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Reasonable growth expectations and conservative underwriting help New England hotel transactions

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Nothing to buy? No deals to be had? That doesn't seem to be true for New England hotel investors. The "new" Ritz Carlton is reportedly under a sales contract, the Marriott Hotel-Newton, Doubletree Guest Suites-Waltham the Sheraton Hotel-Braintree and the Doubletree Hotel-Lowell have all recently traded. The Sheraton Hotel over the Mass Turnpike changed tenants on a new space lease and converted to the Crown Plaza brand. None of these transactions were "bank owned". OHG expects to see other full service hotels come to market in the last half of 2010. What is different about these sales is that the acquisitions are based upon reasonable growth expectations and conservative underwriting standards. Gone are the ridiculous low risk assumptions and capitalization rates made in 2007 that caused hotels to be treated in the same asset class as core office and multi-family.

O'Connell Hospitality Group (OHG) and its hotel consulting company Collateral Strategies, Inc. have valued over $1.5 billion in hotel loans in the past 12 months. Besides the approximate 45% drop in values compared to 2008 levels, we have determined that in general, the value of hotels should approximate the present "Revenue Per Available Room" or "RevPAR" Index for the competitive set of hotels that it competes with. Meaning, if the RevPar is $100, then the hotel may not be profitable if the value goes above $100,000 per room. This is proven by the success of limited service hotels that are constructed for under $100,000 per room and the failure of large full service hotels with much higher costs basis', trapped in those same $100 per night markets.

Although a return to 2007 peak performance levels is not expected for a number of years, an OHG survey of local and regional hotel owners showed that business and leisure travel has begun to creep forward. Advanced bookings pace is on the rise and barring another travel related incident, the third and fourth quarter should show real progress for hotel owners.

It does not appear that the mass foreclosure of hotels anticipated for 2009 is going to materialize. It certainly won't happen in the northeast. Lenders are just now coming to grips with these realistic values and are unable/unwilling to take the 40% - 50% write down of these asset values. However, Buyers have begun to acknowledge that there may be very few deeply discounted transactions on quality hotels. They have come back to the bargaining table and are ready to complete transactions at more reasonable levels.

OHG also anticipates that the Lenders will divest much of the debt they have via the sale of debt, either in pools or single asset loan sales, rather than make the effort to take a property through the foreclosure. At the Mortgage Bankers Assn. annual meeting in February one of the largest servicers of real estate debt, Midland Loan Services stated that they had $28 billion of loans in default. Of that, they anticipated only 27 transactions post foreclosure. However, they anticipated recovering loan losses through the auction of debt.

In 2008 and 2009 the financial performance of most of the hotel industry went into a nose dive. This drop in performance placed many hotels in "technical default" of their mortgages. With cash flow off, debt coverage ratio's dropped below acceptable levels. It was anticipated that bond holders and their "servicer's" would take the hotel's back through foreclosure and then sell them off to investors waiting to acquire distressed assets at "pennies on the dollar". An action we experienced in the early 1990s.

The reason we have not witnessed a wave of these foreclosures is because the FDIC and SEC are not pressuring banks and bondholders as they did in the early 1990s. The "book value" of real estate loans has remained high because these institutions have not had to complete "mark to market" exercises. A move that would stress or collapse many banks both regionally and nationally. Also, lenders understand that moving to foreclosure is like pushing the value of these assets off a cliff. They lose any ability to maximize loan recovery. Servicers of CMBS are swamped with bad loans and the sheer volume has overwhelmed the system. Asset managers are inundated and can't keep up with the mountain of debt that is coming due and is valued far below the face value of the note. The hope, as all this drags on, is that the economy will improve, hotel cash flow will improve and values will come back.

There is a general belief that the investment market for hotels is dead and nothing is trading. Worse, that if hotel owners wish to sell, they will suffer deep pricing discounts. This may have been true in the third and fourth quarter of 2009, but it is not true any longer. Sellers that "take the plunge" have been pleasantly surprised. There are billions of dollars of equity on the sidelines and quality assets that are cash flowing are receiving attention from dozens of qualified buyers. It is an excellent time to test the market. In February there was a sale of a 7 year old, upscale, limited service property that received 29 offers and was sold for a 7.5% direct cap.

Hotel debt for acquisitions and even new construction of hotels is available and at decent rates for projects under $10 million. Life Insurance companies have begun lending on trophy and "Triple A" rated projects. Other lenders will follow their lead in 2011.

OHG believes that the 2010 summer and fall seasons will be fairly strong for hotel owners in seasonal areas. The leisure transient guests will be more willing to drive to Cape Cod, White Mountains and Vermont as well as the coast of Maine. Tour operators are booking rooms on par with 2009 levels albeit at a slightly lower room rate.

The news for hotel owners is that there actually is a light at the end of the tunnel and it's getting brighter every day. Buyers are well capitalized, have financing sources and are ready, willing and able.

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