners are not passive investors. The second potential REIT investor is an innkeeper who enjoys managing and operating a property but would rather not own the property for reasons such as nearing retirement, unexpected personal bills, or dissatisfaction with ownership. The participants indicated a great deal of satisfaction with ownership; in fact, owner satisfaction was even higher than job satisfaction. The REIT needs a steady supply of investment properties to select from without the ills of oversupply in any given year. The participants' exit horizon has a nice distribution over time (flat parabolic curve when plotting years against cumulative percentage planning to exit the business). A startup REIT specializing in Inns introduces a degree of risk for investors. While the participants' attitudes indicated they were slight risk takers, the ideal REIT investor should be able to tolerate a higher degree of risk.

The most desirable REIT properties are those with a history of profitability. These properties are more likely to be larger in size with longer operational histories. Specifically, a participant with more years in the business offers a degree a maturity and stability to the property. Properties with more rooms offer better economies of scale to take advantage of volume purchase discounts and spread out fixed costs. Country Inns are more likely to be larger in size, have standardized practices, and operate like small motels. There were no significant correlations between factors favorable to a REIT and years in the business, lodging type, or Inn size.

An owner with a successful business would strongly oppose a sale scenario offering them a sale price equal to their equity plus liens. The financially successful owner would expect a reasonable return on their investment that would include appreciation, good will, and profits. An owner who would agree to sell their property without a return on investment is a distressed seller. A distressed seller may be the result of a life altering event or because the property isn't a viable business. The participants indicated only a slight disagreement with this sale scenario suggesting that many properties are not viable business investments. In other words, the survey identified

41.4% of the participants as potentially distressed sellers because they agreed or were neutral to this sale scenario.

A second sale scenario asked the participant to operate the property for 2 years in order to recoup their equity. This sale scenario was an attempt to assess the strength of a distressed seller's desire to sell. Surprisingly, 13.9% of the participants were neutral or agreeable to this second sale scenario -- a strong measure of distress. The participants' write-in comments indicated burnout, spouse transfer, young children, and health problems as reasons for needing to leave the business quickly.

The 1996 PAII Industry Study collected capital investment data from 177 Inns that were purchased, built, or converted since January 1, 1992. The average cash equity was $213,150 while the average lien was $309,318 per property (Professional Association of Innkeepers International [PAII], 1997). The same study collected net operating incomes, labor hours, labor rates, benefit rates, and staff wages from 386 Inns. The net operating income did not include mortgage payments, depreciation, or income taxes. The average adjusted net operating income after taking into account the owner's draw was $7,591 (see Table 9). It's important to account for the owner's draw because the REIT would incur this expense in hiring a property manager and staff. A negative cash flow would result when the mortgage interest was subtracted from the adjusted net operating income. A negative cash flow suggests that the property should be appraised as residential real estate rather than commercial real estate. Since the financial ratio data from the participants were similar to the PAII Industry Study, the average participant's property is not generating income.

Table 9

Adjusted Net Operating Income

Financial item	PAII Study
(a) Net operating income (NOI) M	$63,471
Owner's draw	
(b) Staff size M	5.3
(c) Hourly labor rate M	$7.41
(d) Annual labor wages (b x c x 40 x 52 = d)	$81,534
(e) Annual labor benefits (d x 0.156 = e)	$12,719
(f) Annual labor expense (d + e = f)	$94,253
(g) Reported annual labor wages M	$33,195
(h) Reported annual labor benefits M	$5,178
(i) Reported annual labor expense (g + h = i)	$38,373
(j) Owner's draw (f - i = j)	$55,880
(k) Adjusted net operating income (a - j = k)	$7,591

The National Association of Real Estate Investment Trusts (NAREIT) reported that publicly traded equity REITs had a historical 20-year compound annual return of 12.34% as of December 31, 1999 (2000). Lodging REITs are equity based. Price appreciation accounted for 25.9% while income represented 74.1% of the total return (NAREIT, 2000). The Lutheran Brotherhood Securities Corporation reported that Standard and Poor's 500 Index historically returned 12% per annum from December

