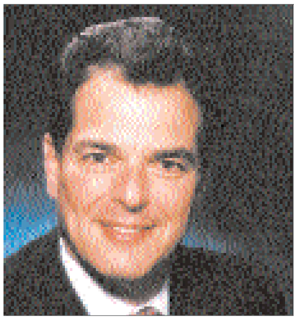

By Rick Swig

Investors Seeking Opportunistic Buys Are Likely to Come Up Empty Handed

THE HOTEL REAL ESTATE SEGMENT SEEMS TO BE a trend leader when demand is spiraling downward and then a follower when demand recovers. This has become evident in this recent cycle. First came the deterioration of the corporate segment, when travel was victimized by economic cutbacks, and then the leisure segment followed, when terrorist attacks and deteriorating personal wealth slowed travel. In a recovery, however, hotel revenue improvement will not anticipate economic growth.

Revenue deterioration has reached as high as 40% in some markets over the past 36 months, while operating profitability has shrunk, in many cases, by more than 50% due to the inability to slash fixed operating expenses. The primary impact of these declines has been felt in the top 20 urban markets, where the economy soared to its highest levels in 2000 and where both the corporate and international leisure travel segments are important to room demand.

Transactions that have occurred in 2003 have included premium pricing, which reeks of speculation on a recovery in the hotel sector.

But what about asset value? By the end of the last decade it became clear that market value mostly had to do with trailing 12-, 24- or 36-month net operating income trends. Buyers, sellers and lenders seemed to have reached an agreement that at least some target of value was identified through a quotient of a cap rate and NOI.

In this environment, it seems that other factors in assessing property value are being considered. As the decline of revenue has reached the point where profitability decreases have accelerated faster than customer receipts, NOI slides have escalated just as fast. Shouldn't this mean that values are declining with equal speed?

Although there has not been a voluminous amount of transactions during 2003, those that have occurred included premium pricing, which reeks of speculation on a recovery in the hotel sector. But why? Economic reports are still erratic. While there are some trends pointing to a stabilization in individual business segments, there are reports of unrealized earning levels, continued conservatism with regard to a forecasted expansion and minimal indication that foreign capital is re-entering the US.

In addition, recent trends indicate that companies are still holding back on business travel. Few surveys on corporate travel are forecasting major increases for 2004 at this time. Meanwhile, negotiations for high volume travel accounts are increasingly challenging, as traditionally high volume accounts are not able to produce anticipated levels.

Bargain hunting has become the game, and customers are learning that the best room rate is only a "point and click" away and not through their travel agent, company resource or meeting planner. Commercial travelers are not always booking through their in-plant agency, leisure travelers have left their travel agents behind and meeting attendees are booking outside of the specified room block—all to get the real deal. As a result, even as demand is increasing in many markets, room-rate levels are still retreating. This will continue to put downward pressure on RevPAR and profitability.

For the speculators who are buying properties in anticipation of the great recovery, they may have to wait awhile for adequate investment returns, as cash flow and property values may not readily increase. Additionally, if there are interest rates increases, which will undermine financing deals and shift debt payments upward, the current investors who are playing the interest-rate spread will be challenged.

The current mantra in the lodging industry is that there is too much money chasing too few deals, as the segment has for some reason found itself viewed as opportunistic. Due to too much speculation on a recovery, the only opportunity that may exist is with a longer-term hold on a piece of property in anticipation of demand growth and solid profitability.

Hotel investors may not be taking the time to properly research markets before swooping down to pay highly speculative prices for assets. The historically tried and true markets may not be reliable; although predisposed as candidates for a recovery, they may not respond favorably. Many traditional patterns have changed in this cycle, which makes assumptions from past experience obsolete. It's time to revisit acquisition fundamentals. Value should be based on net income trends, while speculation should involve complete market and property research before an acquisition is made. ◆

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