**This 3DAdvisors Report Covers:**

- ✓ **Insider Trading**: Insider Trading Behavior
- ✓ **Accounting**: Quality of Earnings Issues
- ✓ **Governance:** Corporate Governance Issues

# Thin Disclosure Hides Multiple Complex Issues
# Marriott International, Inc. (NYSE:MAR)

**August 22, 2003**

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Marriott International Inc. is an operator and franchisor of hotels and related lodging facilities worldwide. The Company operates or franchises 2,557 lodging properties worldwide, with 463,429 rooms as of January 3, 2003. It provides 4,316 furnished corporate housing units. Its operations are grouped into five business segments: full-service lodging (Marriott Hotels, Resorts and Suites; The Ritz-Carlton Hotels; Renaissance Hotels, Resorts and Suites, and Ramada International); select-service lodging (Courtyard, Fairfield Inn and SpringHill Suites); extended-stay lodging (Residence Inn, TownePlace Suites, Marriott ExecuStay and Marriott Executive Apartments); timeshare (Marriott Vacation Club International, The Ritz-Carlton Club, Horizons and Marriott Grand Residence Club brands), and synthetic fuel (the operation of its coal-based synthetic fuel production facilities).

## Summary of 3DAdvisors Findings for MAR

- **Governance:** Disclosure is the key overall issue with MAR
- **Accounting:** Timesharing is a bigger issue than disclosures suggest
- **Accounting:** MAR's legal battles spawn interesting transactions
- **Governance:** A recently filed suit reveals related-party transactions
- **Accounting:** The strange purchase of 14 senior care properties
- **Insider Trading:** Selling is subtle, but possibly significant

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## Discussion of 3DAdvisors Findings

Governance: Disclosure is the key overall issue with MAR

This company is one of the most difficult to sort out we've seen. Marriott does little to make this easier. Part of the problem lies in the Company's obfuscated disclosure of detail involving large transactions. Then there are dealings, carefully concealed, that would indicate that significant chances for conflicts of interests exist with regards to certain Marriott family investments.

Marriott CFO, **Arne Sorenson (44)**, is one of the few CFOs we've seen with primarily a legal background, as opposed to financial. Prior to joining Marriott, he was a partner with Latham & Watkins in Washington, D.C. It is Sorenson who runs the conference calls and seems to very much be the architect of much of Marriott International's complex web.

Wrap all this together with the rather well-known quality of earnings issues related to both timesharing and the Synthetic Fuel business and we have a company whose results are heavily dependent upon two areas where disclosure has been clearly sub-par (details on several aspects of the timesharing business are discussed below).

With regards to the Synthetic Fuel business, we all know that it brings large tax benefits that boost Marriott's otherwise sagging bottom line. We also know that those benefits are somewhat in doubt, both with Marriott's recently-announced but yet to close sale of 50% of its Synfuel business and recent IRS statements regarding potential problems with ongoing tax credits for such businesses. Because of this, given the heavy contributions tax credits have brought to the Marriott bottom line, we have chosen to relate earnings contributions of any element in this report to Earnings Before Taxes (read: before contributions from Synfuel).

## Accounting: Timesharing is a bigger issue than disclosures suggest

In the latest conference call (Q2 of 2003) some analysts pressed CFO Arne Sorenson on whether or not the timesharing business was showing a bit of "buyers fatigue" as sales seem to have cooled off a bit (down 15% in the first half of 2003 from the same period in 2002). Sorenson's answer was characteristically brief. It seemed to imply that although sales were weaker in "markets like Orlando" and for the "fractional product in London", which had been impacted by travel in Q2, while other markets, like Hawaii and California, were "quite strong". Not much of an answer to sink your teeth into, but typical of Marriott's cryptic disclosure surrounding this critical area.

Critical indeed, as in the first half of 2003 timesharing contributed $62 million, or about 38% of consolidated income from continuing operations (before taxes) for the period. The big contribution seems somewhat belied by the fact that, for the period, the $62 million represented an 11% decrease in the earnings contribution from the prior year period, and that year-earlier period being one where a higher timeshare earnings number represented a lower contribution of just 28% of Consolidated Income from Continuing Operations (before taxes). Clearly, timesharing has become an integral part of Marriott's business model, and a critical component of the Company's overall risk picture.