1925 through December 1998 while the inflation rate was 3% (Bjelland, 1999). Stocks and real estate have historically provided the best risk adjusted return rates. The participants expected to earn a 14.38% rate-of-return on their sale proceeds. The participants' expectation levels exceeded historical return rates for both stocks and real estate. The 1996 PAII Industry Study gave no indications of the equity appreciation for the 87 purchased Inns. Given that the average Inn produced no income, it is safe to assume that these properties would not outperform the real estate market by generating a 14.38% return. The study found no way to predict a participant's target ROI based on their questionnaire responses. It is unknown whether the distressed sellers had an effect on rate of return targets.

The REIT requires investors to exchange their property equity for shares in the REIT. The ideal investor would sell their REIT shares gradually over time or hold the REIT shares for an extended period. The REIT would pay the investor quarterly dividends as required by tax law. The investor would receive tax benefits by delaying the capital gain taxes until the REIT shares were sold. There were signs that the participants wanted their equity and profits at the time of the property sale. First, the participants were generally not interested in taking their profits in the form of a second lien to the REIT. Second, the participants were against any effort to withhold a portion of the sale proceeds as proof of the Inn's performance. In this second sale scenario the participants felt they lacked the necessary controls over revenues and expenses to protect their investment. Is this any different from investing retirement funds in stocks of publicly traded companies? The investor isn't involved in decision making, profitability, dividend payments, and the like at these publicly traded companies and yet investors still buy stocks. A typical investor may not be attracted to a REIT specializing in Inns. Therefore, it's extremely important that the participants be willing to invest in the REIT for a long period. The survey results show that the participants do not favor long-term REIT investments.

The participant’s preference in investment alternatives wasn’t REIT friendly. A REIT behaves more like a stock than it does real estate yet the participants favored real estate over stocks or mutual funds. A REIT specializing in Inns offers less diversification than mutual funds. The participants favored the more diversified mutual funds over stocks. As shown by NAREIT’s performance figures over the last 20 years, equity REITs provide much greater income return than equity appreciation yet participants slightly favored equity appreciation over income. A REIT does not offer the safety of principal as an annuity. The participants favored stocks or mutual funds over annuities. This was the only time the participants selected investment alternatives that were REIT friendly. Overall the participants' investment selections were in the wrong direction 50% of the time and of the wrong strength (level of agreement) 83% of the time. The participants preferred to invest their sale proceeds in personal real estate and mutual funds rather than stocks and commercial real estate. A REIT friendly investor would have made the opposite selection. The high non-response rate to the question concerning how long would they invest in a REIT suggests either a lack of knowledge regarding REITs or a distaste for REITs.

The REIT needs individuals to manage and operate the properties. The logical choices are the existing innkeepers. The innkeepers preferred to sell their property and leave innkeeping altogether. Very few innkeepers were interested in managing and operating the REIT's property for more than one year. The average innkeeper would only manage and operate the property for 3 to 6 months as a condition of the sale. Since it takes a year to fully season a replacement as reported in Chapter 1, the existing innkeepers are at best an interim solution to REIT property management. The participants indicated they would train the new innkeeper. Approximately 40% of the innkeepers were interested in short term (not to exceed 2 months) Inn sitting. A much lower percentage was interested in part-time or full-time employment at an Inn. The participants could fill short term and peak staffing requirements the REIT might have. The even distribution of the participants' exit horizon gives the REIT a better chance to find and train property managers.

Incentive fees to manage the REIT properties did not gain much interest. Only the incentive plan based on improving gross revenue had any favorable agreement to the innkeepers. The REIT would prefer the three other incentive plans because each takes into account expense control as well as revenue growth. The responses indicated the innkeepers favored a lower base salary with performance bonuses rather than a higher salary with the possibility of paying back some of the base salary if objectives were not achieved.

