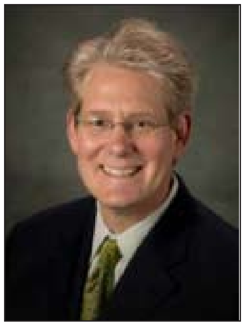
Can A Rain Dance Induce Financial Precipitation?

Analzying recovery solutions in the current economy.

By Eric E. Belfrage and John W. O'Neill, Ph.D

O'Neill



Belfrage

Native American Indians once believed that through a rain dance, they could induce the clouds to form, and rain to fall on the parched soil. They desperately needed the water that would yield crops and sustain life. Today, science suggests this activity had no effect on the meteorological conditions generating precipitation. However, at least the Native Americans felt like they were doing something about their drought!

The current hotel market, indeed the entire commercial real estate economy, is in desperate need of financial precipitation. We all do our part to beat the drum trying to please the mortgage deities so they will open up the debt to feed dehydrated hotel projects. As practitioners (owners, operators, developers, brokers, appraisers and consultants) we may feel like we are doing something, but will our effort result in the availability of debt, or are we just doing a rain dance? What are the conditions that need to occur, and what is the likely scenario that will unfold over the next couple years related to market recovery in the hotel business?

If dancing in the desert won't do it, what is the right strategic approach to prepare for the next cloudburst? There are lots of opinions; some suggest there is nothing we can do to cause financial institutions to loosen up lending to the hotel community because governmental regulators are enforcing such limited and strict percentages of hotel debt allowed to be held on banks' books — percentages that are significantly lower than they were a couple years ago. Others believe hotel performance metrics must improve before significant lending returns. Many suggest it is attitudinal, and market participants must believe that the future will be better before it will occur. All of these perspectives have merit. Recovery will be a process that requires a convergence of elements, a bit like the perfect storm.

Recovery will require many conditions that fall under three broad categories: Economic, Functional, and Psychological. Currently these elements are in disarray, which is not surprising given the economic freefall of the 2008 financial markets, and the resultant "clenching" of the free flow of debt. Further, there are functional problems with hotel operations due to low lodging demand. Psychological uncertainty is a logical outcome for people who naturally shifted into panic mode as drought descended on their financial world. Thankfully, the spirit of man is hearty, and elements of a recovery are already being cranked into focus by proactive entrepreneurs, some of whom are in the hotel business.

Like the formation of precipitation, the elements (Economic, Functional, and Psychological) are interrelated. General economic conditions will improve as businesses see opportunity to capitalize on new production. We have already seen the beginnings of this improvement in the medical, renewable energy, and governmental sectors. The Auto industry has also gained new purpose as brands have sharpened their focus as a realization that the recent government infusion will give them another shot at their target. Their aim must be "dead on" to survive, and some may not.

Housing (which led us into the financial meltdown) is by most accounts beginning recovery in some market areas. When the upswing in home sale transactions that we've seen in some markets results in home value increases, consumers will feel the comfort of knowing their home is once again an important component of their nest egg, Americans' great and pent up desire to travel will be unleashed, and hotel performance will improve.

Debt for housing is affordable, albeit not as liberally available as before the fall. Perhaps that is as it should be. The stock market has regained much of the ground lost in 2008 and financial institutions are largely recovering. The table is set for modest increases in production.

Increases in production should lead to more hours for workers, employment additions, and decreases in the high unemployment rate. As the Gross Domestic Product reports positive incremental growth for a few consecutive months, corporate confidence will lead to economic expansion. Of course these changes do not happen in a vacuum; Functional and Psychological elements must be part of the mix to fuel this "economic emergence". Early in this process, entrepreneurial activity is funded with risk capital and expensive equity.

Some good news is that the Wall Street Journal reported in January that consumer spending during the 2009 Christmas season increased compared to 2008. This positive sign suggests that consumer spending on travel in 2010 should also increase, resulting in improvements in hotel occupancies.

As early growth occurs, debt will become available at increasingly more reasonable terms, such as higher loan to value ratios. As debt becomes less onerous, combined with an improved attitudinal shift and better market metrics, buyers will deploy finite equity to purchase hotel assets. Currently, significant sums of equity are sidelined waiting for a "better forecast." This pent up demand will likely flood the market at the right tipping point.

Psychologically, buyers are in want of more certainty that the market is beginning a rebound. While most prognosticators believe we are at the bottom of the cycle, limited improvement in hotel market metrics has been evidenced. Buyers have limited confidence in future increases in revenue (more specifically, when those increases will occur). They are reluctant to pay an incremental premium above the price warranted by the trailing 12-month performance.

This current conservative investment perspective is largely because loan underwriting does not recognize projected financial performance, and no model can be built that quantifies with certainty when the rebound will occur. This attitude will in retrospect seem short-sighted as conditions turn positive and pent up equity capital rushes into the market after the tipping point has passed.

Of the three primary sources of hotel demand (corporate, leisure, and group), corporate declined most precipitously through late 2008 and 2009. Most corporations have had a moratorium on non-essential travel for over a year. Hotel demand declines, measured against prior year performance, have begun to moderate as the significant corporate demand losses have reached their one year anniversary.

Recovery will require many conditions that fall under three broad categories: Economic, Functional, and Psychological. Currently these elements are in disarray, which is not surprising given the economic freefall of the 2008 financial markets, and the resultant "clenching" of the free flow of debt. . .

To capitalize fully on the rebound, the seed must already be in the ground when the rain falls (or to complete the metaphor, your hotel project must already be a reality).

Even slight increases in corporate productivity and GDP will result in lodging demand increases. In the short run, with occupancy still very low by historical standards, room rates should continue to decline. As corporate demand rebounds, and more fill nights appear, rates will begin to increase. RevPAR will turn positive (many consultants project this change will occur in some markets as early as mid-2010, but not until 2011 in other markets). This shift in market metrics will provide the psychological impetus signaling that lodging is in recovery mode.

A fundamental shift in lodging metrics will be the fulcrum marking the turning point from a "buyers" to a "sellers" market. The preponderance of the market will then believe the future looks brighter, tolerance for risk will increase, and debt and equity requirements will soften (evidence that lenders and buyers are building future benefits into their modeling). The market will have reset to a "new normal."

Like an ecosystem that creates rain, this cycle is organic and interrelated. Hoteliers that acknowledge, participate in, and in fact capitalize on this cycle must be prepared to adapt a "contrarian" attitude to benefit fully from it. If one waits for all of the elements to align and the "rain" to start, they have already missed the first part of the "growing season," and will trail the competition. To capitalize fully on the rebound, the seed must already be in the ground when the rain falls (or to complete the metaphor, your hotel project must already be a reality).

As always, the fundamental principles of supply & demand, location, condition, brand, customer service, distribution…etc. have to be right.

So, when to plant the seed of limited equity capital is the question. The successful lodging investors in the next cycle will have been those who brought market knowledge, a keen sense of the fundamentals, and a strong strategic business plan together with market timing. These elements will not be in place at one time in all markets. It will roll through the economy like a good soaking spring rain shower, yielding a crop for those prepared to harvest.**ALB**

Eric Belfrage is a Vice President for CB Richard Ellis' Columbus office. He can be reached at eric.belfrage@cbre.com or by phone at 614-430-5048.
Dr. O'Neill is Managing Director of Hospitality Advisory Services, LLC, and Associate Professor at the School of Hospitality Management at The Pennsylvania State University. He can be reached at jwo3@psu.edu.