The conundrum with the timesharing picture is that, due to the Company's cryptic disclosure policies, only those at the highest Company levels seem to possess the knowledge with which to evaluate the timesharing-related risk picture. Granted, disclosure in this area has opened up a bit. Opened enough, that is, to cause us to ask more questions. A key disclosure relates to the periodic repurchase of timesharing notes that Marriott transacts. Last November (2002), Marriott repurchased timeshare notes receivable, with a principal balance of $381 million and immediately resold $365 million of them, along with $135 million of additional notes, in a $500 million securitization. The Company realized a $14 million gain on the transaction, which we believe came from the gain associated with the $135 million of additional notes added to the deal. But what about those repurchased notes? Could it really be that there was no gain or loss associated with their resale? We're not so sure. In a relatively new disclosure, appearing for the first time in the Y/E 2002 10K, the Company revealed the following [the bolding is ours for emphasis]:

**"We enter into guarantees in conjunction with the sale of notes receivable originated by our timeshare business. These guarantees have terms of between seven and ten years. The terms of the guarantees require us to repurchase a limited amount of non-performing loans under certain circumstances. When we repurchase non-performing timeshare loans, we will either collect the outstanding loan balance in full or foreclose on the asset and subsequently resell it. "**

Now, for the first time, Marriott has revealed that it is required to buy-back some level of non-performing timesharing loans, originally securitized through a Special Purpose Entity. But even given the limited nature of this increased disclosure, another item jumps out: the guarantees discussed above have terms of seven to ten years. In the world of timesharing, recourse over this long of a period could be a significant exposure.

What makes this more interesting is the method by which these loans are re-packaged, by adding in new notes, before re-securitizing them. What catches us, between the eyes, in these re-securitizations, is the fact that, thanks to the sales of new receivables mixed in with the package, Marriott is able to report a gain on the transaction but nothing is said about whether or not they have been hit by a loss on resale of the non-performing notes. It seems illogical that there would be no loss, to Marriott, associated with taking the original bad loans off the hands of their buyers through securitization. And now the original transactions are unwound, and most of the gain, in the new securitization, is from the sale of the $135 million of new notes. The bottom line is that we wonder if a loss is buried in the transaction somewhere that does not hit the income statement.

There very well may have been a trick played with the related interest-only strips associated with the repurchases. Marriott discloses that it holds its strips as either "available for sale" or as "trading" securities. In other words, they do it both ways. There's a significant difference between the two choices. If the strips are held as "available for sale", any change in their fair value goes through Other Comprehensive Income in Shareholders Equity. If they are held as "trading" securities however, any valuation change must end up in Income. Marriott, it seems, reserves the right to utilize judgment as to how to handle this. We must assume that the treatment complies with GAAP. However, if the repurchased notes were held for sale, and if they were bought back because they had to be, the treatment looks to be a crafty way to avoid hitting the income statement with fair value losses that might have more properly been chargeable to income. But there's more: Marriott doesn't give you a clue, in its Other Comprehensive Income schedule, what any effect this transaction have had on shareholder's equity. Any potential effect has been obfuscated by netting it, with other items, in the "Other" category of Other Comprehensive Income.

We note that another transaction of this nature occurred back in 2000. At that time, the Company had repurchased timesharing notes receivable with a principal balance of $359 million and immediately sold those notes, along with $19 million of additional notes, in a $378 million securitization. Like the November 2002 deal, this one allowed for Marriott to book a gain ($3 million) primarily associated with the additional notes sold. No mention of any losses associated with the repurchase, and resale, of the non-performing notes. It's not so much the size of this particular transaction that gets our attention, but rather the fact that it represents a repeating pattern of behavior.

<u>Accounting: MAR's legal battles spawn interesting transactions</u>

For quite some time now, we have been intrigued at Marriott's proclivity towards entering into large transactions that seem to have no merit other than to fend off one of their many legal exposures. These transactions represent executive behavior in our accounting category because the financial implications are material, but due to the way disclosure takes place (or doesn't, in some cases), this is also a governance issue for us as well.

- Courtyard joint venture: Marriott overpays to avoid suit

In the early '90's, a partnership (which included CBM II LLC as General Partner), which owned 120 hotels, was having trouble trying to sell the properties. Merrill Lynch was retained and over 70 prospective buyers were contacted. The group only received one bid, from a Blackrock entity, totaling $64,000 per partnership unit. The deal did not go through because Marriott, who was under contract to manage the properties, revised downward budgeted operating results for the Partnership's hotels. A few years later, with the properties still unsold, CBM II filed suit against Marriott, claiming breach of fiduciary duty, breach of contract, fraud and negligent misrepresentation. Class action status was applied for and granted. As part of the settlement of the above mess, a joint venture, owned (50-50) by both a Marriott subsidiary and an affiliate of Host Marriott, bought the properties. This unconsolidated joint venture is called The Courtyard Joint Venture. We were surprised to discover the agreed-on price. At $147,959 per unit, plus additional payments to the plaintiffs of about $31 million, the deal, at $254 million, was far pricier than what Blackrock was willing to pay initially. The deal closed in early 2000, actually costing $374 million, or $120 million more than the originally agreed-on price. In response to this, Marriott cited, with rather uncharacteristic detail (for Marriott, at least) a number of factors that caused the final upward revision.

