By Rick Swig

With New Supply at a Near Standstill, Now Is the Time to Buy Hotel Assets

SPECULATING ON WHETHER TO BUY OR BUILD IS very challenging. Looking back over 2007 offers a mixed bag of predictive indicators. The first quarter brought warnings of occupancy slowdowns from astute sources like Smith Travel Research, yet acquisition activity surged and continued through the first half. There were continual questions about "What's the right cap rate?" But establishing the "right" cap rate did not seem as important as purchasing the right strategic property.

Nevertheless, there are solid reasons to buy hotel real estate even at premium prices, particularly when the asset's makeup includes quality location, solid destination, diverse and consistent demand generators, solid brand affiliation and market barriers to entry. Meanwhile, several factors have quickly slowed a development pipeline that in past cycles would have run rampant. Competition from other real estate sectors, along with other factors, has reduced the opportunity for expansion, therefore making existing hotels sites with these components extremely rare and valuable.

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For a while, it seemed that at least in major urban and resort markets there would be a proliferation of super-luxe hotels, residential mixed-use projects with a hotel component and condo-hotels, if all the proposed developments were to be realized. It has turned out in many cases, however, that sites have gone to "better uses" or projects that in the end were not financially feasible. Construction costs versus potential yields were simply not attractive, while the consumer market for condo hotels was weaker than expected. Maybe the hotel sector should be thankful to the residential sector for sweeping potential hotel sites away for pure residential use and thus pre-empting an oversupply situation.

Another dynamic to emerge this year to impact development was the limited availability of solid brands to stimulate financially necessary short stabilization periods for a new hotel project. The big brands with the most powerful guest recognition programs clearly rule the business.

Although there are many developers willing to join up with brands to build more hotels, prime destinations and the best locations are already dominated by the most popular brands. Although owners of existing branded properties are most likely doing well (at least in this environment), there is little chance that they will warmly welcome new competition in the form of a brand's latest model and certainly will review their geographic protection clauses.

Yes, there are new brands that do not have the critical mass or geographic crowding of the established names that could fill potential development voids. Lack of critical mass, the strength and dynamic nature of their customer loyalty programs or their ability to generate adequate returns on investments do not make them the most viable alternatives, however.

Then there are the mercurial debt markets, which are expected to continue to tighten the flow of funds for both acquisitions and certainly new development. At the same time, projected hotel revenue growth of less than 5% for 2008 and beyond do not exactly auger well for significant enthusiasm from the lending community.

But lenders would be extremely unwise to shut off the hotel sector completely. There is still significant growth and strength in the majority of markets, while the anticipated slowdown of new construction will certainly underpin the competitive power of existing hotels.

So, what's a hotel investor to do? Now may be the time to buy, if good fundamentals are in place. There will be continued competition for prime locations; good brand affiliations within the best locations will become more difficult to come by; and barriers to entry, whether due to lack of site availability or development cost reasons, will become more exaggerated. This should stimulate the value of hotel real estate under the right circumstances.

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

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