

# Where Are We Now?

## A panel of lodging executives reflect on the state of the industry at mid-year

By Ed Watkins  
Editor

Held in early June each year, the New York University Hospitality Industry Investment Conference is a good venue to get a sense of how the hotel industry is faring at mid-year.

To answer that question during the conference, *LH-Lodging Hospitality*, in conjunction with the Lodging Industry Investment Council, convened a panel of hotel industry owners, operators, financiers, brokers and consultants. Questions ranged from operational and cost-cutting issues to capital availability and chain performance standards.

**LH-Lodging Hospitality: How's business?**

**Sean Hennessey, PricewaterhouseCoopers:** Corporate travel has not been as robust as we anticipated. While we had hoped to see big improvements later this year and early next year, we now think it will be primarily next year and 2004. It's still a good rebound from where we were, but it's not as robust as some of the analysts had originally predicted.

**Steven Kisielica, Strategic Hotel Capital:** About a month or two ago we were revising our forecasts upward, but over the last month or last two weeks, we've gotten a little more conservative. We're not getting improvements in either business travel or transcontinental leisure travel, both of which are big markets for the hotels we own.

**James Butler, Jeffer, Mangels, Butler & Marmaro:** The problem is averages. The market is so unique by property type, location and segment that while there are a few bankruptcies and a lot of properties that are struggling, many other hotels seem to be doing all right.

**Peter Rainsford, University of Denver:** At the Resort Management conference we sponsored in April, the opinions were all over the place. A lot of the smaller properties had booming seasons and some of them were able to raise their

rates. These were primarily drive-to properties. For the bigger properties the market mix had changed from business travelers to leisure travelers.

**Hennessey:** For the first time ever in New York City, Friday and Saturday nights have had the highest occupancies of the week, which reflects the dominance of discretionary leisure travel. Also, for the first time the average daily rates for group business are higher than the ADRs for transient business because the strong leisure component of the transient business tends to bring down the rate.

**LH: How long will the industry continue to struggle with rates?**

**Kisielica:** It will continue to be a struggle until we can get some compression back into the market. So far, we're not seeing any significant compression for any day of the week. We're starting to detect it on Fridays and Saturdays, but until you can get near 100-percent occupancy for a couple of days during the week, rates will continue to struggle.

**LH: What is the climate for buying and selling of hotels?**

**Dana Ciraldo, Hodges Ward Elliott:** Since 1998 there has been a growing gap in bid and ask prices that I see narrowing now. During 1999, 2000 and the first part of 2001, sellers looked at the previous few years of performance, saw that it was tracking up and extrapolated those positive trend lines. They told buyers, "Three years from now the property will be performing at so and so, so you should pay me a multiple based on that." To which the buyers said, "You're a cyclical business in the late stages of an economic cycle so I see the potential to go down as much as there is a potential to continue along the trend line. I don't want to pay you a price where you think your trend line will be in three years." That was the basic cause of the bid-ask gap.

By the fourth quarter, we'll have

### The Panel

**James Butler**

Jeffer, Mangels, Butler & Marmaro

**Michael Cahill**

Hospitality Real Estate Counselors

**Dana Ciraldo**

Hodges Ward Elliott

**Sean Hennessey**

PricewaterhouseCoopers

**Steven Kisielica**

Strategic Hotel Capital

**Peter Rainsford**

University of Denver School of Hotel

Restaurant & Tourism Management

**Angelo Stambules**

GMAC Commercial Mortgage

**Eva Wassermann**

Hilton Hotels Corp.

**James Whelan**

Kimpton Hotel & Restaurant Group



positive year-over-year comps. Then it's a question of whether growth will be two, three or four percent, and that's not the stuff of big bid-ask gaps. At that point, the

buyers and sellers will be much closer.

**Kisielica:** Today we can see buyers buying good quality assets by looking at 2003 numbers. Most

of us would like to sell based on the growth potential for 2004 and 2005. Sellers who sell at 2003 numbers are leaving a lot of value on the table.

## Hopeful Investors Gather to Meet the Money

With latent aspirations and expectations coolly in check, hotel investors from around the world gathered at the Westin Hotel Los Angeles Airport in early May for Jeffer, Mangels, Butler & Marmaro's 12th Annual Meet the Money conference.

Never have so many gathered in anticipation of locating or placing hotel funding with so little firm expectations of realizing those hopes. Given the uncertainty in world markets and the hospitality industry, transactions and funding have been at a near standstill over the past six months. In April, however, signs emerged that the financial spigot may be primed to open deal flow once more. As a result, the conference was perfectly timed to bring together investors with an array of funding sources as well as sources of current financial market, hotel industry and operating data.

