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Hotel values, cap rates, deals and recovery

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Story Highlights

- Suzanne Mellen of HVS said there were 129 major hotel sales of more than US$10 million in 2010—and that number has grown by 200% thus far this year.
- The Lodging Industry Investment Council's Mike Cahill said the organization's annual survey shows a large ratio of members think the hotel investment market will peak during 2015.
- California, which in normal environments has between 350 and 375 hotel deals take place, is expected to have a shade over 200 deals in 2011. That will be between 10% and 15% more than were completed during 2010, Reay said.

A large portion of Lodging Industry Investment Council members believe hotel transactions will peak in 2015, said LIIC co-chair Mike Cahill.

LOS ANGELES—Wednesday morning's general session at the Meet the Money conference revealed a message that hotel sellers have been waiting a long time to hear and a revelation that there's a long deal cycle ahead. Hotel values continue to rise, and at least one industry think tank believes the top of the hotel-transaction market won't occur for four more years.

Suzanne Mellen, senior managing director for HVS, was succinct in wrapping up the general hotel transactions environment in the United States. "I can sum it up rather quickly: Cap rates are down, and values are up," she said.

Meanwhile, Mike Cahill, CEO and founder of Hospitality Real Estate Counselors and co-chair of the Lodging Industry Investment Council, told attendees the annual LIIC survey of its 60 members revealed that the majority believe the transactions market will peak in 2015.

Mellen said there were 129 major hotel sales of more than US$10 million in 2010—and that number has grown by 200% thus far this year. She also said the capitalization rate based on net operating income in 2011 for deals in her company's database is 4.5%, while the free-and-clear discount rate is 11.7% and the equity yield is 15.5%. In 2010, those figures were 4.5%, 11.8% and 15.9%, respectively.

Mellen also outlined cap-rate data (based on trailing 12-month NOI) for deals in HVS' database during 2010:

- full service: cap-rate range 1.7%-8.0%; 5.3% average cap rate;
- select service/extended stay: cap-rate range 3.1%-12.4%; 7.8% average cap rate; and
- limited service: cap-rate range 1.3%-16.3%; 8.5% average cap rate.

"Select service and extended stay are getting a lot of attention, and values are going up," Mellen said.

The HVS executive said cap rates continue to be driven down by the increase in sales activity and record-low interest rates for hotel mortgages, which are at historic lows and are 250 basis points below treasury bills.

"There is that expectation that interest rates will have to rise because of the debt situation in this country, and obviously that has a direct impact on hotel values," Mellen said.

Mellen's outlook for the hotel industry includes:

- The expectation is that cap rates will drift upward during the next few years;
- interest rates are likely to rise;
- hotel values will continue to rise, but appreciation will be constrained by the increasing cost of capital;
- the expectation is for operating leverage to continue for the near term;
- capital improvement will further challenge appreciation levels; and
- look out for new supply, especially in the limited-service sector.

LIIC top 10 issues
During the conference, Mike Cahill shared LIIC's top 10 most pressing issues.

10. Occupancy and average daily rate fundamentals continue to improve

- 94% of respondents believe average room rates will grow in the next year. (39% forecast it will be over 5%)
- 89% anticipate occupancy increases.

"Investors are just incredibly bullish and optimistic about the revenue aspects of the industry, but it is market by market," Cahill said.

9. Equity return rates are stabilizing.

- More than half of respondents believe equity rates will be the same in the next 12 months as they were for the last year.
- The equity returns players made the adjustment in bid-ask spread to make more deals happen.

8. Interest rates will rise.

- 58% believe hotel interest rates (senior debt) will increase during the next 12 months, with many concerned about interest rate increases impacting short-term/exit strategies.
- On the flip side, 68% believe loan-to-value ratios are also increasing.

7. Acquisition debt is returning.

- The ability to acquire debt financing appears to be improving.
- 48% of respondents believe they will be able to use acquisition debt financing to leverage deals during the next 12 months.

Alan Reay of Atlas Hospitality expects RevPAR in California to increase by more than 10% in 2011.

6. REIT envy and bitterness

For the first time in 10 years of the surveys, investors are split over which is a better investment vehicle: real-estate investment trusts (public equity) or private equity.

5. It's a new ballgame.

LIIC members believe the hotel industry is in a new cycle.
51% said the industry is in the first or second inning of a nine-inning game.
46 % said the industry is in the third or fourth inning of a nine-inning game.

4. Hotel transaction volume will increase dramatically.

- 39% believe deal volume will jump by more than 20%.
- 29% believe deal volume will increase between 10% and 20%.
- 26% believe deal volume will grow between 5% and 10%.

3. There's better quality hotel product available to acquire—if you can get it.

2. Hotel real property values are only going up.

- 98% believe hotel values will go up during the next 12 months.
- 61% believe hotel values will increase by more than 5%.
- Luxury hotels appear to be poised for the greatest growth in value.

1. Hotel investment market will peak in 2015.

- 38% believe values will peak in 2015.
- 29% believe values will peak in 2014.
- 24% believe values will peak in 2016 or beyond.

California hotel market
Alan Reay, president of Irvine, California-based Atlas Hospitality Group, reviewed the results of the company's 2010 hotel survey.

"Revenue is increasing and buyers have adjusted their cap rates and price expectations," Reay said. "We have seen some values rebound dramatically in California."

Reay provided his predictions for 2011:

- California, which in normal environments has between 350 and 375 hotel deals take place, is expected to have a shade over 200 deals in 2011. That will be between 10% and 15% more than were completed during 2010, Reay said.
- Revenue per available room in California will increase by more than 10%.
- There will be at least two more years of lender/distressed hotel sales in secondary and tertiary markets.
- The cap rate for non-REIT transactions in prime markets will be between 6% and 7%.
- Deals in secondary and tertiary markets will have cap rates between 8% and 10%.
- New development projects are starting to be planned.
- Interest rates will increase.