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EDITORIAL OPINION

Friday the 13th

Is it just superstition or do bad things actually happen on Friday the 13th? This no doubt was a question passengers on a flight a few weeks ago from Copenhagen to Helsinki asked themselves when they looked at their boarding passes only to see: "Flight 666 to HEL." Coincidentally (?), the plane was thirteen years old. (We cannot report whether or not anyone in the crew was named Jason or Freddy.)

Investors in American Realty Capital Hospitality Trust may also be asking themselves the same question, when on Friday January 13th the company announced a complex set of transactions which include the issuance of up to $400 million of convertible preferred units to Brookfield Strategic Real Estate Partners II ("Brookfield") and a "Framework Agreement" with the company's Advisor, its affiliates and Brookfield. In a filing with the SEC, the company (to be known as Hospitality Investors Trust, or HIT) disclosed that it will initially issue approximately 9.15 million Class C Units to Brookfield that are convertible into common units (and ultimately into company common stock generally on a one-for-one basis) at $14.75 per unit, for a total of $135 million. Through February 2019 the company has the right to sell, and after February 2018 Brookfield has the right to purchase, in follow-on fundings an additional $265 million of Class C Units to Brookfield, thereby increasing Brookfield's potential post-conversion company ownership to approximately 41.3%.

Equity capital infusions can certainly be good things and can provide a pathway to growth. So why may some shareholders be hearing the sounds of a chainsaw when they read through the 706-page, investor friendly Form 8-K filing? For one thing, the $14.75 conversion price represents a whopping 31% discount to the most recent per share net asset value reported by the company of $21.48 (down from an original issue price of $25 per share). Said another way, assuming the take down of the full $400 million of Class C Shares, Brookfield will have purchased a preferred interest in $488 million of real estate net asset value for $400 million.

What's more, while common shareholders' distributions were converted from cash to shares at the end of the first quarter, and third quarter share distributions were issued at an annual rate of 6.8% of the net asset value reported as of July 1, 2016, the preferred Class C Units will be paid a total annual cumulative current yield of 12.5% -- 7.5% in cash and an additional 5% in the form of Class C Units on the new money. The 12.5% dividend on the initial tranche of funding will dilute materially the FFO available to common shareholders, resulting in a decline in distribution coverage.

Some investors may also be smelling chain saw gas fumes when they read the terms of the Framework Agreement. According to the filing, that part of the transaction provides, among other things, for payments to the Advisor (ARC Global) and its affiliates in connection *"with the transitioning from an externally managed company with no employees…..to a self-managed company"* and the termination of the Advisory Agreement. This compensation includes the payment of $14 million in cash plus the issuance of 804,285 shares to the Advisor and its affiliates and the waiving of the Advisor's existing obligation to repay $5.8 million of offering and organizational expenses to the company. In addition, Crestline Hotels & Resorts, an affiliate of the Advisor, will be retained as property manager for 74 hotels for a contractual term of approximately 18 to 19 years for a fee equal to 3% of gross property receipts (a reduction from 4% currently). Some investors may perceive a limit on how deeply this particular slice of the saw cuts since, beginning four years after closing of the transactions, the company is allowed to terminate the property management contract in the event of a sale of the properties, albeit for a fee equal to 2.5 times the prior twelve months property management fees.

By our calculation and based on the current valuation of the company, per share net asset value stands to be reduced on a fully diluted basis from $21.48 to approximately $18.00 per share assuming the issuance and conversion at $14.75 of the $400 million of Class C Units, the payments to the Advisor, the waivers of the Advisor's reimbursement obligations, and other estimated fees and expenses of the transaction. The dilution and fees equates to approximately $129 million on a $400 million capital infusion. Perhaps this dilution explains the company's name change to the acronym "HIT".

Why perform such a transaction which takes an axe to the position of the common shareholders at the top of the capital stack? Why not sell the company and provide all the proceeds to investors rather than put current shareholders in a subordinated position with a potential dilution of approximately 16% to their existing per share net asset value? One reason would be a conviction that the equity infusion from Brookfield will trigger dramatic per share growth which justifies the increased risk being placed on existing shareholders. Another reason may be a lack of equity funding available to meet payment obligations on the Grace hotel portfolio purchase. Ignoring the issue of what management decisions and events may have put the company in this situation, the robust magnitude of the dilution to shareholders from this transaction versus possible alternatives to the Brookfield funding is worthy of scrutiny. But some may conclude there are another thirty million reasons, or more. AR Global is being paid $14 million in cash, receiving approximately $14.5 million in stock (based on the fully diluted estimated per share net asset value of $18.00 cited above) and is being relieved of $5.8 million of reimbursement obligations to the REIT, not to mention the retention of hotel property management for up to 18+ years by an affiliate of AR Global. All in all, the package appears to be a pretty nice payday for AR Global, particularly given the dismal performance to date of the company on behalf of shareholders – an aggregate loss on initial gross offering proceeds of approximately $260 million (providing yet another justification for the company's acronym "HIT").

Friday the 13th superstition or Friday the 13th massacre? We won't know the assessment of HIT's investors because they do not have the opportunity to vote on this transaction -- it has already been approved by the company's board of directors without a shareholder vote. But investors in other ARC Global-advised entities (for example, American Realty Capital Retail Centers of America, which is presently voting on a proposed merger transaction) may be well advised to take note of this transaction and decide whether or not they deem it a horror show. The reason: There always seems to be a sequel in the Friday the 13th series. ■