PRIVATE WEALTH ADVISORY

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Portfolio Update: HST

I want to take a moment and discuss Host Hotels and Resorts (HST): the biggest loser in our portfolio, currently down 21%.

At times like these, it is difficult, almost impossible not to become overly emotional. Seeing this position even bothers me sometimes and my skin is thicker than most: in 2008, I was short financials for six months weathering double digit losses before I got my desired double.

So I wanted to perform a quick review of this position. HST is the LARGEST hotel REIT based in the US. The company owns luxury hotels all over the world. All told it has 113 hotels with 62,000 rooms. As such, the company is very closely related to business travel and tourism.

Both of those industries are DEAD.

The UN recently reported that worldwide tourism fell 8% during the first quarter of 2009. Europe saw a 10 per cent decline, while Asia declined 6 per cent. Of 19 European countries with 3-5 months of data available, **<u>10 have seen volumes contract by over 10%.</u>** In the US, Florida has tourism has fallen for the first time in seven years. Total non-resident visitations to the US from overseas are down 9% year to date.

Consider that previous to this, **tourism as an industry grew by 4% a year for DECADES.**

Regarding business travel, the Air Transport Association just reported that June passenger revenue for the largest U.S. airlines fell 26 percent, compared with June 2008. **When you consider that the number of passengers is only down 6.5%, it's clear that this collapse in revenues is due to a HUGE drop in higher-paying passengers (business and first class).** Indeed, Continental Airlines president Jeff Smisek said business passenger **traffic was down 27 percent in June compared with the same period last year.**

Bottomline: HST's two primary sources of revenue are collapsing. So it's no surprise that its fundamentals are an absolute NIGHTMARE. For sanity's sake, let's do a quick review of its 2Q09 results.

	2Q09	2Q08	Change
Revenues	$1.06 billion	$1.39 billion	**-23%**
Earnings	-$70 million	$134 million	**Greater than -100%**
Funds from Ops.	$68 million	$306 million	**-77%**
Occupancy Rates	67%	76%	**-9%**
Revenue Per Room	$117	$156	**-25%**
Dividend	$0.03 in cash	$0.20 in cash	**-85%**

The above table speaks for itself.

Yet, despite what can only be described as horrific earnings, HST's share price has rallied 12% since its earnings release. Hard to believe, but it's totally true. This degree of financial collapse is somehow considered reason for celebration.

The fact that HST hasn't made a dime in six months doesn't seem to bother anyone. Neither does the market seem concerned about the fact that HST is relying on selling its assets and issuing more debt to cover its current debt payments

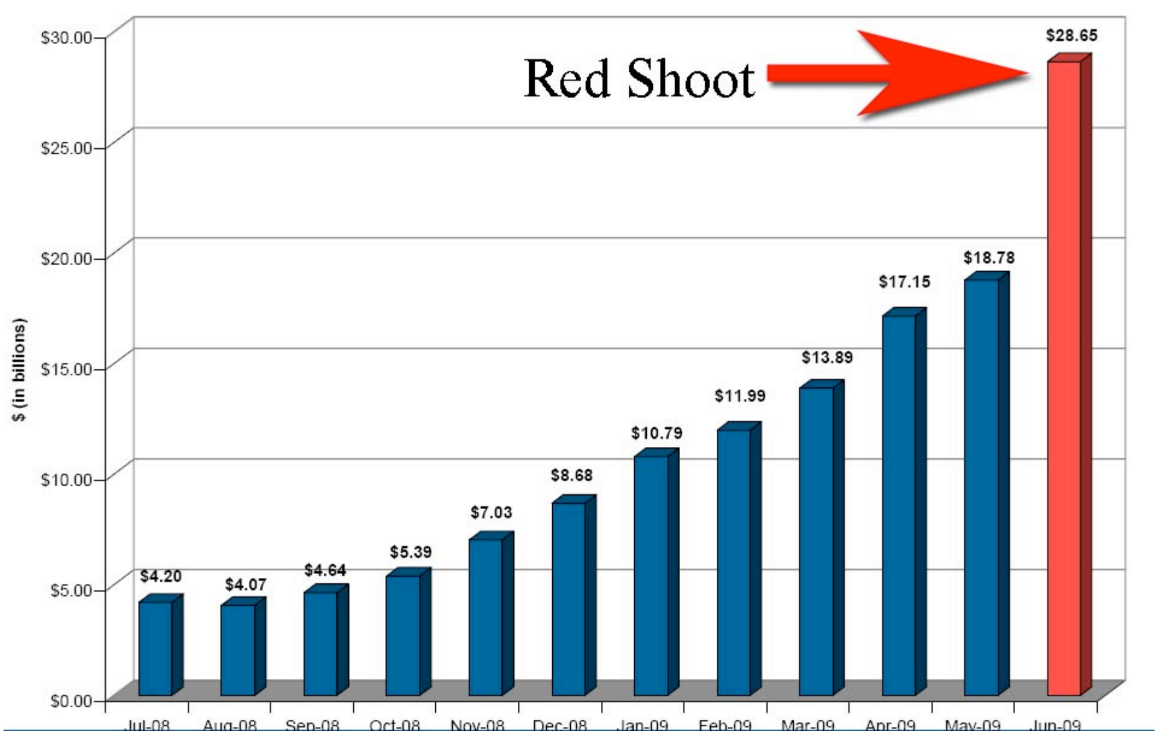
Indeed, HST is beginning to remind me of former mall REIT General Growth Properties (GGP). Like GGP, HST is the 800-lb gorilla of its industry. Like GGP, HST has a large debt load and is no longer able to meet its debt load through earnings. Like GGP, HST's primary revenue streams (business travel and luxury tourism) are NEVER coming back to the levels that they once were.

Why is this company still operating?

For one thing, Moody's and the other credit rating agencies have yet to accurately rate the commercial real estate market. But the loans that generated expansion in the commercial space are as toxic if not MORE toxic than those generated in the residential space.

Indeed, the below chart says it all:

Charts 1 and 2 – Monthly CMBS Delinquency: Balance vs. Percentage (*source: Realpoint*)



As you can see, delinquencies on Mortgage Backed Securities for the commercial real estate sector have exploded 585% higher YoY. **Economists now believe that as many as one in five hotels may default on their loans by the end of 2010.**

HST will lead the pack. It is no longer able to make money and has $480 million in debt due in the next 18 months. To put that number in perspective, HST only made $546 million in annual income from continued operations 2007: **at the absolute PEAK of a 30-year credit boom.**

"Continued operations" is the key phrase there. HST has actually been making 30% or more of its earnings in the last nine years from selling hotels. If you take away asset sales, HST's earnings would plummet. Even WITH asset sales, the company actually operated at a loss from 2002-2004.

So unless, the mega-boom times of 2007 return (NOT going to happen), HST will NOT be able to service its debt load through earnings. Instead it will have to engage in more financial juggling (issuing more debt, diluting current shareholders, etc).

When a company starts doing this (especially a company that is required to pay out 90% of its earnings to shareholders) that company is in SERIOUS trouble. Now add the fact that the company is making 25% less per sale (revenue per room has fallen 25% YoY), and you've got a recipe for disaster.

In a nutshell, HST is primed for a serious collapse. It may take a few weeks. It may take six months. But at some point, HST will become the GGP of the hotel REITs. And we will profit quite handsomely when it does.

So while I am pained to see our position so far in the red, I take comfort knowing that HST's business is completely broken. It is no longer making money from hotels, but financial engineering. The last company I know of that began employing this business model (making money from debt NOT actual sales) was GM.

Look how that turned out.

Good Investing!

Graham Summers