To us, there has been little doubt that the acquisition was primarily for the settlement of the suits. Indeed, even though Marriott wouldn't comment to this effect, its partner in the deal would: Host Marriot, Marriot's joint venture partner in this unconsolidated joint venture, confirmed our suspicions in its 10K for F/Y 2001, stating: "the investment was consummated pursuant to a litigation settlement involving the two limited partnerships…rather than as a strategic initiative."

As part of the above purchase of 120 hotels, Marriott loaned $200 million to Courtyard Joint Venture in a mezzanine loan. The loan boosted interest income by 73% in 2001 ($44 million, or almost 10% of pre-tax income) according to Marriott. With this loan's interest expense lying off on the sheets of an unconsolidated affiliate, half of this interest income is basically income they are paying themselves. The treatment is, no doubt, acceptable but certainly on the creative side.

Recent developments concerning this situation tend to confirm our original suspicions that Marriott overpaid dramatically for the 120 properties. Disclosed in the Marriott's financials is that Courtyard has not been profitable since the deal. Courtyard generated a book equity loss, to Marriott, of $8 million in 2002. More importantly however, further proof that the venture is struggling came out, not in Marriott financials but in related earnings release conference calls. It seems that, in 2003, the Courtyard Joint Venture stopped cash payment of interest on its $200 million mezzanine loan from Marriott. Marriott has not declared the loan impaired and still books interest income (non-cash) from it. Through Q2, 2003, the Company has booked about $29 million in interest from the Venture. This amounted to 19% of Income Before Taxes for the period.

- National Health Investors Inc.

Nowhere in Marriott's financials is there a mention of National Health Investors Inc. (NHI). In a recent National Health Investors 10Q however, there appears an interesting disclosure concerning Marriott. It seems that on June 30, 2003, NHI "reached an agreement with Marriott Senior Living Services to terminate their leases…for four assisted living facilities...". The disclosure further goes on to state that NHI will receive, from Marriot, $5.75 million in settlement of its claims for "certain deferred maintenance and repairs and to compensate (NSI) for any future rent deficiencies."

Thanks to this settlement, National Health Investors has never appeared on the long list of plaintiffs filing suits involving Marriott. While not a large number, this settlement is another example of a behavior repeated over and over again.

- Town Hotels Inc. of Charleston, WV.

In a small but widely followed case, Town Hotels sued Marriott for a number of alleged practices occurring during the period of Marriott's management contract with the hotel. The charges included "secret kickbacks" to Marriott related to purchasing deals, misuse of confidential information, improper allocations of corporate overhead, failure to disclose information and opening two additional hotels in the Charleston area.

The suit was settled in late July when Marriott loaned $1 million for improvements and agreed to invest $2 million in a separate project, owned by Town Hotel interests.

<u>Governance: A recently filed suit reveals related-party transactions</u>

The latest, in the long line of plaintiff's actions against Marriott, is the one brought, just this August, by Amalgamated Bank, who is seeking access to financial records and corporate documents related to a number of other lawsuits brought against the Company. Amalgamated also charged that Marriott has accepted improper kickbacks in its purchasing activities. Now these kickback charges have been used, against Marriott, by a number of entities, including Host Marriott, in their (mostly successful) attempts to renegotiate their management contracts with Marriott. An interesting twist to this action, however, is that Amalgamated is also asking for detail concerning STSN, the Salt Lake City-based high-speed Internet service provider, who has an exclusive deal to provide Internet access in many of the properties bearing the Marriott name. The appearance of STSN in this suit caused us to dig deeper.

There's an interesting legacy to STSN. Investigation into it provides evidence that Marriot Family interests are not beyond putting themselves in compromising positions when it comes to personal interests.

