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State of the hotel capital markets: Are hotels "hot" again?

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Memory seems short as investors are now chasing hotel deals in the top U.S. markets with the same enthusiasm and dare I say it "froth" we experienced four years ago. According to Real Capital Analytics, transaction volume for hotels is up considerably with $8.7 billion closed through 2Q 20011 versus $3.4 billion during the same period in 2010. Values of US hotels are increasing as capital buys into the recovery story and there is very little new construction in the pipeline. Yes, we are long way from the depths of the recession for hotels when U.S. Revenue Per Available Room (RevPAR) dropped by 16.5%, in 2009, the highest annual decline in decades. Fundamentals are well into recovery with RevPAR up 5.1% in 2010 and 8.5% year-to-date in 2011 with occupancy growth the leading trend and Average Daily Rate (ADR) growth still lagging in most markets as companies remain stingy on rate negotiation. Despite this positive momentum, the recovery is still very much piece meal with Boston, New York, San Francisco and Miami outpacing the national trend and Atlanta, Orlando, Phoenix and San Diego lagging the nation. Capital markets appear to be ahead of market performance as there is a mad dash to chase yield in real estate.

Investors today are struggling to achieve returns in the broader market. Yields are at historical lows whether in bonds or treasuries and gold is at an all-time high. Of course, this reflects broader macro concerns about the global economy, anemic job growth and the specter of a stagnating recovery or worse in the U.S. In the search for yield, investment interest in commercial real estate is near an all time high for the better assets in top markets. Institutional investors were battered in the last downturn, particularly those who were over-leveraged, but the capital markets have opened up in the past twelve months and real estate is back in the mix with bidders competing fiercely for core properties that can deliver steady, consistent returns. Cap rates for quality hotels in major markets are back to prior peak levels with markets like New York and San Francisco pricing below 6% on in-place Net Operating Income (NOI). Many core investors and funds are now considering hotel investments and the public markets opened up with the successful raise of several public hotel REITs in the past twelve months. IRR targets for core and REIT buyers are 10% or lower, considerably less than ten years ago. REITs in particular are driving pricing higher in the top ten markets as there is a perceived window to raise and deploy capital.

Why so much interest in hotels? Hotels are traditionally the most volatile real estate asset class and present an attractive story of recovery for investors. In comparison, other sectors are less compelling. The office recovery is less robust in most markets with continued high vacancies and very little rent growth. There are exceptions to this, New York, Silicon Valley, where isolated employment growth and anticipated future potential in fundamentals is driving values significantly. Retail presents a similar picture of haves and have-nots with well located, necessity retail still valued at a premium and many life-style, big box centers under stress as unemployment remains high and consumer confidence low. Multi family remains the hottest real estate asset class but the competition for product and availability of debt has driven going-in yields to below 5%. Investors recognize the opportunity for higher yields in hotels and are having difficulty achieving returns in other asset classes.

On the surface, the level of capital markets interest feels like 2007 again but there are some distinct differences. As with the marco economy, the level of fundamental improvement in real estate varies greatly from market to market with clear leaders and laggards. The most active capital is focused almost exclusively on hotels in the top 10 markets on the west and east coasts driving pricing back to historical highs. The capital "stack" of a hotel acquisition is quite different than 2007 with most lenders still cautious on underwriting hotel loans. Commercial banks, life companies, European banks, debt funds and CMBS shops are the most active, but they are still conservative on sizing hotel loans requiring an 10% to 12% debt yield on NOI in place for debt service coverage. For cash flowing assets that meet this requirement, lenders are aggressive on rates which are being quoted at below 5%. Borrowing on hotel deals that have minimal cash flow and need significant renovation capital is much more challenging. Traditional lenders will only look at these assets with very low leverage and at higher rates. Debt funds are often the only financing source available and their cost of capital to the borrower can range from 8% to as high as 12%. Finally, very little debt is available for new construction with the one exception being New York for the right project. This will continue to serve as a governor on new supply for at least the next 12 to 18 months.

Our outlook for the hotel market remains positive with RevPAR growth expected to be 6.5% in 2011 as most markets continue to gain occupancy from the 2007 trough. However, our marco view on the U.S. economy remains very uncertain. The national debt burden, weak employment numbers and GDP growth point towards an elongated period of very slow growth with a higher probability of a potential "double dip". The pace of the hotel recovery is likely to slow and "real" average rate growth in excess of CPI growth will be achievable in only select markets. The silver lining is that hotel supply will remain in check as construction debt remains constrained and there will be running room for inncreased RevPAR growth as trends in employment and GDP shift in a more positive direction. So be prudent in your hotel investing, focus on market durability, assets in markets with liquidity and potential upside in the next stage of this cycle.

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Over the course of his tenure at AEW, Luchars has been involved in over $2.5 billion in hotel and commercial real estate transactions in the United States and Europe. Luchars has over 17 years of real estate experience and six years of years of hotel operations experience. Prior to joining AEW Capital Management in 1996, he served as a senior consultant with the Ernst & Young Kenneth Leventhal Real Estate Group in New York City. He has also held various management positions within the hospitality industry. Luchars is a graduate of Connecticut College (B.S.) and Cornell University (M.P.S. in Hotel Management and Business).