

Cautious expectations steer hotel investors

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Los Angeles-Lodging industry investors-those who've committed already and those who are waiting to do so-are more subdued in their quest for large returns on their investments as an economic recovery takes hold, according to participants of Lodging Industry Investment Council roundtables held in conjunction with the Americas Lodging Investment Summit.



Bernie Siegel of Lowe Hospitality Group discusses owner interest in the lodging industry at a recent Lodging Industry Investment Council roundtable.

"The availability of equity financing is probably even more shocking today than debt," said Bernie Siegel, executive v.p. of hospitality investments for Lowe Hospitality Group. "However, it's driven by completely different investment yields. Instead of 20-plus-percent returns that were common in the '90s, now most of us are looking to generate something in the mid- to high teens using some form of low-cost debt financing."

"Given low interest rates, given low inflation, given what real rates of return you require on your equity, there's ample supply of product that good, solid deals can be done," said Jim Francis, president of Highland Hospitality. "It is different than in the early '90s. You're not going to get rewarded with 40 percent [internal rates of return], but no one's requiring that. Return requirements have come down."

Compared with other sectors of the real-estate market, the hotel industry is performing well.

"Even though we're talking about returns being more modest, if you compare that to the office and retail sectors, the returns there have been even more modest," said Sean Hennessey, financial advisory services-hospitality and leisure for PricewaterhouseCoopers. "You have the same sort of scenario. People chasing yield, and even though it's not as high as it was, it's still better than what they're seeing in some other property sectors."



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Rob Kline, president of Oxford Lodging Advisory & Investment Group, said the growth potential for hotels is the lodging industry's chief attraction.

"In the office sector, it's very difficult to make a growth bet on an office building, even in a market like Los Angeles right now," Kline said. "Whereas with hotels, you can point to bookings going up, occupancy going up, rates that are starting to inch [up]. It makes you feel more secure."

"There should be a higher required return in our business," Hennessey said. "We sell rooms every night, and there is more risk in our cash flows as an industry than there is in some of the other markets."

As market conditions improve, the story from the hotel industry is only going to get better, according to Frank Nardoza, president of REH Capital Partners.

"We've all been trying to sell the story of buying an asset and saying we're going to get a nice pop on the back end with the ride up in the market, and unfortunately, last year with the Gulf War and orange alerts and some of the other issues plaguing the economy, that didn't happen," Nardoza said. "Now we're starting to see month by month that there is a story showing comparisons to the same month of last year. Once we get into March and April and we're paralleling with the point of when we went into the Gulf War, it's going to be a much better story. So finally, we're going to be able to say, 'Not only are we expecting this nice recovery in our pro-formas, but there's now solid evidence that it's happening.'"

Because of that and other factors surrounding the recovering economy, the industry is an attractive place to be for investors-and for good reason, Kline said.

"If you look at the other competing asset classes, there's really no other growth opportunity that's as evident as it is in the hotel business," he said. "It's attracting people that have not been investors in this business until recently, and it's pushing [capitalization] rates down."

A cap rate is a ratio used to estimate the value of income-producing properties. It's determined by dividing the net operating income by the sales price or value of a property expressed as a percentage.

"Cap rates have become single digit, into the 6-, 7- and 8-percent range, but almost to a deal we've seen net operating cash flows fall anywhere from 40 [percent] to 80-plus percent," Siegel said. "This type of aggressive cap-rate-purchase environment is warranted based on how severely impacted cash flows have become the past several years. Yes, you have to be aggressive, yes, there's a lot of technical liquidity, but we're all expecting the same thing, and that is a reasonably healthy recovery."

"We haven't seen cap rates fall as much as interest rates," said John Arabia, senior analyst for Green Street Advisors. "I'm not just talking about hotels, I'm talking about the general real-estate market. However, I wonder how much lower some of these cap rates can get, and I'm a little nervous that there's too much capital chasing some of these transactions."



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"The worry is when Wall Street starts to come back into the lodging market in a bigger way; it's going to be hard for cap rates to do anything but move down because there's more money in the marketplace," Muller said. "What we've seen clearly is cap rates are falling a little bit because debt is falling. We're also seeing equity return. Our world is probably 9 percent or so."

Operating stress

The economic recovery has been slow to allow hotel operators to increase average daily rates, which declined dramatically during the past three years. That continues to place stress on hotel operations.

"I don't think any of us are strictly relying on net cash flow performance to be much better than it was," Siegel said. "We all expect to expend quite a bit of capital dollars to improve buildings that have been unkempt the last three years. Combined, if you have a strategy that can be triple-pronged or quadruple-pronged with strategies you can bring to the table, it makes sense."

Eva Wasserman, v.p. North Central region-managed development for Hilton Hotels Corp., said discipline is going to be key.

"The teams on property in today's environment have become much more disciplined about their costs, and they're much more agile," Wasserman said. "They've gotten to a level where they can adjust with demand and business. If they're coming into a slow period, they learned how to operate hotels by quickly shifting and reacting to the market in a very expedient fashion; and then as soon as the business is back, being able to come back so the guest, hopefully, never sees those cutbacks that are happening within the hotel, and they have a consistent level of quality."

Kline said there are pressures beyond the industry's control that could have adverse effects on a recovery for the industry.

"Real-estate taxes are going up in many cities," he said. "It's the only place the cities can come and grab money to protect the decline in other tax bases. New York City increased [its] taxes 18.5 percent overnight. You can't control that. Insurance costs are coming down, but they're still so high. You're seeing a lot of labor-cost risk in the marketplace; a lot of contracts are coming up, collective bargaining contracts are coming up. Where you'll see some increased spending just happen naturally is in advertising and sales and marketing."

LIIC's mission

The Lodging Industry Investment Council is an industry think tank that meets three times annually to discuss hotel finance, development and operations issues. Its 70 members include consultants, lenders, operators, developers, educators and legal professionals.

Co-chairmen for LIIC are Mike Cahill of Denver-based Hospitality Real Estate Counselors and Sean Hennessey of PricewaterhouseCoopers' New York office. Vice chairman is Jim Butler of Jeffer, Mangels, Butler & Marmaro, a Los Angeles-based law firm. LIIC's Web site is www.liic.ws.