In opening the conference Jim Butler, chairman of JMBM's Global Hospitality Group, said, "This conference is a gateway to hotel finance. Meet the Money brings together the providers and consumers of capital."

More than 65 hotel debt and equity financing sources and industry lenders were featured as speakers at the event. The roster included CEOs of the nation's leading hospitality companies and representatives from the banks, credit companies, Wall Street firms, life companies, pension funds and mortgage bankers that are most active in debt and equity financing of hotels today.

With a focus on capturing the state of hotel funding and featuring a wide array of experts from the transactional, investment and financial communities, the conference probably realized more than attendees hoped in terms of information and a glimmer of light at the end of the tunnel.

The buzz at the pre-event cocktail party, held for speakers, sponsors, and presenters at Jim Butler's Beverly Hills home, was that funds are loosening, borrowers are becoming accustomed to more rigorous underwriting and that deals are being funded.

During the conference presentations, the consensus watchwords were borrower creativity, tenacity and track record. Real deals related were the funding of the development of the Omni Hotel San Diego by Holliday Fenoglio Fowler and the recently opened Peabody Little Rock facilitated via GMAC's Asset-Backed Lending Division.

The four financing panels and six breakout sessions, including the much-anticipated CMBS panel, represented virtually every type of hotel financing, from construction lending to joint venture equity funding and from mezzanine financing to credit enhancements.

Panelists generally agreed the industry is still suffering from wariness about the current and future state of the hotel marketplace among buyers, sellers and financiers alike, despite the recent advent of generally encouraging numbers. One panelist commented that despite the cautious and conservative mindset guiding the hands of lenders, the times today are really not so difficult for capital sources, particularly those involved in the mezzanine end of the business.

One of the most anticipated events of the day was the sneak preview of the JMBM Lender Survey conducted in conjunction with *Lodging Hospitality* and Zest Communications (see *LH*, May 2002). The initial findings and conclusions of the JMBM Lender Survey indicated that borrowers are challenged, lenders are choosy, creative funding is the order of the day, and because the industry has obviously "weathered the storm," some 85 percent of lenders polled reveal they expect to see more hotel loans underwritten going forward.

Next year's Meet The Money conference is scheduled for May 8 at the Westin LAX. For more information, contact JMBM at 310.203.8080.—*Sharon Lemon* ■■■



The Meet the Money CEO panel: (from left) Bruce Wiles of MeriStar Hospitality, Bruce Wardinski of Crestline Capital, Tom Corcoran of FelCor Lodging Trust, Cass Casserly of Tarsadia Hotels and Jim Butler of JMBM.

Conference chairman Butler hosted a party (right) the night before the conference.





**Michael Cahill, Hospitality Real Estate Counselors:** You need to break it down between the lower-end hotels versus first-class hotels. The lower-end stuff is actually selling, although some of it is for alternative uses, such as drug rehab centers, long-term housing or extended stay.

**LH: Is there money to buy, build or do anything in this business?**

**Angelo Stambules, GMAC Commercial Mortgage:** In light of the recession and Sept. 11, it's shocking how many development deals are crossing our desks. Frankly, very few are getting done. What is getting done are AAA, gold mint, low-leverage deals, and they are few and far between. For existing properties, we're seeing a very slow deal flow from the transaction side and very fairly brisk flow from the refinancing side. Over the past 90 days, we've seen a substantial uptick in the number of lenders out there looking at deals.

**LH: All kinds of property types?**

**Stambules:** It depends on the level of RevPAR declines. We're seeing the best results in drive-to markets. Gateway cities and major CBDs, like San Francisco and New York, are still being impacted. But even in those markets lenders are underwriting the impact and getting deals done.

There hasn't been a whole lot of long-term, fixed rate financing being done because of REMIC and the backlog of deals that are being flushed through that system. The greater opportunities for borrowers and lenders right now is bridge financing, three- to five-year

paper that floats over LIBOR.

**Cahill:** You're going to see action in tax-exempt bond financing, especially for big-box convention hotels. A lot of these projects just aren't feasible without this kind of participation. It's happening in Denver and San Antonio and even in some properties on Indian casinos and smaller projects in secondary and tertiary markets.

There is a perception that traditional lenders are slowing down so developers view tax-exempt bond financing as a window before the traditional lenders come back to the market. In the next 12 months, a lot of deals will be done this way.

