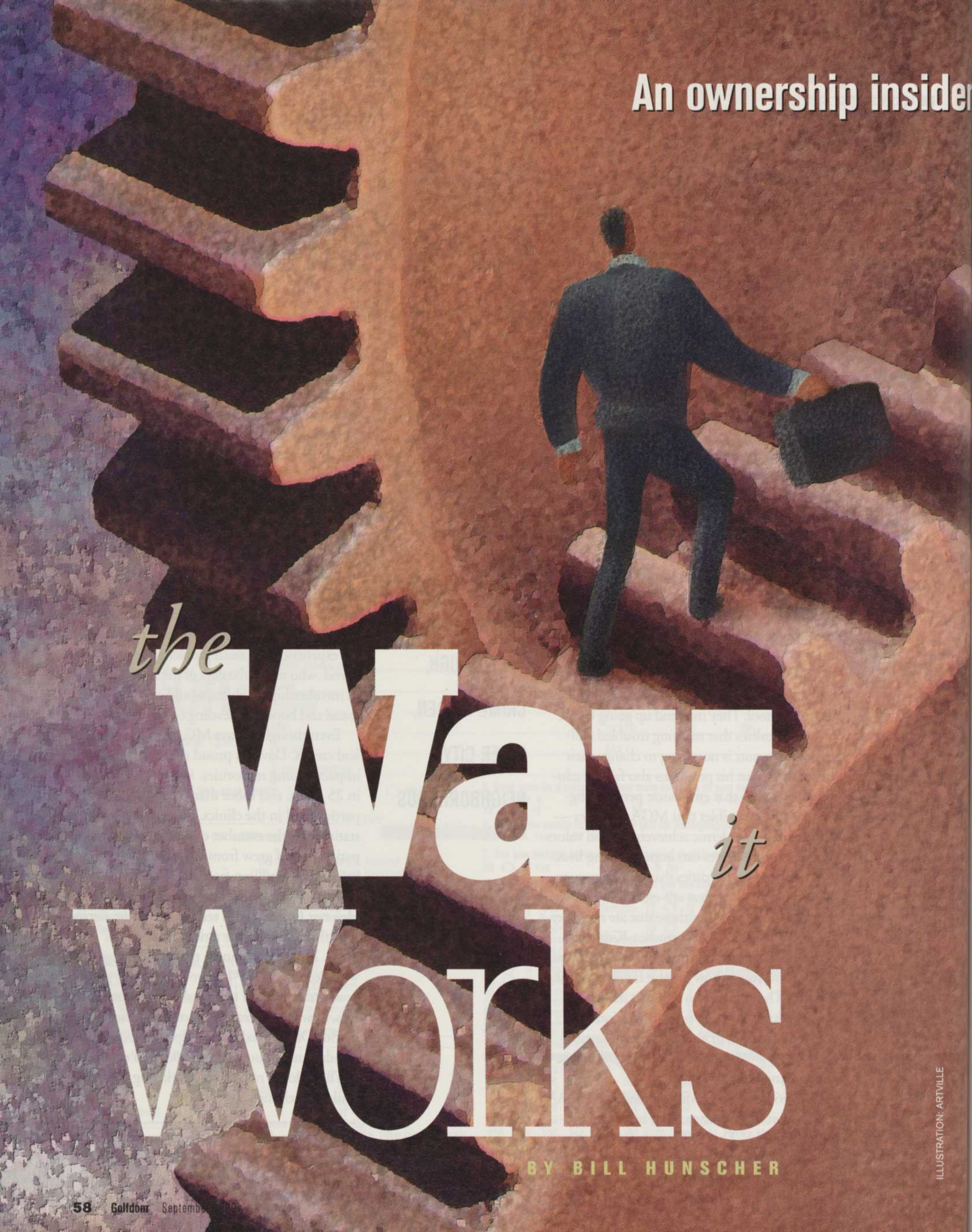
An ownership insider



the Way it Works

BY BILL HUNSCHER

ILLUSTRATION: ARTVILLE

explains the ins and outs of today's acquisition market

Just when you think you understand how golf courses are bought and sold, economic forces again alter the acquisition landscape. Prepare for change.

Gone are the "low-hanging fruit" deals that were easy to turn around. Bigger, regionally focused companies with proven systems, buying power and loyal customer bases are, for better or worse, the wave of the future. Expect downward pressure on prices and multiples paid for golf courses in the future.