Conclusions

The results of this study are very clear in that a REIT is not an appropriate exit strategy for most Inn owners. The Inn owners were not ready and able REIT investors and had little interest in REIT property management. Inn owners wanted their equity and profits at sale closing even though they were subject to capital gain taxes. The REIT is in a position to offer the Inn owners a means to defer those capital gain taxes, but the Inn owners, both directly and indirectly, were not interested in a REIT investment. In other words, the Inn owners' investment philosophy did not match up well with a REIT. The best Inn candidates had no greater interest in a REIT than other Inn owners. The REIT is looking for investors not parties looking to sell their real estate.

The REIT could not afford to pay the dividend rates the Inn owners are expecting for their investment. In fact, the Inns' negative cash flow would not generate any funds to pay dividends. The Inns' adjusted net operating income would not even cover debt service placing the REIT in jeopardy of bankruptcy. The REIT would have to lower the offer price in order reduce the loan value so that cash flow would cover the debt service. As a result, the REIT would not offer a sale price in line with the Inn owner's expectation of property value.

The innkeepers would only make a 3 to 6 month property management commitment to the REIT. The responding innkeepers were not interested in much more than occasional, short term assistance. Incentive fees and conditions of sale did little to change the innkeepers' view. While aspiring innkeepers may provide a suitable staffing source, the success of the REIT is dependent upon existing innkeepers managing and operating the REIT properties for several years.

When it is time to sell, the Inn owners will spend some period of time preparing and putting their Inn on the market. During that time the Inn owner continues to manage and operate the property. The write-in comments indicate that Inns have languished on the market waiting for a suitable buyer. Assume it takes 2 years to turn over a property. Why wouldn't an Inn owner sell their property to the REIT and then manage the REIT property for the 2 years? The property management time period would be the same whether the Inn owner waits on a suitable buyer or sells to the REIT. The Inn owner that sells to the REIT can take advantage of the deferred capital gain taxes and dividend payments.

Recommendations

As a result of this study, a number of recommendations have been made. First, investigate the attitudes of aspiring innkeepers to see if they are candidates for investing in a REIT and managing property for a REIT. Second, educate existing Inn owners on real estate investment trusts and determine if this knowledge changes their attitudes towards REITs. Third, study past property sales by Inn owners to establish benchmark return rates. Fourth, interview Inn owners to understand what conditions may change their attitudes toward REITs.

An aspiring innkeeper has the desire but may not have sufficient capital to purchase, build, or convert an Inn. One way to help the aspiring innkeeper is to partner them with the REIT. The aspiring innkeeper can provide some of the capital and all of the long term property management. The REIT provides the remaining capital, operational support, access to experienced innkeepers, improved loan rates and terms, and assumes the remaining financial risk. A study of aspiring innkeepers' attitudes might provide the REIT with suitable investors and property managers. Most of the questions in this survey could be reused with some minor modifications. Items that relate to experience could be turned into questions about their preferences (e.g., desired geographical region or location setting, how long they plan to stay in the business). The sample population could be gathered from several sources: PAII members who joined as aspiring innkeepers (approximately 500), aspiring innkeeper workshops conducted by current and past innkeepers, and visitors to the PAII web site. The results from aspiring innkeepers would be compared to the results from this study's existing innkeepers.

