By Rick Swig

In Today's Acquisition Market, How Much Do Cap Rates Matter?

WHEN THIS YEAR COMES TO AN END, THERE WILL be a lot of post-game analysis on what buyers over- or under-paid for various assets.

There has been much discussion over cap rates and if they make sense. Whether a cap rate for an asset was 5%, 8%, 10% or 12% may be less important than the consideration of other factors such as the property's physical condition; its location within its market; the brand or lack thereof; and management.

There probably is no right or wrong answer as to what an ideal cap rate is since individual assets and the differing needs of investors determine their own thresholds of risk. More than ever, the sensitivity analyses regarding the individual characteristics of the deal become the defining activities. It is now more important for buyers to understand the hotel business and operations in conjunction with their own expectations for return and exit strategy than to do a regression analysis on a crystal ball reader's forecasts.

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The hotel business has now matured to the point where there is ample data to research and review the trends of even the smallest neighborhoods within a given market. Whereas Randy Smith of Smith Travel Research provided the hotel investment community with simple monthly market data barely 15 years ago, now that same source will supply daily and weekly analyses of both competitive sets in general and within individual segments.

Data from other sources, such as TravelClick, will let an owner, operator or prospective investor understand customer buying habits and an asset's market penetration through electronic channels, plus the third-party sources of that business, booking lead times, product pricing, average length of stay and other key measurements. Using that information, a buyer can determine the strength of a market and an asset, the relative customer base and its buying habits. Each of these elements can reflect the relative value of an asset beyond a cap rate and determine the potential for upside growth.

There have always been considerations regarding barriers to entry, including the potential for new supply based on available sites, brands or other product-driven issues.

The latest and most important barrier to entry has become the cost for new construction or conversion from another use. New construction may be placing the costs of new hotels at cap rates of 1% or 2%, which certainly is not attractive to return-oriented investors. Investors are trying new and creative structures with timeshares, condo hotels or other mixed-use ventures in an effort to leverage projects to a reasonable investment level. Although conceptually exciting, these structures may just not have the necessary market fundamentals to perform.

It all comes down to performance. While it's true that hotels in most markets have shown significant increases in revenue, these same markets may not be performing at adequate levels to support new construction.

This brings the discussion back to smart acquisition tactics and the criticism that 2005 has been stigmatized by the significant overpayment for hotel assets. Once again, there is a risk for a pitfall due to overgeneralization.

The issue really is whether perceived overpayment is actually a value purchase. With a prime location, the acquisition at a premium becomes more justifiable.

Additionally, there may be a general shift in the hold period of a hotel asset—three- to five-year hold strategies may be an outdated concept. Historically, owners of great baseball franchises have always sold the teams for more money than they originally paid, while in between the two transactions there may have been some years with lower-than-desired returns on their investments. Some sports transactions are linked to other purposes, such as cheap programming for a media outlet or the need to sell more beer through a brewery. The hotel business may be moving in a similar direction, where the back-end yield is more important or the hotel is a catalyst for the success of a related or mixed-use project.

Regardless of the motives, success in hotel acquisition and development requires forward vision about assets and individual markets plus solid belief in historic trends. ◆

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