HOTEL INVESTMENTS: WHERE DO WE GO FROM HERE?

By Lori Raleigh

At the recent Americas Lodging Investment Summit conference there was quite a bit of good news---the industry has just finished up the year with record profits for 2006! Transition dollar volume is also at all time high and 2007 is expected to be another record year for RevPAR growth, industry profits and transactions.

There was also some not so good news---supply growth is escalating; the rate of RevPAR growth is decelerating and there has been a significant decline in international business (as a percentage of total demand). Additionally, many hotels are facing increased expenses and human resource challenges.

And there are also many areas of uncertainty---investment return/risk premiums have been collapsing; corporate profit growth rates are declining and the impact of the negative personal savings in 2006 on long term consumer spending is unclear. There is also the issue of the inverted yield curve –and what impact the potential "retrenchment" of foreign investment in US debt might have on long term yield rates.

What does this all mean in terms of where we at in the investment cycle? And where do we go from here?

Following are some thoughts and observations to share.

THE GOOD NEWS….!!

Lodging Industry Profits Reach Record Levels -PricewaterhouseCoopers is forecasting industry profits of $25.2 billion or approximately $5,660 per available room for 2006—this will establish an all time record for the industry. The prior record of $5,353 per room and $22.5 billion for the industry was reached in 2000.

PwC is forecasting another record breaking year for 2007. Industry profits are expected to reach $29.7 billion or approximately $6,005 per available room in 2007. The further increase in profitability is expected to be achieved primarily via revenue growth and rate growth in particular.

Another Year of Strong RevPAR Growth -For the past few years—going back to 2003--demand growth has exceeded supply growth and this in turn has provided an opportunity for hotels to significantly increase room rates. The industry has reported RevPAR growth of 7.9%, 8.5% and 7.4 % for the years 2004, 2005 and 2006 respectively.

PwC is forecasting continued strong RevPAR growth of 5.8% in 2007. And accordingly, the RevPAR growth for the hotel industry is expected to exceed the forecasted revenue growth rates for all other property types (including multi-family, industrial, office and retail/strip centers).

Transaction Dollar Volume at All time High -The lodging transaction market in the US reported a third consecutive year of record sales of $35.3 billion in 2006 (including transactions over $5 million) versus $29.5 billion in 2005 and $15.4 billion in 2004—accordingly to Real Capital Analytics.

According to Jones Lang LaSalle, the "robust" environment of hotel real estate mega-deals is poised to continue through 2007 and 2008.

Hotel Values -In 2006 average per room prices for hotels continued to show substantial growth—due to improved net operating income fundamentals and cap rate compression (or reduced investor return expectations/ requirements).

Continued Availability of Investment Capital ---albeit at least in the Immediate Future -According to Commercial Property News "baring a jolt to the economy from an unpredictable event---capital will continue to flow into real estate from Wall Street, private equity, large commercial banks and institutional investors".

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THE NOT SO GOOD NEWS …

Supply Growth Escalating -In 2007 for the first time in several years supply growth is expected to exceed demand growth. And based on current pipeline projections this could continue well beyond 2007. Escalating constructions costs and challenges "penciling out" new projects, however, could temper supply growth projections.

Decelerating RevPAR Growth - In 2007 RevPAR growth is expected to moderate to 5.8% from 7.4 % in 2006 and versus 8.5% in 2005 and 7.9% in 2004.. And some question whether this growth rate is achievable on an industry wide basis in light of potentially detiorating supply vs demand fundamentals.

Decline in International Business International business has declined by nearly 30% since 2000—-- from accounting for approximately 12.8% of total demand in 2000 to 9% of total demand (in the US) in 2006.

Based on total rooms revenue of $100 billion dollars in 2006, this decline in international demand represents the equivalent of nearly $4 billion dollars in revenue in one year alone.

Human Resource Challenges -The problem of attracting and retaining qualified workers, once an issue only in an isolated number of markets, is increasingly become a global challenge. The "shrinking labor force" was recently identified by the International Society of Hospitality Consultants at the number challenge in the hospitality industry for 2007.

AREAS OF UNCERTAINTY: SOME ADDITIONAL THINGS TO THINK ABOUT….

Investment risk premiums Investment risk premiums for many asset classes—including hotels-- have been declining. At the far end of the risk continuum premiums for highly speculative bonds have fallen to historic lows—with a spread of 4.59% over the 10 year treasury---well below the historical average of 11.20 percentage points; high yield corporate debt premiums have narrowed to below 3%. And risk premiums for all real estate asset classes have dramatically narrowed as well.