Many of the marginal players — those who have created marginal deals by paying whatever it took to get deals done — will be weeded out of the business. The creation of value through acquisition will get tougher, especially in the coming economic downturn.

The result may be a better product for the golfing consumer, as courses compete to grab the shrinking number of available green fee dollars. Ultimately, the focus will be on improving the golf course model, not just swapping assets for more than you paid for them.

Gaining a perspective

In order to understand how to best market your golf course in today's acquisition environment, it's important to develop a historical perspective on golf industry consolidation as a whole. With this viewpoint, one can better determine the future value and marketability of golf courses, in general, and your course in particular.

Like many other industries (including waste management, funeral homes and hardware stores), the golf business was ripe for consolidation in the late 1980s and early 1990s. For starters, ownership of golf courses was and remains highly fragmented, with the major management company players controlling less than 5 percent of the nation's growing facility stock. And the golf business — if you're located in a halfway decent market and run an efficient operation — can be highly profitable, with strong underlying real estate appreciation. Over the last decade, the golf industry has also undergone an unprecedented boom — industrywide revenues and public interest worldwide are at an all-time high.

These industry fundamentals sparked a keen interest on the part of investors, large and small, to put money to work buying and improving golf facilities. The formula was simple: Buy courses cheap with lots of leverage; make the capital and operating improvements the mom-and-pop operators couldn't or wouldn't; and sell the portfolio of courses at a high multiple to another larger player or through an initial public offering.

The returns, theoretically, were in the venture capital range (30 percent) and thus many of the initial golf management firms were backed by these types of large, sophisticated investors. The result was hundreds of millions of dollars of investment fueling a growing number of golf management companies hell-bent on the "Great Consolidation" we see today.

Riding the waves

As I have watched and been an active participant in this process, I've noticed what I call the first and second waves of fuel entering the golf arena. The first wave, which I mentioned earlier, was predominantly venture capital funds and wealthy individuals who formed limited partnerships to provide the equity required by the management companies. At the same time, the golf business became better understood by lenders — and golf courses became an "approved asset class" for commercial lenders other than the traditional golf lenders such as NationsCredit and Textron Financial.

The second wave of capital, which is still with us, was more institutional in nature. Large real estate investors, who traditionally financed commercial and residential developments, began to view golf courses as an attractive real estate-related play. Publicly traded real estate investment trusts (REITs), which basically allow investors to pool their money into large chunks for real estate investment, popped up and were initially well-received by the market. At the same time, more well-funded golf management companies entered the game, and competition for courses began to heat up.

The funds available and the number of firms competing to buy golf courses naturally caused a fairly dramatic increase in purchase prices as a multiple of operating income — the "market multiple," the industry standard for valuing acquisitions. (For example, you pay $10 million for a facility that generates $1 million in annual income, giving you a 10 times multiple of earnings.)

Perception vs. reality

It's interesting to take a step sideways and discuss the pitfalls of paying the market multiple. Many acquirers of golf courses, in the perfect world of Excel spreadsheets, have modeled their golf course acquisitions at the market multiple with the traditional 75 percent debt and 25 percent equity funding the purchase.

Through capital investment and better management, the assumption is this: With increased revenues and expense control, the operating income increases in the first three years by the industry standard — 25 percent, 15 percent and 10 percent, respectively. Based on this kind of financial scenario, and an eventual sale of the improved property at a higher multiple, a 25-percent-plus return is achievable and everybody makes out great.

But what sorts of returns are achievable when high prices are paid and the cruel reality of running a golf course sets in? When I speak on this subject, I like to show folks a five-year comparative spreadsheet illustrating the impact on returns of the inevitable:

- resistance to price increases;
- cost overruns on capital improvements;
- major storms forcing shutdowns and/or more capital to repair

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the damage;

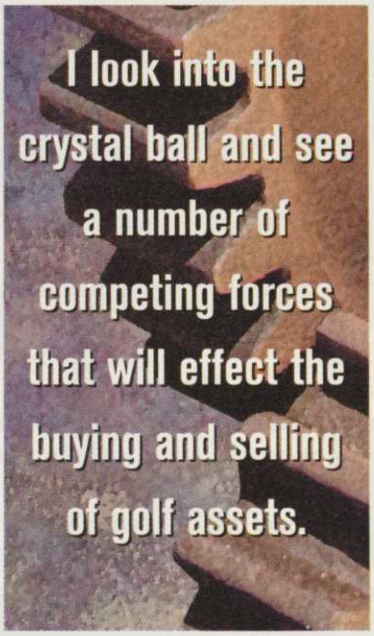
- bad weather during the peak summer months; and
- increased competition by new, sexy courses.

