The Investor Perspective: Some Thoughts to Share

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In recent months the hotel investment climate has changed substantially. The industry has experienced a dramatic increase in hotel supply, there are indications that revenue growth is eroding and the cost to acquire most hotels is close to, and in some recent instances has actually exceeded, replacement cost. These changes among others in the fundamentals underlying hotel investments raise many questions and concerns about where the investment return performance of the industry is headed going forward. These changes also suggest areas that we need to focus on to better manage hotel investment risk and to potentially improve performance.

Following are some thoughts to share:

Asset or Real Estate versus Business or Operating Value

The focus in the recent 2-3 years has been on leveraging investment return performance via buying hotels at discounts to replacement cost. With the cost of most hotels now approaching and in some instances actually exceeding replacement cost, we can anticipate a return to focusing on the business fundamentals of operating hotels to improve return performance.

In particular it is anticipated that yield management is an area with untapped potential for building revenue (to support revenue growth). From an expense perspective the management of labor, distribution costs and capital expenses represent areas for potential improvement for many hotels.

Total Return Performance - Income versus Capital Appreciation

In a period of less than 5 years we have moved from a situation where many hotels were valued (from an investment perspective) on a direct cap basis and essentially 100% of the value of a hotel was based on cash flow performance to a situation where today as much as 60-70% or more of the value of hotels is based on future growth or capital appreciation expectations.

The dramatic shift in the contribution of the income component versus the capital appreciation component of "Total Return" performance raises some significant questions about share valuations and the cost of capital going forward...in particular for public hotel companies and REITS... should they not be able to meet investor growth expectations underlying their stock values.

Potential Valuation, Liquidity and Cost of Capital Exposure

With the tremendous premium for growth reflected in the stock prices of several REITS and public hotel companies, there is substantial valuation and cost of capital exposure should the implied growth objectives (in their current share valuations) not be achieved. Additionally, for very high growth REITS there appears to be the potential for share liquidity challenges for investors, should return performance not meet the markets expectations.

High growth hotel REITS and public companies, given their high price earnings ratios have been able to fuel/support future growth with a very low cost of capital. Prospectively, however, they face a double dilemma i.e. the potential for substantial erosion in their market values and the potential for significant increases in their cost of capital to support operations and expansion should they not be able to meet investor growth expectations reflected in their share values.

Replacement Cost: Upper Limit of Value ?

Just recently, for the first time in several years, we have experienced a situation where the acquisition costs of some hotels are exceeding replacement cost. This is a very alarming trend, in particular for types of hotels (i.e. limited service, extended stay etc.) that are experiencing significant increases in supply. One can t help wondering what ever happened to the traditional thinking that replacement cost should always represent the upper limit of value?

We also seem to be forgetting that from a purely mathematical perspective, any time the denominator (i.e. the acquisition cost/investment basis) of a hotel increases, cash flow performance needs to also improve to provide for a return on the increased investment. If a hotels cash flow performance were to at best only remain the same, investment return performance would actually decline.

The recent dramatic escalation in hotel acquisition costs can be expected to result in tremendous pressure (on asset and property managers) to improve cash flow from operations performance to support the increased investment basis of hotels and to achieve investor return expectations.

Supply Outpacing Demand

New supply is outpacing demand in several markets. For an industry that even under the very best of times is functioning with over 30% excess capacity (i.e. with an all time high national average occupancy rate of only 67%) this is an ominous trend. In particular when evaluated in light of the potential for margin erosion exposure should the new supply result in declines in revenue performance.

It is estimated that Revenue growth , ADR Growth in particular, has accounted for over 70% of the increase in profits in the industry in the past 2-3 years. Given the high degree of operating leverage (or high ratio of fixed to variable costs) in the hotel industry in general, the overall profitability of the industry is extremely vulnerable to declining revenue growth...average daily rate growth in particular...performance.

Operating Leverage Exposure - Potential for Margin Erosion

Operating leverage can work for or against the performance of a hotel. During periods of strong revenue growth operating leverage can dramatically lever or improve financial performance. For once the fixed costs of operating a hotel are covered, a very large percentage of the incremental revenue can potentially fall to the bottom line as profit.

