

Ready, Willing, and Unable?

By Rick Swig

The hotel business is enjoying its most productive year ever. Revenues and profits are at or beyond historical peaks. Some markets are being stretched to capacity, where the availability of hotel rooms is often nil during mid-week periods. Seemingly this should be a period where further expansion is merited and welcomed, where values are growing. This is simply not the case, however.

Growth is the focus of both the public and private market hotel investment communities, yet there seems to be a growing matrix of barriers blocking the investor s or developer s ability to perform. In 1999 hotel transactions slipped to 300 from 830 in 1998 with a continuing pattern in 2000. Additionally, expansion of new development has become more challenging.

Wall Street has become wiser or at least more strategically purposeful. As hotels do not have the predictable income streams that some traditional publicly held companies have, either the manipulation or misunderstanding of data may have "tricked" many Wall Street investors into some initial ambitious readings of their potential in the hotel segment. As this set of lender/investors experience has grown, their sophistication about the vagaries of hotel investments has improved. Certainly, these financing sources have become more circumspect with regard to their enthusiasm to blast forward continually into hotel investments.

Wall Street has moved hazily from in and then to mostly out of the picture. Private equity funds may be emerging as the new support position for public and private companies alike, but even with forthcoming equity the real difficulty is the limited ability to find available or reasonably priced product. "Good quality hotel assets with preferred locations in markets featuring significant barriers to entry" seems to be the ongoing mantra for all investors and lenders alike, yet how many of those markets really exist?

There has been an increasing cap rate trend since 1997, when the new public companies utilized their capital to purchase assets at levels that were often between 8% and 9%. Now with interest rates rising, the market cap rates have risen above 10% for the same assets, thus often lessening their value even as the net incomes have risen substantially.

Additionally, many markets are clearly near their occupancy peaks and average daily rate growth has slowed from well over 5% to levels at or just above 3%. Thus, there is a new reality that most hotel assets are performing at their peak with modest growth

potential and in fact with higher risk due to market capacity levels, which will inevitably invite new supply and some downward occupancy trends.

This has created a widening gap in the perception of hotel asset values between sellers and buyers. Sellers perceive that since their assets are performing better, then they should be entitled to more purchase proceeds. Buyers in anticipation of higher interest rates, reduced REVPAR growth, new supply, and a slowing economy have become more cautious about enriching sellers over benevolently.

There are still some willful would be buyers awaiting the deconstruction or redeployment of less desirable REIT or publicly held hotel real estate assets. This slim down has been in the forefront of rumored anticipation for over a year, but any "fire sale" is unlikely to happen, however, as public companies are not likely to sell assets for less than their original investment.

Additionally, more supply is coming. New hotel construction starts in 1999 were the highest in ten years. This means that in 2001 and 2002 existing competitors will be impacted by the opening of this new supply with resulting dilution of market occupancies and reapportionment of market share.

Most of this new supply is in the upper mid-market limited service segment, which will continue to show continued expansion. Unlike full service hotels, these developments are still relatively low in land and construction cost, and they require less equity to initiate. These so-called "ankle biters" will continue to erode the full service segment base.

Expansion in the full service segment seems mostly stymied at the moment. What full service development is ongoing seems to be attached to creative mixed-use projects, which include commercial and/or residential pieces to mitigate the hotel component's exposure.

This reluctance towards full service development continues, even though this segment has shown the greatest growth in REVPAR in recent periods. Plus, most prognosticators predict that the segment will also provide the greatest revenue upside in the mid-term future.

The memories of over-expansion of supply and over-extension of credit in the late 80 s are still on the minds of lenders, however. Regardless of willingness of buyers and sellers to consummate a deal or for developers to stimulate enthusiasm to build, financing has become an additional challenge. Lenders have thrown up aggressive barriers with more conservative thresholds of loan to value, debt coverage, and also a great sensitivity to barriers to entry. These have caused many would be borrowers to

forget about bringing in a significant loan request.

There is clearly an impasse on both the transaction side and the development side of hotel real estate. The hotel real estate sector seems stigmatized. Wall Street has found other segments in which to deploy its capital. Buyers and sellers are not finding "win/win" solutions to each other's desires to trade. Lenders seem to want a no risk environment of endless growth with complete barriers to entry before funding any project.

Many good hotel projects are being developed or exchanged in selected markets with either high growth assurances or extreme barriers to entry. The question remains about reputed challenging markets with the potential for contrarian investment postures with greater risk/rewards. Have equity stakeholders and lenders lost their enthusiasm for looking in crystal balls, even when there is significant evidence from past cycles that constructive risk can result in lucrative future trends?