**Eva Wassermann, Hilton Hotels:** It is very difficult to build a large convention hotel today without this kind of financing. We did a project in Omaha this year and the bonds sold instantly; in fact, they were oversubscribed at a 5.17-percent interest rate.

**LH: What is the outlook for the boutique hotel business?**

**James Whelan, Kimpton Hotel & Restaurant Group:** It's not so much the segment as it is specific markets. Some of the secondary markets are strong, while the gateway cities are still tough. We see 2003 coming back much more strongly. In San Francisco, for example, the convention bookings for next year are a lot stronger.

**LH: There's been a lot of talk in the press that the boutique segment is over the hill, passé, not cool any more.**

**Whelan:** Boutique as a single word has been applied to such a wide swath of hotels that it doesn't

really communicate anything to anybody. There are boutique hotels in Aspen and in San Diego. Some are 40 stories tall with 450 rooms made of solid granite. It also gets applied to our Bishop's Mansion conversion in San Francisco. Is it passé, over the hill? Absolutely not. Does the word need to be redefined? Yes. It applies to too broad a category and cannot give a real direction to it.

**Ciraldo:** You must break it into sub-segments. At one level of boutique you have hotels focused on media and fashion, which can only operate in three or four cities in the U.S. How long these kinds of properties will last is a more germane question than asking about Kimpton hotels, which have a residential feel in an urban environment that appeals beyond just what's hot today.

**Hennessey:** Boutique hotels were impacted probably more than their peers over the past six months, but that's not necessarily because boutiques are over the hill. A lot of them are relatively new, so they're still getting their sea legs in terms of competitiveness. They don't have much in the way of meeting space or extra facilities which other hotels use to stimulate demand in a period of low occupancies. But they've come back fairly well fairly quickly, and by all indications they still have very strong repeat demand and make strong impressions on consumers, so there is no sense at all of boutique fatigue.

**Rainsford:** In the past couple of years, our students have taken a lot more interest in smaller properties

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Hennessey



Butler



Kisielica



Ciraldo



instead of the big companies and their training programs. Part of it is that they're promised too much and then the corporations don't deliver. In smaller properties, they see how they can climb the career ladder faster and easier.

**LH: Are the problems with conduit loans and REMIC rules being resolved?**

**Butler:** I think they are. Over the past six months, there has been more of what I call a common-sense approach. It affects all aspects of the conduit market. There are still very dramatic differences in how different servicers will approach problem hotel loans. Some of them believe in strict letter of the law while others are closer to the model of the neighborhood bank.

**Stambules:** These vehicles provided great liquidity to the market back in the early 1990s. It is still a relatively new process, and everyone is learning how to work with it, but we haven't seen any suggestion that this part of the market is going away, certainly not from a broader real estate perspective and for hospitality in particular.

**LH: Following Sept. 11, many hotel companies did a lot of cost-cutting. How much of that has been institutionalized, and what kind of lessons did hotel owners and operators learn from that situation?**

**Kisielica:** We're challenging all our operators to look at their operations to maintain certain levels of service as well as acceptable profit levels. We're challenging them to provide these

efficiencies even beyond our current economic crisis. If we can all do so, we'll be a much healthier industry. We're getting some help from our customers since they're paying substantially lower rates and thankfully requiring fewer services for the price they're paying. The question is, will they begin to require more when the rates start going up? It will all come down to competitive pressures. Unfortunately, some of the cost savings have been offset by increases in insurance, in some cases up by 100 to 125 percent. So we're one step forward and two steps back.

**Whelan:** It's difficult for a number of reasons. One, of course, is that we have a commitment to our employees. Early on, we asked ourselves, "What is it that has changed and what is no longer required?" For example, we're constantly looking at ways to reduce energy expenses and insurance expenses. Yet we must still provide customized personal service. It may not be as over the top as it was in the past, but we still have very satisfied guests, and that's our most important criterion.

**Kisielica:** A substantial amount—if not all—of the corporate overhead at the managed chains gets passed on to the hotels. That's an area that historically has been very hard for an owner to control and monitor. We're very focused on this topic, and the industry should be, too.

**Wassermann:** At Hilton, a lot of our corporate charge-throughs have actually gone down over time. We actually pay more into

our programs than anyone else does. We have two focuses: one is on third parties but also on our own hotels because we manage the properties we own. For example, we try to lower our frequent guest program costs because they impact us as much as any one else we manage for, if not more so.

**Ciraldo:** The trick is to avoid the airlines trap in which you reduce your services so much that you make yourself into a commodity. Three quarters of all business failures are failures to execute. That usually means you didn't take care of your customers, your investor or your employee. In the long term, services are more valuable than assets.

