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We believe in the economic fundamentals and remain bullish on investment and management opportunities

January 27, 2010 - Spotlights

As the year came to an end, the entire hotel industry dreamed of better days ahead. Everyone asked themselves: could 2010 possibly be worse than 2009? In fact, according to PKF Hospitality Research (PKF-HR), in 2009, hotels suffered their worst decline in Net Operating Income (NOI) since the 1930s, a sickening 34.9%. What did PKF-HR recently forecast for 2010? Unfortunately for owners, operators and their lenders another 5.3% drop.

Driving NOI is the unprecedented drop in revenue per available room (RevPar) caused by decreased demand, lower average daily rooms rates (ADR) and an increase in room supply. In the December 2009 "Hotel Horizons Report" PKF-HR predicted the year-end 2009 results and the 2010 forecast:

Occupancy:

2009 -8.9%

2010 0.4%

ADR:

2009 -8.8%

2010 -1.5%

RevPar:

2009 -16.9%

2010 -1.1%

Supply:

2009 3.1%

2010 1.5%

Demand:

2009 -6.1%

2010 1.9%

Unit Level NOI:

2009 -34.9%

2010 -5.3%

Reviewing the numbers, there are positive signs including: modest increases in occupancy, ADR and RevPar combined with a decrease in supply (caused by the inability to finance new projects), an increase in room demand and an improvement to NOI. PKF-HR predicts a measurable year over year improvement by mid-2010.

Assuming the PKF-HR forecasts are correct, it will be too late for many owners/operators and their lenders. Unfortunately, for some, the end arrived this past fall. Current circumstances call for

investors to accept the harsh reality that the Net Present Value (NPV) of certain hotels no longer exceeds the outstanding debt. These difficult situations force loan defaults; this is a very real situation that is rapidly accelerating. Upon default, owners request loan modifications from their lenders. If a compromise is not reached, lenders eventually foreclose on loans. Although unfortunate, this particular cycle is simultaneously sparking renewed interest among both seasoned and first time hotel owners with the real estate expertise and equity to make timely opportunistic investments in hotels.

The financial fallout in the fall of 2008 coupled with the political backlash against corporate meetings and travel led to a dramatic fall in business travel that has not yet stabilized itself. Leisure travel showed signs of recovery in 2009, but the demand appeared artificially fueled by desperate hotel operators slashing rates to fill empty rooms. As a result, Smith Travel Research predicts a long, painful road to recover to 2007 industry highs. Jan Freitag of Smith Travel wrote in the December edition of *Loading Magazine*, "Because of the steep ADR discounts of around 9 percent (in 2009) it will take the industry about 10 years to get back to inflation-adjusted 2007 ADRs."

Hotel investments are similar to every real estate asset class. They are governed by inevitable, and fairly predictable cycles. The current downturn, although longer, deeper and more painful than others, will not last forever. Most experts agree that the leading indicators of improved hotel demand are GDP and employment growth. That being said, without significant improvement to those indicators, hotel cash flow and asset values will continue to deteriorate leaving current hotel owners with limited options.

Conversely, new investors will focus on "distressed" hotels: loans in default with a clear path toward asset control and under valued properties owned by highly motivated sellers. In these situations, investors will focus on improving cash flow over a four to six year period followed by the inevitable return of historically strong values fueled by traditional cap rates and the return of the debt markets. The hotels we own and operate as well as those we manage for third party owners and investors are budgeted to remain flat in 2010 with only a slight improvement starting in June of this year. As always, an increase in occupancy provides a leading indicator of better days ahead and we continue to look for positive signs. Fortunately, our investments are located in the eastern United State in markets with high barriers to entry. That being said, we feel fortunate that new hotel supply is neither currently under construction nor scheduled to open in 2010 or 2011.

Despite the negative numbers, we believe in the industry's economic fundamentals and remain bullish on additional hotel investment and management opportunities. Our advice heading into 2010: maintain positive, customer focused operating teams, be realistic and proactive with investors and stakeholders and take immediate action to resolve ownership and operational challenges.

David Roedel is a partner with the Roedel Companies, LLC, Wilton, NH.