The mismatch between Inn owners' attitudes and REIT attributes may relate to a general lack of knowledge regarding REITs. I recommend that PAII take the leadership role in educating Inn owners about real estate investment trusts. This education would demystify the terminology used to describe a REIT. Inn owners should understand the tax implications and business frameworks associated with a REIT. Finally, the Inn owners must ultimately understand how their situation can be impacted by a REIT. Since this is a complex subject, my recommendation is to build small learning modules that reinforce previous modules and introduce new modules. These learning modules could be delivered in the PAII newsletter and over the PAII web site in the form of a series. The most effective learning modules incorporate multimedia (audio or video). The multimedia could easily be delivered over the Web using data streaming technologies. The multimedia could also be delivered through VHS tape, CD-ROM, or audio cassette. The production of the learning modules and multimedia would make an excellent undergraduate student project. Furthermore, the PAII biennial conference makes an excellent forum for delivering this education in an informal setting. This study's questionnaire would be administered to those completing the training and its results compared to the results of this study. This comparison would determine whether education made a difference in the Inn owner's attitudes toward a REIT both as an investor and property manager.

It would be very interesting to know how long a property is on the market and how much time was spent preparing the property before it went on the market. If an innkeeper is going to spend several years before they ever get the property sold, why would they be opposed to managing the property for the REIT if that sales mechanism reduced the sale cycle considerably. A study of past Inn sales would provide this insight along with why it was sold, what did the owners do with their sale proceeds, what was their asking and closing price, and what overall rate of return did they earn on their Inn investment. These figures would establish a benchmark for determining the actual return rate associated with these types of properties. PAII should coordinate the data collection by enlisting the help of real estate brokers who specialize in these types of properties. The study results should be reported through PAII's newsletter, web site, and biennial conference. The factual recording of past Inn sale prices and financial statements would establish a frame of reference for current Inn owners. It is believed that such a study would reset Inn owner's rate of return expectation level to better match historical stock and real estate rate of returns such that a REIT would be more attractive.

Focus groups and interviews with innkeepers attending the biennial PAII conference in 2002 would provide insight into their attitudes toward REITs. These conversations should explore key topics like how can the REIT persuade innkeepers to manage and operate the property for an extended period. The facilitator would be in a position to educate the participants on basic points (e.g., deferred capital gain taxes) before asking open-ended questions. The complexity of the subject material makes it difficult to gather problem definitions and alternatives using a written instrument. The same questions used in this survey are valid starting points. The sampling could also take place at regional meetings and innkeeper workshops. I do not recommend the use of conference calls or web based meeting facilities because the facilitator loses eye contact and can't pick up on participant's body language. These mechanisms are more suitable when relationships between the facilitator and participant are already established. These interview results may confirm the results of this study or persuade a researcher to ask different questions in a written instrument to PAII members.

Innkeeping is a lifestyle. In many cases innkeeping is more a hobby than a business venture. I get a real sense from innkeepers that a REIT would just complicate their lives. When innkeepers are ready to leave the industry, they are ready for a lifestyle change. Managing and operating the property for the REIT wouldn't allow them to change their lifestyle (e.g., retirement). When it's a hobby or lifestyle, the money is secondary. Their investment philosophy is counter to what's important to the REIT.

APPENDIX A

COVER LETTER

November 1999

Dear PAII member:

As you know there comes a time in your life when you may want to sell your Bed and Breakfast or Country Inn. The University of North Texas is conducting research on another potential sales channel for property owners which may help increase the property value or defer capital gain taxes. The study will determine the feasibility of this sales channel as an exit strategy for Bed and Breakfast and Country Inn owners.

Confidentiality and privacy of responses will be maintained. Your participation is voluntary. You may participate anonymously by declining to fill out the optional information. Please take 10 minutes to complete the questionnaire and return it by November 30th. No postage is necessary. For those owning more than one property, please fill out one questionnaire for each property.

The survey was approved by the University of North Texas Committee for the Protection of Human Subjects. A summary of the findings will be made available to the Professional Association of Innkeepers International for publishing on their web site and monthly newsletter. A summary of findings will also be sent to those replying with an e-mail address.

We thank you in-advance for your participation in this study. Looking forward to seeing you at the 2000 PAII biannual conference in Hilton Head where the results of this study will be reported. Should you have any questions or desire further information, please contact Dan at 972-492-8074.

