By Rick Swig

Lodging Business in Transitional Year, But Challenges Will Remain After '05

FOR THE HOTEL BUSINESS, THE FAST AND FURIOUS year of 2005 is nearing the three-quarter mark and racing to a triumphant end. This may be a year when owners are happy with their operations, sellers are pleased with their results and buyers are licking their chops for great returns from their new assets. Exuberance on all accounts may be fully justified.

Key indicators in most markets are positive. The business segment is returning with the expansion of the national economy. Leisure travel is still making Saturday night the high-occupancy night of the week, while group travel has stabilized satisfactorily and is growing. Foreign tourism is even trying to make a return.

New business is once again forcing room rates upward in most major markets, while occupancy levels are reaching the necessary critical mass to enable more profit flow-through. As a result, solid profitability has returned to the hotel sector.

In a world that seems destined for indiscriminate development, a hotel with truly unique attributes is worth a premium.

There are challenges for operators, however. Rising health and workers' comp expenses are threatening potential profitability growth. Brand standards are also creating more expenses. Major hotel brands are struggling to win the latest "bed war" or keep pace with what customers expect as the guestroom standard for entertainment or business technology, and hotel owners are footing the bill. There will be a continuing debate between owners and their franchise companies or operators over whether these capital-intensive improvements will enhance asset value.

In both primary and secondary markets, organized labor is making its move to extend its reach. In 2005, the unions, major hotel brands and owners have done battle in several high-profile markets. But the victims in places like Los Angeles, San Francisco and elsewhere are union and non-union hotel workers, who are being impacted by cancellations of convention groups, as well as residents of the affected cities, where millions of dollars of hotel occupancy taxes have been lost. Although settlements have occurred, this will absolutely continue into 2006.

As mentioned earlier, both hotel real estate buyers and sellers are probably winners. Sellers are yielding prices based on historically low cap rates, while buyers are taking advantage of a favorable financing environment to capture buildings. Buyers, of course, are taking on the highest risk. Strengthening markets and purchases that are well below replacement cost can create positive yields from any fundamentally strong hotel with a good location, brand and competitive product.

Many consider that some significant hotel purchases are being approached or justified in the same philosophy as buying a baseball franchise. The initial purchase price does not allow initial cash flows, but the back-end sale of the property results in a significant profit. In consideration of some of the large full-service hotel transactions in 2005 this is probably true, as primary and traditionally high-yielding city center locations are no longer available, replacement/new construction costs are not financially feasible and dominant brand availability is slim. These barriers to entry add immediate value to significant existing assets, when strong market, location and product fundamentals are in place. This may not be good for the "buy and flip" opportunity fund, but patient owners should harvest handsome returns.

Disregarding historical financial performance and basic market trends is not recommended, however. Differentiation is a critical component in the value of an asset. In a world that seems destined for indiscriminate development, a hotel with truly unique attributes is worth a premium.

The final 2005 conjecture is the accelerated move toward mixed-use hotels, either as a financial vehicle to fund new development (i.e., the condo-hotel) or as the alternative overnight stay mousetrap (i.e., hotels with fractional ownership or residential condominiums). Like most development trends in past cycles, the herd mentality will cause some overkill, while real questions still remain about the depth of the market and real customer demand

It's not over yet, but 2005 has shaped up as a transition year on many fronts. The best, of course, is that demand is strongly emerging, and as many hoteliers have noted, "good business covers a lot of sins." ◆

The views expressed in this article are those of the author and not Real Estate Media or its publications.

Rick Swig *is president of RSBA & Associates, a hospitality industry consulting firm based in San Francisco. He may be contacted at rickswig@rsbaswig.com.*