

Hotel Investments: Will You Still Love Me Tomorrow !?! Carole King

Article by Lori Raleigh

I recently returned from "California Dreamin'" *Mamas & Papas* and the 2008 Americas Lodging Investment Summit (congratulations to the BHN team and the AH&LA on another excellent conference!). And I couldn't help reflecting on "What a Difference a 'Year" Makes". *Dinah Washington*

Following are a few thoughts to share ...

Global Perspective- "We are the world..." Lionel Richie and Michael Jackson

This year's conference clearly brought this home.

- Investment capital including private wealth, pension fund capital and sovereign wealth is increasingly crossing borders—with an estimated \$3 trillion in assets, sovereign wealth funds alone currently have more cash under management than all of the hedge funds (worldwide) combined. And according to National Real Estate Investor, sovereign fund assets could grow to over \$15 trillion dollars within the next 7-8 years.
- Emerging markets are increasingly challenging traditional established hotel destinations. While emerging destinations are clearly generating some "incremental demand" many customers represent business being "captured" or displaced from other markets/destinations.
- Airline Industry -There was also discussion about the challenges facing the airline industry, the potential for further consolidation along with the potential impact of "open skies" on International travel. These are issues which can be expected to impact routes, lift capacities and pricing to various destinations—all changes which will clearly represent challenges for some hotels/markets but will also present opportunities for other hotels/destinations.

The flow of investment capital worldwide, emerging markets and the airline industry are all issues we should be keeping an eye on.

Going Green- "Let's make it a better place.." Lionel Richie and Michael Jackson

For the first time the ALIS programming included a special "Green" track. The critical importance of the hotel's industry's embracing and taking a lead role was the topic of discussion in several sessions---not only because it is the right thing to do...but increasingly hotels can anticipate that consumers will expect and demand it —and for many meeting planners this has already become a "pre-requisite" for considering a hotel.

And thus "Going green" will not only impact expenses it can be expected to clearly impact the revenue or Top Line as well.

The (US) Economy - "Back in the USA..." *Bruce Springsteen*

The US economy is first and foremost on the minds of hotel investors. With well over \$100 billion in sub prime and securitized loan losses to date along with the tremendous uncertainty about the potential for further substantial write downs/losses investors understandably are still trying to sort out and digest the magnitude of the situation.

"Bridge(s) over troubled waters" *Simon & Garfunkel* -the Federal Reserve has responded with a series of cuts in the Fed funds rate –from 5.25 to 3.5 percent. Additionally, a \$168 billion US government fiscal stimulus package has recently been approved.

These programs however are not without risk---the most recent surprise Fed rate cut of 75 basis points along with the proposed stimulus package have created tremendous volatility in the fixed income markets.

This most recent rate cut by the Federal Reserve one week prior to their regularly scheduled meeting was the single biggest move in more than 20 years and the first intra-meeting cut since 2001.

The credit markets are still trying to unwind a substantial backlog of prior commitments potentially representing significant further write downs—which will need to be "worked out" to restore confidence in the markets.

Unfortunately, a bit more troubling news was also released (following the ALIS conference) regarding the jobs market –with the US reporting its first decline in the jobs market in over 4 years.

Transactions - "Know when to hold em—know when to fold em" *Kenny Rodgers*

The Lodging transaction market in the US is expected to report a fourth consecutive year of record sales of approximately \$45 billion for 2007 versus \$35.3 billion in 2006, \$29.5 billion in 2005 and \$15.4 billion in 2004 --- accordingly to Jones Lang LaSalle, Real Capital Analytics and other industry sources.

It is important to note however that although transaction sales volume is up for the full year transaction activity declined dramatically in the second half of the year. And transaction sales volume is expected to further decline in 2008 (to \$26 billion per Jones Lang LaSalle)—due in large part to the turbulence in the credit markets and also to the overall uncertainty regarding values and resulting substantial gaps in buyer vs seller expectations.

ROI performance- "Its all coming back to me now...!!" *Celene Dion*

Investors buy hotels to earn a return on their investment via the income generated from the hotel and/or through the capital appreciation or increase in value of the hotel over time (or more typically through a combination of both current yield and capital appreciation).

"What goes up ..must come down?!?" *Blood Sweat & Tears* In recent years it is estimated that approximately 70% or more of the increase in the value of hotels has been attributable primarily to cap rate compression or changes (i.e. reductions or the lowering of) in investor return on investment expectations.

