

EXPECT A SUBDUED MARKET IN 1999

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Risking a look into the hotel industry's 1999 crystal ball requires a glance back at the recent past when from a real estate point of view the hotel sector has gone through some radical changes in the last 24 to 36 months. The highlights have included the invasion of Wall Street, consolidation of owners and operators (REITS and C-Corps), and assets traded at premium pricing levels.

Real estate issues aside, hotel occupancies have peaked due to market capacity or new supply introduction, while room rates are still growing yet slowing. Positive influences have included a favorable supply and demand climate, better revenue management skills, and a booming, less price sensitive economy. Expense management controls and a favorable inflation rate have allowed operators to maximize profitability.

Wall Street investors have responded to this mostly favorable news with increasing bearishness. Shares of public companies have plummeted and more than extinguished any recent growth in stock price. For the most part, the hotel IPO class of 1996 is selling at or below their entry level pricing. Enthusiasm for this beleaguered sector has faded.

As fast as the frenzy to purchase hotels mushroomed throughout 1996 into 1998, the pace has slowed as 1999 approaches. Transactions continue. Public companies will strategically refine and pare portfolios to regain some focus and raise capital which might not be as available through secondary offerings or cash flow. The previous drivers of peak pricing and purchasing activity may now be the sellers, while the sales of assets may not be as automatic as they have been. Trading values are plateaued and will slip along with the expectations of sellers.

Low stock pricing may now breed the possibility of leverage buyouts, as the sum of individual asset value may outweigh any combined corporate or REIT value. Another side effect should be a greater opportunity for further consolidation, hostile or otherwise. The scenery should be anything but calm.

The operating future of the hotel business may be more predictable. Occupancies will at best stay stable due to new supply dilution and some guest room capacity limitations. Otherwise, occupancy percentages will fall due to new supply in markets with low barriers to entry, global economic influences, and growing price resistance from various market segments. Room rates will not reduce, while revenue trends will stabilize at not so unfavorable 5%-7% growth levels.

Wall Street's reaction aside, hotel real estate will find success. The winners will be the long term owners of real estate with primary locations, well maintained high quality buildings, good management, and strategic brand names (chain or independent). Subsiding REVPAR growth requires the basic fundamentals of quality (regardless of price segment) as the best prescription for survival.

Owners with the financial capacity to improve and differentiate products then flexibly reposition assets will prosper. Adequate capital reserves will provide the support for product embellishments to sustain customer response and offset unfavorable market trends.

The strongest hotel brands with a critical mass of locations, product consistency, frequent guest programs, and other influences will build on their domination. Effective brand development will continue to pay off well for owners of established franchised or chain operated products, as the best brands bring impact:

- Customer loyalty.
- Instant positioning.
- Defined and familiar products.
- Global distribution.
- Ongoing technology development.
- Profit enhancement mechanisms (ex. purchasing programs, operating systems, and training tools).

As new locations are developed, the need for reliable brands will be an important fundamental. Ownership alignment with this type of brand strength is critical given the confusion of new product proliferation, especially in the extended stay segment. Slow developing customer familiarity or loyalty with many current brands will either stimulate further consolidation or some deep rethinking in corporate boardrooms.

The best independent operators are proving that brand affiliation is not always necessary to succeed. Segment leaders are creating winning formulas with differentiated products or quasi-brands with focuses on lifestyle orientation, peer group influences, and the creation of environments.

New development is and will be a positive activity, when strategically planned in terms of fundamental market segment demand generators which are broad enough to sustain long term staying power. Some of the current supply growth unfortunately may only be responding to only periodic or temporary demand pressures with limited absorption potential.

Only a historical perspective will prove whether the high prices paid for hotel assets over the last twenty-four months were wise investments. Many buyers used the "less than replacement cost" justification to stretch cap rate trends and decision making standards based on historical or

trending operating activity. Some investors justified their premium purchases based on the fundamental strengths of location, brand, management, and building infrastructure. This strategy, although not offsetting any immediate return on investment limitations, should provide some cushion and a defense against market downturn, as customer preferences have always favored the fundamentals of location and well managed, high quality product.

Who knows whether Wall Street will again respond to the hotel industry in a positive fashion? Stock prices indicate a rejection of one the most lucrative periods in the hotel industry s operating history. This may mean that the public market marriage to hotel real estate investments should be annulled, as the basic fundamentals plus the cycles of owning and operating hotel real estate may not be compatible to investor expectations.

There are still and will continue to be good high yield investment opportunities with underperforming assets plagued by physical problems, poor management, weak product positioning, or a historically stable location hampered by a weak market situation. Other circumstances, associated with over leverage, change of a portfolio strategy, or insufficient funding to make necessary physical improvements for repositioning, will also stimulate transactions.

In 1999 sellers must recognize that the premium pricing days for hotel assets are mostly over. To maximize financial opportunity and to minimize the effect of negative market trends, continuing transactions, including new development, should be based on more traditional market demand and asset fundamentals: real (not imagined or anticipated) demand generators for stabilization and growth, reasonable barriers to entry to prevent over-supply dilutions, plus the elements of location, product strength, and management.