Sincerely,

Dan Spielman
Graduate Student
Hotel and Restaurant Management
University of North Texas

Johnny Sue Reynolds, Ph.D.
Associate Dean and Associate Professor
Hotel and Restaurant Management
University of North Texas

APPENDIX B

QUESTIONNAIRE

SECTION I	This section includes statements describing your general attitudes. Please **circle** the number that indicates your level of agreement or disagreement with the following statements.

	Strongly Disagree						Strongly Agree
1. I am satisfied with my investment and ownership in a Bed and Breakfast / Country Inn	1	2	3	4	5	6	7
2. I plan to take investment risks for the opportunity to earn greater rewards in the future	1	2	3	4	5	6	7

Answer question 3 only if you are involved in managing or operating your Bed and Breakfast / Country Inn:

3. I am satisfied with managing and operating a Bed and Breakfast / Country Inn	1	2	3	4	5	6	7

SECTION II	This section includes questions regarding your intentions or preferences. Please **check** (✓) the category or **write in** the answer that best describes you.

4. I plan or expect to sell this Bed and Breakfast / Country Inn in how many years?

❑ Less than one year ❑ 1 to 3 years ❑ 4 to 6 years ❑ 7 or more years ❑ No plans

5. Assume that you sold your Bed and Breakfast / Country Inn and agreed to manage and operate your Bed and Breakfast / Country Inn for a fee as a condition of the sale. How long would you agree to manage and operate your Bed and Breakfast / Country Inn past the sale closing date?

❑ 3 months ❑ 6 months ❑ 1 year ❑ 13 to 24 months ❑ 25 to 60 months ❑ More than 5 years ❑ Never

6. Assume that you sold your Bed and Breakfast / Country Inn and you have the option to manage and operate your Bed and Breakfast / Country Inn as a paid employee. How long would you like to manage and operate your Bed and Breakfast / Country Inn past the sale closing date?

❑ 3 months ❑ 6 months ❑ 1 year ❑ 13 to 24 months ❑ 25 to 60 months ❑ More than 5 years ❑ Never

7. Assume that you sold your Bed and Breakfast / Country Inn. Please **check all** employment categories you find desirable. If none of the categories are desirable, proceed to question 8.

At your Bed and Breakfast / Country Inn (no ownership):

❑ Part-time (1 to 30 hours per week)
❑ Full-time (31 to 40 hours per week)
❑ Train new Innkeeper
❑ Inn sitter (short term not to exceed 2 months)

At another Bed and Breakfast / Country Inn (no ownership):

❑ Innkeeper in immediate geography
❑ Innkeeper in different geography
❑ Inn sitter (short term not to exceed 2 months)

8. If you sold your Inn and invested the sale proceeds, what rate-of-return on the sale proceeds would you expect to earn on that money expressed as a whole percentage from 0% to 40%? __________

9. If your property sold, where would you invest the majority of your sale proceeds? Please **check all** that apply.

- ❑ bonds
- ❑ CDs
- ❑ commercial real estate
- ❑ personal property (e.g., boat, car)
- ❑ mutual funds
- ❑ pay off debts
- ❑ land
- ❑ stocks
- ❑ donations / gifts
- ❑ personal real estate (e.g., house)
- ❑ savings account
- ❑ other ______________

SECTION III	This section includes statements concerning your attitudes toward property management fees. You have agreed to manage and operate someone else's Bed and Breakfast / Country Inn for a base management fee plus an incentive plan. Please **circle** the number that indicates your level of agreement or disagreement with the following statements.

