IMMUTABLE LAWS OF LODGING INVESTMENT

Author: Richard A. Warnick, ISHC
Date: June 15, 2010

Richard A. Warnick, ISHC

Warnick + Company
www.warnickco.com
2398 E. Camelback Rd. Ste 1150
Phoenix, AZ 85016-9018
Phone: (602) 955-9393

As the industry continues its slow climb out of the Great Recession, investors are either licking their chops or licking their wounds. While many investors will blame the sheer magnitude of this downturn for the economic devastation that occurred in the lodging sector, it is undeniable that much of the hardship was caused by – or at least exacerbated by – questionable investment decisions before the recession started. It is equally undeniable that all those mistakes will be repeated in the future for a variety of reasons, not the least of which is a conscious – or subconscious – amnesia.

As a veteran of six economic cycles of varying severity, I can say with conviction that, for those who do not want to repeat past mistakes (or for those new to the game who do not wish to make them in the first place), there are repetitive patterns that are not only clearly observable, but definitively predictive. I have distilled them into 13 distinct observations that are so incontrovertible that I refer to them as ***the immutable laws of lodging investment***.

Heeding them may not totally prevent financial hardship in the lodging sector – especially in an era where unexpected events like 9-11 can suddenly and radically disrupt normal cycles…..nor will it completely insulate investors from downturns as severe as what we just experienced. They should, however, dramatically reduce the likelihood of problems and mitigate adverse impacts if/when they occur.

The immutable laws of lodging investment, in no particular order, are…..

1. **With few exceptions, hotels are not an appropriate asset class for a long-term hold…** because the lodging business (i) is highly cyclical, (ii) has high operating leverage (rapidly eroding profit during cyclical lows), (iii) is vulnerable to uncontrollable and unpredictable external events (e.g., terrorist attacks; epidemics, oil spills), and (iv) is subject to extreme irrationality by those who control pricing decisions. So, the highest yields will accrue to industry-savvy *cyclical traders*.

2. **<u>Never</u> fall in love with real estate.** It is all too easy for irrationality to quietly creep into decision-making when one becomes too attached to the allure of a particular site, building, concept, or opportunity. Emotional attachment has undone more investors than affairs of the heart have undone politicians.

3. **Location is and always will be the most important criteria in differentiating real estate – and hotels are no exception.** This law applies at both the macro/destination level (e.g., airlift, demand base, local economy, labor market, etc.) and the micro level (access, visibility, surrounding uses, barriers to entry, etc.). Market compression is no substitute for location…..a lesson learned episodically when markets go through their inevitable declines.

4. **Leave some chips on the table.** No one is smart enough to know when the bottom or the top will occur. Those who catch it just right are simply lucky. You do not need to be a first mover during cyclical lows to buy at a good price – and there are plenty of signs to indicate when the sector is "nearing" the top (i.e., still time to exit).

5. **Do not equate luck with skill or intellect.** Many lodging industry investors, who made money because they hit a cycle right, have gone on to lose it because they could not distinguish their good fortune from their ability.

6. **Easy credit is a leading indicator that the top is approaching.** Because lenders generally rely on the false security of well established trends, one of the first signs that the market is becoming risky is when lenders deem it to be safe (high leverage, easy terms, and narrow spreads). Easy (easier) availability of construction financing is an even brighter beacon because that spigot generally opens at about the time it should be closing. When hotel debt becomes easy and plentiful, it may not <u>yet</u> be time to run for the exits – but the hairs on the back of your neck should be tingling.

7. **If you can't build a hotel so as to open in the initial stages of a growth cycle, you probably shouldn't build it at all.** In most instances, the only guaranteed winners of late-cycle new construction – especially for upscale and luxury full-service hotels and resorts – are developers using other people's money, brands bent on growth, and (somewhere in the future) the second or third owner. This may be the most difficult of the laws to adhere to because it requires financing to be obtained at the time when most construction lenders are loathe to provide it (and, ironically, the only time in the cycle that they should).