Risk premiums have expanded dramatically during the past several months and with cap rates increasing hotel owners will need to look to improvements in "NOI" to keep us alive" *Eagles*

Underlying Fundamentals – "Celebration—we're gonna have a good year" or are we??? *Kool and the Gang*

- **Rev Par-** Despite the credit crunch, hotel fundamentals –according to Smith Travel Research –remain strong and further RevPar growth of 4.4% is forecast for 2008.
- **Supply-** industry wide supply–accordingly to both STR and PKF-is expected to outpace demand in 2008 however it is anticipated that demand will catch up in 2009....or will it?
- **Consumer Demand-** "What's sub prime got to do with it.?" *Tina Turner*. According to Gene Sperling, Former White House National Economic Advisor and Director of the National Economic Council and a keynote speaker at the conference---a lot!
- The average national wage has only increased 2 cents to \$17.91 since 2000. Gene went on to explain with income essentially flat that consumer spending—which accounts for two thirds of the economy--- has been supported primarily via draw downs in home equity.
- And with the credit crisis coupled with the decline in real estate values in many markets—"home equity" can no longer be expected to support consumer spending. Accordingly to Gene, "if we pull out this HUGE" driver of consumer spending we should anticipate a much broader impact (which has not happened yet)...on the level of consumer spending (and GDP)."
- Corporate profits –according to the Wall Street Journal over 30% of companies reporting for 2007 as of early February have missed their 4th quarter targets and the further deterioration in corporate profit growth is expected (for many companies) in 2008.

Pension fund capital- "Looking for returns in all the right (4 quadrants) places !" *Waylon Jennings*

Pension fund capital directly and/or indirectly has been a primary source of investment capital for the hotel industry in recent years. It is important to keep in mind with over 10 + trillion in assets, even minor shifts in the allocation of pension dollars to "alternative investments" in general and the hotel industry in particular can have an enormous impact on the availability of capital to the hotel industry.

Some pension funds have (already) indicated that they will be cutting back on their allocations to real estate and alternative investments which in turn over time can be expected to impact the availability of capital to the hotel industry. And one industry expert noted during the IREFAC session at ALIS---they (pension funds) were the last ones in (to invest in hotels) and they may well be the first ones out.....

Will they "Stand by me (the hotel industry)?" *Ben E. King*- is a question on the minds of many –and this will ultimately depend upon the risk versus return of hotel investments relative to alternative investment performance.

Alternative Investments "Did you ever have to make up your mind..." *Lovin Spoonfuls*

The risk vs return on investment performance of hotels/hotel companies relative to other investments is what ultimately will impact the availability of capital to the hospitality industry.

Overall hotel returns have held up extremely well relative to alternative investments.

And for yield investors in particular, hotels (albeit certain types of hotels in specific locations) potentially can provide one of the highest "income" returns among many investment alternatives (equities, other types of real estate, fixed income investments etc.).

Hotel Investment Risk vs Return Performance- "Changes in attitude (to risk); Changes in Latitude (risk premiums)" *Jimmy Buffet*

As noted above, the on going availability of capital to the hotel industry is ultimately a function of the risk versus return performance of hotels relative to alternative investments.

Risk-- Risk premiums for hotels are increasing however risk premiums for other asset classes are increasing as well.

Returns -While the hotel industry clearly faces some challenges—with the economy in general and the turbulence in the credit markets-- the underlying performance fundamentals are holding up fairly well.

Versus Alternative Investments -The stock market has been extremely volatile and is down approximately 7% year to date in 2008 and nearly 15% from the peak for the year in 2007.

All things considered the ROI potential of hotels remains attractive in particular in light of the very weak performance of some alternative investments.

All hotel investments are not created equal -“I Walk the line and keep my eyes wide open all the time” *Johnny Cash*

The hotel industry is a very “imperfect” market and as a result there will always be opportunities for astute investors.

The ROI performance potential for different hotels can vary dramatically depending upon the location, the type of hotel, the age of a hotel, fixed vs variable cost structure, the demand mix (and seasonality of demand), the cost and availability of capital –along with many other factors.

Return on Investment (ROI) performance is primarily a function of the numerator or net operating income relative to a denominator or the investment basis of a hotel and the combined or weighted cost of debt and equity capital.

Essentially there are three ways to improve ROI performance

1. Increasing the “numerator” via revenue growth or reducing expenses or margin improvement (via combination of revenue growth and reducing expenses) and/or
2. Decreasing the “denominator” or investment basis of a hotel and/or
3. Reducing the cost of capital

With forecasted further NOI or “Numerator” growth (albeit at a significantly slower pace than recent years) along with the expansion of cap rates (and the potential for the reduction in the “denominator” or investment basis in hotels) --- we are transitioning into an environment where there well may be excellent opportunities for experienced hotel investors that have access to capital.

About the Author- Lori Raleigh is the founder of The Travers Group, a hotel investment and asset management advisory firm and is currently serving as the Executive Director of the International Society of Hospitality Consultants. Ms Raleigh is a frequent guest speaker at industry conferences and events. She has written numerous articles and is co-editor and author of “Hotel Investments Issues & Perspectives”, published by the Educational Institute of the AH&LA.