	Strongly Disagree						**Strongly Agree**
Incentive plans							
10. I would like my incentive fees based on percent improvement in Net Operating Income (NOI)	1	2	3	4	5	6	7
11. I would like my incentive fees based on percent improvement in Gross Revenues (Sales)	1	2	3	4	5	6	7
12. I would like my incentive fees based on each percent exceeding a preferred Return-on-Investment (ROI)	1	2	3	4	5	6	7
13. I would like my incentive fees based on each percent exceeding a Cumulative Cash Flow target	1	2	3	4	5	6	7
Base management fee							
14. I would refund a proportional amount of the base management fee for not achieving predetermined and mutually agreeable Net Operating Income (NOI) targets	1	2	3	4	5	6	7

SECTION IV	This section includes statements concerning your attitudes toward sale terms and conditions. Please **circle** the number that indicates your level of agreement or disagreement with the following statements.

	Strongly Disagree						**Strongly Agree**
15. I am satisfied with selling my property at a purchase price that recoups my equity invested in the property	1	2	3	4	5	6	7
16. I am satisfied with selling and then operating my property for 2 years in order to recoup my equity invested in the property	1	2	3	4	5	6	7
17. I am satisfied with selling my property where my profits are in the form of a second lien (mortgage) to the buyer	1	2	3	4	5	6	7
18. Assume that a portion of the sales price is withheld in a fund. The funds are paid out over 3 years as cash flow in each of those subsequent 3 years achieve presale levels. The presale level is determined by the actual cash flow in the 12 months preceding the sale closing date. I am satisfied in withholding a portion of the sale proceeds to be paid out as future cash flows achieve presale levels	1	2	3	4	5	6	7

SECTION V	This section is related to your attitude toward investments. Please **check** (✓) the blank___ location that most accurately reflects your position relative to your preference between the two options.

Assess each pair of investment alternatives and determine the degree to which you favor one investment alternative over the other.

19. Income	___	___	___	___	___	___	___	Equity Appreciation
20. Mutual Fund	___	___	___	___	___	___	___	Stock
21. Mutual Fund	___	___	___	___	___	___	___	Real Estate
22. Real Estate	___	___	___	___	___	___	___	Stock
23. Annuity	___	___	___	___	___	___	___	Mutual Fund
24. Annuity	___	___	___	___	___	___	___	Stock

Assess how long you would invest in a real estate investment trust fund.

25. Short Term	___	___	___	___	___	___	___	Long Term

SECTION VI	The following questions will be used for descriptive purposes only. Please **check** (✓) the category that best describes this property.

26. How many years have you been in the Bed and Breakfast / Country Inn business?
❑ 1 to 3 years ❑ 4 to 6 years ❑ 7 or more years

27. Lodging type? ❑ Bed and Breakfast (breakfast only) ❑ Country Inn (serves dinner and/or lunch)

28. Geographic region?
❑ NM, CO, WY, MT, AZ, NV, ID, UT, WA, OR, CA, HI, AK (West)
❑ KS, NE, SD, ND, MN, IA, MO, IL, WI, IN, MI, OH (Midwest)
❑ TX, OK, AR, LA, MS, AL, GA, FL, SC, NC, TN, KY, WV, VA (Southeast)
❑ PA, MD, DE, NJ, NY, CT, RI, MA, NH, VT, ME, DC (Northeast)

29. Location setting? ❑ Rural (in the country) ❑ Urban (cities and suburbs) ❑ Village (towns)

30. How many available guest rooms are in your Bed and Breakfast / Country Inn?
❑ 1 to 4 rooms ❑ 5 to 8 rooms ❑ 9 to 12 rooms ❑ 13 to 20 rooms ❑ 21 or more rooms

31. What is your current business structure? ❑ Sole proprietor ❑ S-corporation ❑ General partnership
❑ Limited partnership ❑ C-corporation ❑ Trust ❑ Limited Liability corporation

THANK YOU FOR YOUR TIME!
Please return only one questionnaire per property by November 30th. **No postage is necessary.**
Or fax to the attention of Dr. Johnny Sue Reynolds at 940-565-4348**.**

Your name (optional): ____________________________ E-mail address (optional): _____________________

Bed and Breakfast Inn name (optional): ____

Comments (optional): ____

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