8. **Cap rates should be viewed as a derivative of rather than an indicator of value.** Viewed in the context of real estate cycles, cap rates are the inverse of what they should be. That is, they are at their lowest when the cycle is near the top, net operating income

is peaking, and there is no place to go but down. They are at their highest when the market has hit bottom, net operating income is at its lowest point, and the future holds the most opportunity for growth.

9. **There will always be a replacement source of irrational capital.** Every cycle manages to attract a source of capital that will over-value assets as the cycle matures. Indeed, these are the buyers every cyclical investor prays for. The trick is to take advantage of them – not become one of them.

10. **Leverage over 65% loan-to-value is a high-risk strategy for hotels.** The degree to which a borrower chooses to lever lodging assets in excess of this level is inversely proportional to (i) the number of cycles the borrower has experienced, (ii) the amount of the borrower's "own" money in the deal (versus other people's money), and (iii) the borrower's propensity to avoid risk. Even experienced cyclical investors can be impacted by excess leverage because of event-related downturns that are entirely unpredictable. Indeed, the only "safe" way to over-leverage is to go all the way (i.e., little or no equity and non-recourse financing) – assuming the borrower won't mind if the lender ends up owning the asset.

11. **Understand the nature of various industry participants and diligently observe their behavior.** It is easy to get swept up in excessive exuberance, especially when the entire market seems to be moving in the same direction. But most industry participants are self-serving entities that are unwittingly or intentionally stoking the cyclical flames. After all, developers need to develop, managers/brands need to grow, lenders need to lend, brokers need transactions, etc., etc. These (and others like them) are the least reliable indicators of cyclical downturns. The entities to pay closest attention to are industry-savvy agnostics – that is, those who are knowledgeable of the business and indifferent to advancing any agenda other than optimizing returns. They most likely have a strategy – and the discipline to stick with it.

12. **The degree to which pricing is rational is inversely proportional to the amount and cost of capital in the system**. This phenomenon is clearly observable in the market today as asset prices are unjustifiably high in comparison to industry performance and market uncertainty. Although asset pricing has been exacerbated by a dearth of available product (basic supply and demand), the central cause is plentiful low cost capital, particularly from the public markets.

13. **The first sign that a down market is about to turn positive is when the vast majority of industry participants have joined in its funeral dirge.** Looking back on this latest cycle, for example, it was early in the fourth quarter of 2009 when Chopin's Op.35, no.2 became the background soundtrack for nearly every conversation about the lodging

industry. Thus the bottom in terms of asset values is already behind us. Most investors, however, should take comfort from Law Number 4, because the only entities who *can* (read *should*) take advantage of the lowest cyclical pricing are those who can afford to guess wrong.

Richard Warnick is president of Warnick + Company, a strategic advisory firm that specializes in the lodging and recreational real estate industries. Reach him at (602) 955-9393 or rwarnick@warnickco.com.

About WARNICK + COMPANY

Warnick + Company is a strategic advisory firm that creates opportunities and value-enhancing solutions in lodging and recreational real estate for our clients worldwide. We are in the knowledge business, and the hospitality industry is our passion. Our multi-disciplinary expertise, real-world perspective, and hands-on experience generate insights that deliver high-impact results. We provide trusted, partner-level attention and a tailored, comprehensive approach to meet your individual objectives. We have unwavering dedication to your best interests. You can rely on us to uncover the underlying issues, provide candid answers, and craft strategic solutions that achieve maximum benefit and competitive advantage.

About ISHC

The International Society of Hospitality Consultants (ISHC) is a professional society whose membership includes some of the world's leading hospitality industry consultants. Membership is by invitation only and the members are required to abide by the ISHC Code of Professional Conduct. Collectively ISHC members have expertise in over 50 different specialty areas and work experience in 65 countries. ISHC members' clients include public and private hotel owners, financial institutions, Fortune 500 companies, food and beverage service firms, timeshare and vacation ownership companies, universities, state, national and international convention, hospitality travel and tourism bureaus. A complete listing/directory of members and specialty areas of expertise represented within ISHC is available under "Consultant Search" on the ISHC website at www.ishc.com.

This article was previously published on HotelOnline.com and HospitalityNet.com.