The STSN-Marriott time line starts in September of 1999. At that time, Marriott International and STSN reached an agreement where STSN would be the exclusive Internet provider for Marriott Hotels, Resorts and Suites, Renaissance Hotels and Resorts, and Courtyard by Marriott. At the time of the deal, Marriott also made equity investments in STSN, buying equity at $.50 per share "and additional equity at $9.12 per share". These deals were not disclosed by Marriott (probably deemed too small) but were disclosed in documents released by the Courtyard Partnerships (the entities that were created, by Marriott and Host Marriott, to own the 120 hotels bought in order to avoid further litigation by prior owners, which is referenced above).

Two months later, STSN announced that it closed a second round of financing and had secured funding from, among others, First Media (the Marriott family venture capital firm). The amount of the financing was not disclosed.

On September 21, 2000, First Media sold what appears to be its entire STSN position, a 4.5% interest (in non-publicly traded shares), to Host Marriott for $4.5 million. The deal, disclosed in Host Marriott and Courtyard by Marriott Partnership documents, was not mentioned as a related party transaction in Marriott Intl. financials. We found it interesting, based on the fact that Marriott Intl. had signed the exclusive distribution deal with STSN a year earlier, that the company did not to mention the fact that Richard Marriott is a major stockholder of both Host Marriott and Marriott Intl.

It is clear that Marriott International continues to own part of STSN, however Marriott's financials have never disclosed its interest in the entity.

<u>Accounting: The strange purchase of 14 senior care properties</u>

It's no secret that Marriott had been planning to exit its Senior Living Services (SLS) business for some time. In 2001, it placed the division's assets in "Assets Held For Sale". On December 30 2002, Marriott entered into an agreement to sell the SLS business to Sunrise Assisted Living. Making matters interesting was the fact that, on the same day (Dec. 30), Marriott purchased 14 senior living communities for $15 million in cash plus the assumption of $227 million in debt. Marriott had previously agreed to provide a form of credit enhancement on the outstanding debt related to these properties. The Company goes on to say that it expects to restructure the debt and resell the properties in 2003.

Now, it's counterintuitive that Marriott would buy 14 such properties at the very same time that it had announced the sale of its Senior Living Services business. That is, unless they had little choice in the matter. True to form, Marriott not only provides no detail as to the seller of the properties but also refrains from providing any further detail on the transaction.

Further inspection of the deal leaves us with the impression that these were properties, previously sold by Marriott (hence the credit enhancement on the associated debt) that were now being repurchased (read: put back to Marriott). The Company certainly has no interest in owning them. Its board had committed to their resale within 12 months of the purchase, allowing for it to list the properties as "Securities Held for Sale" and avoiding any mark to market earnings effects while holding them.

Marriott usually cranks up its press release machine when buying or selling properties in deals of magnitudes much smaller than this. Other than the terse disclosures mentioned above, there has never been a mention of the deal, either in Marriott financials, 8-K's, Press Releases, or conference call transcripts. Yet, the deal has caused Marriott to assume $227 million in debt.

Having so many transactions such as this, where properties are bought and sold, raises a caution flag about the timing of the recordation of income. When Marriott originally decided to exit the companion living concept, the Company took an impairment charge of $60 million (in 2001) to reduce the related facilities to fair value. They then sold the facilities for more than they previously estimated fair value to be, and managed to plug $11 million into income for the F/Y 2002. Based on estimates of fair values, Marriott is able to move income around with apparent ease.

<u>Insider Trading: Selling is subtle, but possibly significant</u>

Prior to recently, you had to go back to early 2001, when Marriott shares traded at their all-time highs in the $50 range, to see insider distribution of any size. Since then, selling has been light. Recently, however, in addition to recent selling by the likes of **Richard Marriott** (75,000 shares), and V.P Human Resources **Brendan Keegan** (6,345 shares), insiders whose sales we've become accustomed to seeing, we are beginning to see distribution spread to others:

- **William Shaw (57)** – President and COO (former CFO). A recent (June 13th) large sale by Shaw hit the middle of our radar screen. On that day, he exercised options for 243,281 shares and sold them for prices just under $39 each. Now, prior to this, Shaw had not sold a share since May of 2001 when he dropped about 137,000 shares at prices in the $45 range. Shaw's recent sales are clearly his largest on record and represent a reduction of about 18% of his holdings.

- **Joseph Ryan (61)** – General Counsel. Ryan sold 6,600 shares, in late May, for about $38 each. Now, the amount of shares sold does not represent a big piece of his holdings. They were however, his first sales since April 2001 where he was a seller in the $46 price range.

We find the convergence of the actions of these two to be more-than-interesting since they both had seen their last sales (in early 2001) converge together during a similar window, and near a peak in the price of Marriott shares.