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Buying smart in a tough economy: The market is challenging, but not impossible

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Even in today's challenging economic climate, there are market segments that are still active for hospitality real estate transactions and certain properties are continuing to be sold as they would in any market, good or bad. However, understanding and accurately assessing hotel market values in the current hospitality real estate market is a difficult task, even for the most experienced professionals. Many appraisers, lenders, owners, and buyers are calling upon experienced brokers in this regard. By following the right steps, buyers can make educated decisions that result in profitable transactions, even in the toughest economic climate.

Step 1: Be Aware of the Current Market and Act Accordingly

Today's financing struggles have a huge impact on hotel buyers, and buyers should be aware of what to look for when purchasing a hospitality property. Based on recent transactions and market trends, more buyers are showing concern for clearly stated exit strategies and looking for markets with high barriers to entry. Educated buyers are also factoring new development and on-going capital improvement programs into the proposed value of a property.

Step 2: Identify Areas of Opportunity and Capitalize on Them

A very important factor in the current New England market is the aging of area hotels. For example, the two-story interior corridor hotels of the 1970s and early 80s are facing functional obsolesce, as they often require extensive maintenance and high operating cost. The good news is that many of these properties have the best locations and are well-suited for redevelopment. When purchasing an older property that may be nearing the end of its economic life, it is important to consider potential redevelopment opportunities as an exit strategy.

Many older properties, such as these two-story interior corridor hotels, occupy locations where the value of the site is greater than the value of the hotel based on the revenue the hotel generates. Redeveloping the property may be a terrific exit strategy. Where an old, functionally obsolete hotel resides, new retail shops, restaurant PAD sights or large box stores could create much higher value.

Step 3: Know the Key Factors that Affect Sale Price and Transaction Structure

When considering the purchase of a hospitality real estate property in any market, knowledgeable buyers must consider the cost of the Product Improvement Plan (PIP) for the property and how that plan affects the hotel value. PIP costs will continue to have an affect on pricing in this market, and sellers will likely see a dollar for dollar reduction in a buyers offering price after capping the Net Operating Income for the price of the PIP. Educated buyers should not assume that just because they plan a property refresh that revenues will increase; in fact, it is more likely that the refresh will be necessary just to maintain the same revenues.

Allocation of sales price is often a very important part of structuring a transaction. An experienced broker would assist in suggesting allocations in order to reduce or increase the following: land and building; furniture, fixtures, and assets; and good will. Proper price allocation can create favorable tax treatment for both sides of the transaction.

Lastly, do not be fooled by quoted sale prices that are based on state tax stamps, as state tax stamps are paid only on the allocation of land and building when the deed is recorded. Many appraisers, buyers, and lenders are often misled when the value of a property is assumed to be equal to the state tax stamps paid on that property, when in fact the actual sale price may be much higher due to the allocations of personal property and goodwill.

Step 4: Make Smart Choices for the Future Based on Knowledge of the Past

Consolidation in the hospitality real estate industry since the early 90s has allowed for fewer foreclosures in this downturn, since more owners have concentrated on maintaining capital reserves, providing better management, and maintaining expense control. Today, without any indication as to when room demand will increase, hotel owners should continue to focus on developing programs to keep operating costs as low as possible while still providing a hospitality experience that exceeds customer expectations.

Many participants in the hospitality real estate market believe that the market hit bottom between May and July of this year, based on revenue and a slowing in the decline of values. In the Northeast, this period of time may have been affected as much by rainy weather as it was by the recession. Regardless of the cause, hotel revenues have been down, along with cash flow and net operating income. So the big question for hotel owners, buyers, and sellers is: "Will prices continue to drop?"

It is reasonable to predict that revenues in 2010 will be, at the very least, the same as 2009, and that the worst of the revenue decline is over. Therefore, it is also safe to assume that cap rates will be geared toward the cost of funds and the required yield on equity. In this market, yields may range from 15% to 20% or more. If this is the case, cap rates will likely range from 10% to 11% on 2009 numbers, with the chance that they may be slightly lower if there is a shift toward increasing revenues. A buyer who expects a 20% return on equity, a return that has historically been more in line with hotel operators based on risk, and who will be looking at a 6% interest rate, will require a cap rate of 11.4%, which is much higher than the cap rates of the past few years.

The Wrap Up: Buying Smart in a Tough Economy

It is clear that understanding hotel market values in the current hospitality real estate market is challenging, but not impossible. Working with a qualified hospitality real estate broker is a great way to streamline and safeguard the process. A qualified broker will understand the current market conditions and trends, helping the buyer make educated decisions based on that knowledge. Once the current market has been carefully assessed, it is in the best interest of the buyer to seek out a property that has redevelopment opportunities that make sense in today's economic climate. Having identified an appealing property, an informed broker will assist the buyer in carefully assessing the sale price and expediting an efficient and successful transaction. Finally, new and existing hotel owners are advised to stay abreast of current and future trends, and learn from past experiences of participants in the hospitality real estate industry to ensure the greatest success of their investment.

By following these tried and true steps, any buyer can achieve a successful hospitality real estate transaction.

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Wason has brokered more than 150 hospitality transactions over the past 15 years and has fostered excellent relationships within the Northeast hotel industry. Wason has devoted a significant portion of his career to the commercial real estate industry and has held the CCIM designation since 1985.

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