Conversely, however, should a hotel with high operating leverage (or high fixed versus variable costs) experience a decline in revenue, it runs the risk of not being able to cut back expenses commensuately to offset the decline in revenue.

The dramatic increase in supply in the industry can be expected to ultimately adversely impact the revenue performance of many hotels....in particular for older (versus newer) limited service and extended stay hotels. And in turn, a decline in the revenue performance of hotels with high degrees of operating leverage can be expected to potentially result in margin erosion.

Availability of Capital

The amount of capital available to the hotel industry today is unprecedented. The availability of capital is attributable in large part to the industry s ability to tap into the PUBLIC debt and equity markets.

It is important to keep in mind the importance of investment return performance in attracting public investment capital. The hotel industry emerged as the "darling of Wall Street" in the mid 1990 s, given the potential of the industry to generate returns exceeding many alternative investment categories.

Given that the hotel industry is a very "imperfect" industry, there will always be opportunities for certain hotels to perform much better than others and to substantially exceed the performance of the industry as a whole. From an industry wide perspective, however, the substantial increase in supply, evidence of a decline in revenue growth along with the dramatic escalation in the acquisition cost/investment basis of hotels suggest the potential for significant erosion in investment return performance for the industry as a whole.

Should investment return performance decline for the industry, it can be expected to substantially impact the potential on going availability of investment capital.

Hotel Investment Risk

Given the challenges the industry faces achieving recent investment return performance levels, it is critical that investors appropriately evaluate hotel investment risk factors.

There are several different perspectives we need to think about when evaluating and managing hotel investment risk including the 1) general economic conditions 2) key trends in the hotel industry 3) significant trends in related industries and 4) individual hotel specific risk factors.

As an industry we have historically primarily focused on 1 and 2 above i.e. general economic and hotel industry trends. The issues identified in 3) and 4) i.e. trends in related industries and individual hotel specific risk factors are ones that we have not traditionally focused on on an industry wide basis. These areas continue to represent special opportunities for better managing hotel investment risk.

Related Industry Performance Risk

It is important to keep in mind that the performance of the hotel industry is very dependent upon what is going on in certain other industries/lines of business. Some of the lines of business/ industries in particular that we should be evaluating relative to their impact on a hotel investment include the airlines, third party distribution systems and the group meetings market business. The performance of many hotels is very dependent upon both the availability of airlift/airline service as well as airline fare structures. The airlines "Saturday night stayover" requirements (to qualify for lower airfares) for example, has had a huge impact on day of the week demand patterns for many hotels.

Additionally, many hotels are very dependent upon travel agent and other third party distribution systems. Significant change are and can be expected to continue in both the airlines and travel agent communities in particular and in marketing and promotion distribution channels in general... which should be...but oftentimes are not...monitored and evaluated on an on-going basis. The group meeting business represents a 40 billion dollar plus industry and collectively represents one of the primary customer demand segments for many hotels. Yet very few hotel companies identify and actively manage issues in the group meetings industry which could potentially very substantially impact the performance of certain types of hotels.

Individual Hotel Investment Risk

The identification, analysis and management of the specific issues that represent substantial risk exposure for a particular hotel can make a tremendous difference in the financial performance of a hotel. Issues to think about in this area include functional obsolescence concerns, accessibility, diversification of the business mix, the potential to influence or "induce" demand versus "capture" (only) demand, high seasonality and/or volatility of cash flow performance patterns, the degree of operating leverage, the structuring of the contractual relationships (from third party vendor to management and affiliation relationships), potential capital reinvestment exposure (from necessary additional investment to remain competitive to compliance with franchisor or with regulatory requirements), human resource issues and exit strategies etc.

In Brief Summary

The dramatic escalation in the acquisition cost of hotels can be expected to result in tremendous pressure (for asset and property managers) to improve cash flow performance to support the increased investment basis of hotels and to achieve investor return expectations.

Yet at the same time...given the substantial increase in supply along with evidence of a decline in revenue growth for the industry as a whole... we can anticipate that it will be increasingly difficult to improve cash flow performance.

Going forward we will need to look to 1) revenue growth...in particular through improved yield management programs; 2) improvements in the management of expenses...labor and distribution expenses in particular...and 3) improvements in preventative maintainence and capital programs to mitigate capital reinvestment exposure to improve cash flow and return on investment performance.