Sound familiar? The returns from any combination of this bad luck fall off the shelf quickly, especially if you have paid too much. I bet a few of the well-funded golf management companies (though they probably won't admit it) have some of these stories in their portfolio and, as a result, are facing suboptimal returns for their investors. These suboptimal returns will only be made worse if we suffer a sustained economic downturn in the near future.

Competing forces

I look into the crystal ball and see a number of competing forces that will effect the buying and selling of golf assets. On the positive side, there's still a big universe of courses to be purchased. In fact, the golf industry consolidators are, collectively, buying less than 100 courses per year. The latest National Golf Foundation statistics indicate that more than 300 courses are opening every 12 months. If anything, the market for acquisitions is expanding.

The capital which entered the golf business in the first two waves is also pushing companies to acquire, as these funds must be deployed in order to make a return. If the capital cannot be deployed (market multiples get too crazy), then investors will seek other opportunities outside the golf business. Another factor bolstering the acquisitions market is the number of new golf management companies that continue to be formed. Many of these firms are started by refugees from larger companies who have the experience, contacts and financial backing to make a go of it.



The last factor is the continued strength of the game itself. Dollars spent in the golf industry, though down from recent records, are still robust. The interest in the game, its new facilities, its personalities and tournaments has never been stronger, and people want to get involved in the business. I don't think golf, so tightly woven into the fabric of our business and social lives, will ever go the way of tennis.

The negative pressures I see center mainly on an inevitable downturn in the economy. Having lived through at least one business cycle, I remember what happens when things get bad. The impact on discretionary dollars that flow into the game of golf will be felt quickly, especially at the higher-priced courses and facilities that are not located near population centers. There are also a lot of dicey deals out there. Let's face it, paying a high multiple for anything is only sustainable in an increasing market — somebody has to pay more for the asset than you paid.

Otherwise, in a downturn the whole return scenario unwinds. With all the courses that have been constructed in the 1990s, many markets are overbuilt. Unfortunately, given a fixed number of rounds, many of the newer courses must charge high green fees in order to make their returns. Again, these will be the first courses to feel the brunt of a downturn.

The capital markets, to which many companies look for their fuel, have been erratic of late. Prices of the publicly traded REIT stocks have fallen considerably. This drives the cost of capital up and, all things being equal, dictates that these major course acquirers pay less to get the same return.

Given the erratic market, I see a move toward more traditional (read: conservative) capital, which comes at a higher cost than institutional money. Higher cost capital means higher returns required and thus lower multiples being paid for golf courses.

Marketing your course

It's important to have realistic expectations about what your course is worth. Asking prices should be functions of your facility's historical performance, as well as its upside potential factored by the time and dollars needed to create this upside.

Course location is also key. In the near future, many companies will be reluctant to stray too far beyond the population centers and/or corridors of growth. Another factor is the barriers to competition in your market. I've seen the economics of otherwise healthy golf courses gutted by three or four new courses coming on line. Given the flux out there, it's important to keep an open mind to alternative structures, such as leasing, joint ventures and management contracts with options to purchase.

These structures provide a potential buyer more time to assess risk and, in the end, will probably yield the value you desire for your golf course.

My last point focuses on packaging your course for sale. Buyers of courses have multiple choices in the expanding acquisitions market and, many times, rigorous investment criteria from their institutional investors. If not properly presented, you might scare buyers off quickly. If you are serious about selling your course, make sure the major issues such as title, survey and environment are clean, documented and organized. Your historical financials also need to make sense, with any owner-incurred costs (like the company jet) pulled out. Detailed rounds and mix-of-rounds information is helpful for acquirers to understand your business and build their pro formas.

Massive reductions in expenses are difficult to hide on the course, to say nothing of their effects on customer satisfaction. They are also the first sign that numbers have been cooked for sale. Most buyers will see through th s. If you have any questions on what information buyers look for, give one of the larger management companies a call. I'm confident you will get a comprehensive due-diligence checklist, as well as a new best friend. ■

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