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Asset pricing remains difficult piece of lodging puzzle

Jul 19, 2004
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NEW YORK-Setting prices for hotel assets in the transactions markets remains a tricky business, even as the lodging industry rebounds from a three-year downturn that some experts rank as the worst the industry has ever faced.

Pricing and the pace of transactions were topics that repeatedly surfaced during HOTEL & MOTEL MANAGEMENT-sponsored roundtable discussions by members of the Lodging Industry Investment Council. The roundtables were held in conjunction with the New York University International Hospitality Investment Conference.

"Even though prices are strong and getting stronger for assets, they're still generally trading at a discount to replacement costs," said Sean Hennessey, LIIC co-chair and principal of Lodging Advisors.

Dan Lesser of Cushman & Wakefield said that's a good formula for the current lodging landscape.

"As long as we see transactions that are occurring at amounts that are equal to or below replacement costs, I don't see a whole lot of downside," Lesser said.

C.A. Anderson, executive v.p. of development for Interstate Hotels & Resorts, said pricing for hotel assets has been kept in check by the lack of new hotel development.

"The supply-demand metrics are not in balance to the point where you're going to go out and spend $200,000 a key for a vanilla Sheraton, Hilton or Marriott box," Anderson said. "Land costs are very high, especially in the markets you want to be in. In the Western United States and California, the cost of land could run you $30,000-$35,000 a key."

Roundtable participants agreed that a fair amount of hotel assets traded hands during the first six months of 2004, and for the most part, buyers are getting good deals.

"Some of the numbers that are being paid now, when you look at them two or three years from now, are going to look pretty inexpensive," Lesser said. "I see investors, smart money, that sees a lot of upside in this industry, where they look at alternative investments. At the end of the day, these investor groups look at the broad array of investment opportunities that are out there and compared to a 3 [capitalization rate] on a Wal-Mart lease, it's a pretty attractive opportunity."

"That's what's driving a lot of the pricing models right now-there's a lack of alternatives for the same capital that's out there," said Bill Sipple, corporate v.p. of development of full-service hotels for Carlson Hotels Worldwide. "When you're talking about 6 caps and 5 caps and 7 caps, obviously there has to be some caution on the part of people who are buying. It is such smart money that's chasing these deals, it's not inexperienced real-estate money that's chasing them."

Frank Nardozza, president of Miami-based REH Capital, said that because cap rates in the lodging industry are higher than those in other real-estate sectors, more outside money will seek out the lodging industry.

Capitalization rates are on the minds of most lodging executives.

"Let's not forget how far down our numbers are relative to where they were two or three years ago," said Bob Alter, president of Sunstone Hotel Investors. "You might want to say it's a low cap rate, 7.5 or 8 percent, but if your income's down 30 [percent] or 40 percent from two years ago as a result of '02 and '03, then you're capping a finite number that's pretty low. The expectation is we're going to see with 5.4 percent [revenue per available room] growth, even with reasonable flow-through you're going to get either 9-percent improvement in [earnings before interest, taxes, depreciation and amortization] and then cap that two or three years out and then it doesn't look like such a low cap rate."

"If you look at your value with your high cash flow three years ago and you had your suburban property at a 10 or 11 cap rate, now you look at your 6 or 8 cap rate today and you come out very close to that same value," said Rich Conti, president and

c.o.o. of Boykin Hospitality. "If you are selling in the market, you don't have to adjust your risk of holding for the three years to get cash flow up."

The uncertain interest-rate environment gives the industry a reason to remain cautious, Anderson said. Roundtable participants agreed that interest rates will increase, but were uncertain about when or how much.

"We now include interest-rate sensitivity models [in potential deals]," Anderson said. "We include a 5-point range. A lot of this pricing is driven by the fact that you don't have any numbers to write on from a historical sense, so you're saying when we get back to relatively stabilized levels, to go back to [Lesser's] point, what should we be paying now for the future. Our challenge is trying to guess-and that's all we're doing is guessing. It's all driven by two things: operating performance and interest-rate dynamics. We know interest-rate dynamics are going to move."

Angelo Stambules, v.p. of GMAC Commercial Mortgage Corp., said the interest-rate uncertainty is causing hotel owners to re-evaluate their debt.

"Our business mix has changed over the past six months with a greater number of fixed-rate applications coming in," Stambules said. "With the anticipation of rates running up a little bit now, people that are long-term holders are wanting to lock in for the next five to 10 years. We see a lot of requests for five-year fixed. On fixed, we're going 70-[percent to] 75-percent [equity]."

Rob Kline, president of Oxford Lodging Advisory & Investment Group, said the refinancing option, coupled with the better performance of the lodging industry, makes it a more difficult decision to shed a property from a portfolio.

"In selling an asset here in New York, we're constantly competing against the refinancing option," Kline said. "With the liquidity in the lending market right now it's a real challenge whether to sell or refinance."

Rob Koger, president of Molinaro Koger, a Virginia-based brokerage, said the market is flush with capital.

"It's a great time to be an owner, whether you're owning for the next five or 10 years or you're selling in this market," Koger said. "There's a lot of low-yield buyers out there that are paying for a lot of upside."

Lenders continue to make debt available, but they are being rigid about their requirements, particularly for new-construction projects, roundtable participants said.

"Because we lost so much value in many of these assets the past three or four years, the underwriting is more aggressive," said Rick George of Hospitality Real Estate Counselors. "But it's still below the point where we're seeing irrational behavior."

"Financing is still a huge break in development," said Jim Butler, LIIC co-chair and partner with Jeffer Mangels Butler & Marmaro, a Los Angeles-based law firm. "It is very difficult to get the debt financing. There are relatively few senior debt lenders who are willing to undertake new development. A lot of projects that have merit are either delayed or don't get off the ground."

"That is going to be the situation naturally, where construction lenders are going to be hesitant to get in the game unless they start to see demand fundamentals improving," Hennessey said.

Commercial mortgage-backed securities lenders are the most aggressive lenders in the lodging industry, Kline said.

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