By Rick Swig

Hotel Real Estate Owners Face a Brave New World

WITH 2009 NEARLY HALF OVER, THE HOTEL SECTOR is clearly in a brave new world. The trends for the first few months of the year showed average national declines of 10.5% in occupancy and 6.5% in average daily rate. This decimated gross operating profits and related EBITDA by at least 30%, even with significant and successful efforts by hotel operators to cut expenses.

Few owners today actually know the value of their individual assets. Those that do are part of a minority who were actually able to sell. Cap rate erosion coupled with general EBITDA declines would equal more than a 50% reduction in a hotel's worth. Does this mean that hotel real estate values have been halved? Some owners might object to that assessment. By comparison in 2002, there was a 23% decrease in per available room value based on a 30% EBITDA decline with fairly stable cap rates.

A key issue affecting RevPAR is the practice of room rate discounting, which endless studies have concluded does not build occupancy. Discounting stems from panic by myopic operators desperate to capture market share at the risk of accelerating profit and property value declines, undermining brand value and having a long-term impact on pricing power. In the 2001 recession, as a result of rampant discounting, room rates did not return to 2000 levels for five years. Based on the current RevPAR trends, which are exacerbated by ill-fated discount mania, the 2010 national RevPAR forecast of $54.85 is almost on par with 2000 RevPAR of $53.79, according to Smith Travel Research.

The real issue today is EBITDA, or what is actually left from revenues to pay debt. Recognize that during low occupancy periods, decelerated profits accompany RevPAR declines. In the previous recession there was a 22% RevPAR drop with a 32% GOP collapse between 2000 and 2002 across all segments. A general decline of 28.5% in RevPAR and 47% in GOP between 2008 and 2009 is likely, with even steeper drops in the luxury segments.

Since hotel revenues plummeted after October 2008 in most markets, many owners are barely able to make payroll, much less debt service. This issue, in conjunction with little to no available financing, would lead one to believe that the lodging sector is about to enter the next phase of suffering: default due to non-performance.

This is the fifth recession the hotel industry has seen since 1973. The current downturn, although seemingly more grave, is similar to the 1980 recession because of the limited supply increases in recent years and relatively little development on the horizon. Additionally, given the government's injection of capital into the financial system, there is great risk of inflation coupled with high interest rates, which neared 20% in the early '80s.

Historically, there has been less than a 1.5% annual increase in inventory growth in the first four years after the start of a recessionary period, which indicates that no significant new supply would appear before 2014. Furthermore, after what might amount to a 10% decline in ADR in 2009, with some additional dropoff in 2010, room rates will begin to accelerate in 2011. Rates will likely exceed 2007 levels in 2013, with occupancy reaching 2007 parity one to two years after. So don't panic yet. Just think of the opportunities that may await investors with available capital to buy some lower-cost assets later this year or in 2010.

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There will be many factors to determine the timing for hotel transactions. These would include the narrowing of the bid/ask gap between sellers and buyers with differing opinions of current value declines of between 20% and 50% from 2007 levels; the process by which lending institutions either force or create a sale of distressed assets; the availability and the cost of credit; and the risk tolerance of buyers during the recovery. It would seem that hotel owners with loans coming due and with no ability to refinance might create some quick dispositions and bargain values, although there is a strong belief that lenders may gain little or no value in foreclosure. However, look out for some lender epiphanies resulting in some temporary foreclosure reprieves. ◆

The views expressed in this article are those of the author and not REAL ESTATE FORUM.

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