**Hennessey:** When money is tight, the owners really focus on those types of expenses. There's going to be a lot of pressure on the hotel companies, especially since they must now grow through management contracts as much as through development. They'll be competing with each other to offer better deals to owners.

**Butler:** I disagree on the shift of power. A number of operators have either reneged on promises or done whatever they could to cancel and get out of capital investments. The pendulum may not be quite back to the 1986 environment in terms of the owner-operator balance, but it has swung significantly toward operators. Now there are longer periods before owners can get a termination on sale or performance. This creates an interesting opportunity for those brands in a growth mode. It's an



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opportunity Starwood took advantage of in the last 8-10 years in which they had reasonable contracts and usually threw a little capital into the deals. That kind of opportunity is out there for hotel companies willing to be a little gentle with their owners.

**Wassermann:** We're always getting beat up. In general terms, management agreements today are much more owner-friendly than they were in the past. At Hilton we're more flexible than we have been before. We have a lot of pressure to grow income, but fewer new hotel development opportunities means we have to find more management contracts.

Almost every third-party management deal done in the past 18 months has required capital from the management company.

**Kisielica:** The difference is that owners are really starting to recognize how expensive is that operator capital. It's absolutely the most expensive capital when you factor in the impact it has on the encumbrances of the deal. Owners are looking toward getting value out of the operator in other ways, whether it's guarantees or termination upon sale or other ways. It's very competitive for operators so we're seeing a lot more flexibility in management contracts.

**LH: What are the biggest challenges facing the lodging industry?**

**Whelan:** Greater distinctions need to be made between markets. Why do the decisions about lending or leverage in Manhattan also seem to apply to Denver, Seattle or San Diego. I'd like to see distinctions made on market-by-market basis that are more clearly understood. We don't make a decision to do a hotel in one city based on decisions we made in another city. Everything we do is tailored to where we are.

**Hennessey:** People have been saying for a while that the hotel

industry has a lot of strength and should be able to weather a downturn, and in fact, we've weathered this one very well. In New York City, for example, we've had the greatest single-year occupancy drop since we've kept records starting in 1927. But hoteliers have done things like going back to their lender to get the ff&e escrow available for working capital. They've extended their payables and tried to speed-up their receivables. They postponed new projects. They stopped paying partner dividends. Almost all of them have weathered the storm,

## What is LIIC?

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

Current co-chairmen are Mike Cahill of Denver-based Hospitality Real Estate Counselors and Sean Hennessey of PricewaterhouseCoopers. Vice chairman is Jim Butler, a partner in the Los Angeles law firm of Jaffer, Mangels, Butler & Marmaro.

and it's a testament to the industry that there was a lot of financial strength in reserve that allowed the business to carry through.

**Rainsford:** We must deal with two issues: First is consolidation. You'll see fewer companies and bigger companies, and the question is how are they going to differentiate themselves. The other thing is the global issue. We're a global economy, and to get the kind of growth public companies need they must go global but that presents them with all kinds of operating and marketing problems they may not know how to handle.

**Wassermann:** The biggest challenge is attracting capital back into the lodging industry so operating, developing and buying hotels are more achievable than it is today. We need to reeducate people that the lodging industry has a lot of positive things about it and that the cost of capital has been too high in the last 18 months. The

other challenge is making the American public more comfortable with travel again. That's what it's going to take to get us to the next level. We need to get occupancies up so we can push rates again.

**Cirialdo:** Human beings have the tendency to take the recent past and extrapolate it into the future, usually incorrectly. Don't take the last six months as a sign of what the future may bring. There is a huge baby boom demographic that will drive leisure business over the next 10 years. The U.S. economy has been strong for a decade, and it will continue to be strong.

Remember, the biggest historical risk in the hotel business hasn't been demand risk; it's been supply risk, and new supply has been greatly reduced.

**Cahill:** Timing is essential to create profitable hotel investment, so the people who can reliably predict when debt capital will loosen up, or can predict when new supply will

come on line, or can predict when to buy, bid or sell will be the real winners. This cycle has been a little bit different. The rebound is going to come a little bit slower than many people anticipated.

**Butler:** Financing, financing, financing and every dimension of it—availability of capital, cost of capital, terms of capital, decent appraisals. This is clearly the number-one challenge the industry faces. In light of that, we may have an interesting challenge in redefining marketing. We need order makers, not order takers. We need people who listen to the customers. This environment puts a premium on asset management and a team approach of smart owners, smart asset managers working with operators to determine the value the customer is looking for and then delivering that value. **LH**

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