The collapsing of risk premiums (and lowering of return expectations)—due in large part to the tremendous surplus of investment capital-- in turn has supported substantially higher property values—and some argue "artificially" so.

Corporate Earning Growth Rates Expected to Decline in 2007 -While still strong corporate earnings growth is expected to decline into the single digits this year

Consumer Spending Supported by Negative Savings Rate Consumer spending currently accounts for approximately 2/3 of the economy. The Commerce Department recently reported that the nation's personal savings rate for 2006 was a negative 1 percent---the lowest rate in 73 years. And with consumers essentially dipping into savings to finance purchases it begs the question of whether current consumer spending levels are sustainable..

Potential retrenchment of foreign investment in US debt- China is currently the largest investor in US debt. China has recently announced it's intention to evaluate other "investment" alternatives, including potentially cutting back on its current level of investments in US Debt.

Despite an increase in the federal funds rate from 1% in 2004 to 5.25% currently, long term rates have not increased correspondingly. And many believe that long term rates have been held artificially low due in part to the high level of demand for US debt by foreign investors. While the specific impact of a potential retrenchment of foreign investment in US debt is unclear at this time ---it warrants keeping an eye on.

WHERE ARE WE IN THE INVESTMENT CYCLE: WHERE DO WE GO FROM HERE?

It is important to keep in mind that there are two components of the "total return" on investment i.e. a capital appreciation or growth component and an income or yield component. And we appear to be at different points in the two cycles.

Capital Appreciation Cap rates for all types of real estate have declined substantially during the past few years. It is estimated that approximately 70% or more of the increase in value of hotels during the past few years has been attributable primarily to cap rate compression or changes (i.e. reductions or the lowering of) in investor return on investment expectations.

While there are indications that we are close to the 9th inning—there are also factors suggesting that we could well go into extra innings.

- ***Surplus of Investment capital*** - There currently is a "huge" surplus of investment capital---a large percentage of which represents, either directly and/or indirectly, pension fund and individual retirement capital. And in the US this is due in large part to where we are at in the "retirement cycle " for the baby boomers!. And this "surplus of investment capital" may well continue until significant numbers of additional baby boomers retire.

- ***Pension fund Investment cycle***-in the pension fund industry there is typically a substantial lead time in making and/or changing investment dollar allocations to various alternative investments. And the hospitality industry is currently benefiting from the "momentum" of decisions made previously-- but not necessarily yet implemented-- to allocate investment capital to real estate in general and alternative investments (i.e. hotels) in particular.

- ***Alternative investment performance***- it is important to keep in mind that ultimately, however, the continued on going availability of capital to the hotel industry will depend in large part on the investment performance of hotels relative to alternative investments (including other forms of real estate, stocks,bonds etc.).

Of particular note is the dramatic improvement in the performance of the stock market this past year. The Dow Jones was up 16.3% for full year 2006 and the S&P 500 was up 13.6 percent during this time.

As the "Total Return on Investment" performance of alternative investments improves –in particular relative to hotel investment performance—we need to be on the alert for potential signs of capital retrenchment from the lodging industry.

Income Cycle -Growth in net income or profit performance is primarily a function of revenue growth, margin performance and operating leverage.

While the outlook suggests that we are in the 6^{th} or 7^{th} inning, for many hotels there are clearly opportunities for additional growth in net operating income/ profit performance—in particular in light of further RevPAR growth potential.

WHAT DOES THIS ALL MEAN?: A FEW TAKEAWAY THOUGHTS TO SHARE…

All hotels are not created equal—it is important to keep in mind that industry averages are not representative of individual hotel performance. There can be a substantial "spread" or range in the performance for different types of hotels and depending up specific operating parameters, the age and condition of a property and the competitive market environment etc. There will *always* be an opportunity for some hotels to perform better than the industry averages.

Alternative Investment Performance and Capital Flows –It is important to keep an eye on alternative investment performance in general and capital flows in particular.

Stay focused on operating fundamentals—the opportunities for capital appreciation and increases in asset values via further cap rate compression are very quickly drying up and for the most part are behind us. Accordingly, going forward it will become increasingly important to stay focusing on hotel operating business fundamentals and improving net income performance.

Human Resources-with the emphasis often on the transaction side of the business we tend to lose focus on one of the most critical components of a hotel investment—the employee. It is important to keep in mind that the hotel business is a people business. Well trained and motivated employees can ultimately make a tremendous difference in hotel investment performance.