Hotel & Motel
MANAGEMENT
www.HotelMotel.com

Council sees transparency as early-warning system

Mar 6, 2006
By: Jeff Higley
Hotel & Motel Management

Hotel&Motel
MANAGEMENT

LOS ANGELES—The lodging industry will get plenty of notice before the next economic tailspin takes place.

LIIC
LODGING INDUSTRY INVESTMENT COUNCIL

Members of the Lodging Industry Investment Council said during a January roundtable that the industry's information transparency provides a system to identify the next downturn before it happens—and watching for a slowing of the flow of capital into the industry will be the first indicator.

"As we get to the point in time when there's a real deceleration of [net-operating income] growth, the industry is going to know sooner," said Rob Stiles, managing director of Sonnenblick-Goldman Co. "Liquidity is going to dry up faster than it may have in the past because of the nature of investing this time, but the situation will be clear due to the transparency of the industry's fundamentals."

"It will be an early-warning system to everybody," said Bill Reynolds, managing director of Hospitality Capital Partners. "Sure, the money will dry up, but it also means you probably won't have 15 percent overbuilding."

Reynolds attributed the lack of overbuilding to the rising construction costs.

"[Construction costs] are clearly protecting us on some level, but eventually there will be growth and it will be noticeable," he said. "It's like a dashboard, the earlier you see it, chances are you brake better, as opposed to slamming into the wall like we did 20 years ago."

The development of the warning system hasn't been an overnight process. Sean Hennessey, c.e.o. of Lodging Investment Advisors, said the system began taking shape in the early 1990s, when investment banks started putting money into the lodging industry.

Bill Reynolds of Hospitality Capital Partners explains that transparency of fundamentals serve as an early warning.

He, too, said that once construction hits full stride, the warning lights for a potential downturn should be flashing.

"The fact that the operating fundamentals have continued to improve and profits have expanded has not been lost on the development community," he said. "So, there are a lot of projects entering the early planning stages. It's a natural consequence for people to think, 'Gee, I wish I could build to get into some of this good stuff that's going on,' but it still remains very challenging to put a deal together and make the economics work. Once those economics start working in favor of developers, we should start getting concerned."

Joe Green, Winston

Joe Green, c.e.o. of Winston Hotels, said because construction costs have risen 20 percent to 30 percent, development will continue to be placed on the back burner. His company has four projects under development.

The construction environment has even forced developers to change the style of construction for projects—going from concrete to lumber in many cases.

Mike Cahill, president, Hospitality Real Estate Counselors, said the consulting practice of his company has conducted more development feasibility studies over the past six months, and he expects the development cycle to kick into a higher gear sooner than later—regardless of

Hotels, tells the roundtable participants that development is staying on the back burner.

construction costs.

"There are a lot of people in the early development stages that right now are just planning to bring projects forward," he said. "The interesting factor that's never really happened in my career before is that when we're doing appraisals for our consulting group, lenders are calling us back every two or three months with revised construction budgets. We're getting these calls like, 'Well, the price is not finalized yet. Here's the new construction budget—it's up 50 percent.' And then the follow-up question from them is always, 'Did the value go up also?' We have to reply to them, 'Not really.'"

Greg O'Stean, senior v.p. of hospitality financing for GE Capital, said developers know that not all projects are going to get built, but most of them believe their project is the one that will make it through to completion.

LIIC's mission

"There's only one that's going to get built, and the costs have gone up so much that that actually helps in that it forces people to re-evaluate their projects," O'Stean said. "Maybe they were going to compete with an extra 200 rooms, now there are only going to be 100 rooms. So maybe they swallow that additional cost of concrete and steel and still build. Land is more expensive, so the easiest way to save costs on a hotel is purely square footage. You start taking out the ballroom, start taking out the big banquet kitchen. [Rising construction costs] force a reassessment of entire projects."


Sean Hennessey, Lodging Investment Advisors, says the early-warning system began in the 1990s.

One area of development that continues to outpace the rest of the lodging industry is condominium-hotels.

"We've seen a lot of residential components, where the top two floors are being converted to residences just to be able to pay for the construction of a project," Green said.

Jim Butler, partner with the law firm Jeffer Mangels Butler & Marmaro, has developed an extensive clientele in the condo-hotel arena. He said the fundamental funding mechanism of condo-hotels works in their favor in today's economic climate.

"Although there is a tremendous wealth of liquidity in general in the industry, it has not permeated down to construction and development as it has with transactions," Butler said. "Residential components tend to sell by dollars-per-square-foot instead of cap rates on income, which provides a higher yield to the developer."

Roundtable: Stay on top of your business

Members of a Lodging Industry Investment Council roundtable conducted at the Los Angeles offices of Jeffer Mangels Butler & Marmaro prior to the start of the Americas Lodging Investment Summit offered suggestions for hotel owners and operators to address business issues during the current economic upswing:

Mike Cahill, Hospitality Real Estate Counselors: "As you're starting to get double-digit RevPAR growth in certain market areas, make sure your expenses don't increase at a greater level than you're increasing your RevPAR. Really watch your expenses and don't go overboard. It's a natural extension when times are better to really not control expenses that much, but it must be done."


Mike Cahill, Hospitality Real Estate Counselors [right], and Bill Reynolds, Hospitality Capital Partners, discuss their expectations of the development cycle.

Rob Stiles, Sonnenblick-Goldman Co.: "It's a great time right now to clean up your balance sheet. This is below the operational bottom line, but look at how debt markets are incredibly supportive of this industry. If you're a long-term holder, look at moving to fixed-rate financing now, at the appropriate level. If you've got some high lease costs and other things, again, look at your balance sheet, take advantage of the capital markets today."

Sean Hennessey, Lodging Investment Advisors: "There are some pressures on the horizon on operating costs, like labor in particular, that are going to affect operations. Reinvesting in the capital needs of the property and getting your property in good shape is to my mind, a sound strategy. One of the things the industry had going for it, sort of post 9/11, is that in my view, the quality of the hotel stock we had was about as high a quality as it had ever been, and hotels were able to ride it out without much reinvestment in the property level for quite a while. Making sure your property is up to standards is going to be important should there be a blip in cash flow."

Joe Green, Winston Hotels: "Manage the [profits-and-loss statement] as opposed to every single line. You just have to be on it all the time because the franchisors have crammed down so much amenity creep that it costs money. We went from cold breakfast to hot; I mean that could be worth 100 basis points on a GOP if you don't watch out."

Bill Reynolds, Hospitality Capital Partners: "Your ability to pay for the so-called amenity creep varies by location, and that's the problem. It's one thing to say to someone in New York City right now, 'You've got to renovate.' Well, if they have time, they'd do it, but their occupancy rate is so great they don't take the time to do it right now, they'd start taking time out of the market. In other words, be very careful how you approach any cap-ex projects to not hurt cash flow."

jhigley@questex.com