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Well located hotels with strong brand affiliation are proving well-timed investments for buyers

May 22, 2012 - Spotlights

U.S. lodging investment fundamentals are solid, with most in agreement that the hotel sector is far down the path of recovery, fueled by continued demand growth and limited additions to supply anticipated over the next two to three years. Demand growth, which started in the second half of 2010 and continued to gain momentum through 2011, outpaced industry forecasts and effectively teed up the industry for strong RevPAR growth and projected NOI recovery for 2012 through 2015. Favorable operating conditions and continued signs of economic recovery, albeit modest, resulted in a notable surge in transaction activity in 2010. In 2011, transactions increased to the highest level in the past four years, with annual volume of nearly $16 billion (a 30% increase over 2010), signaling to the market that investors are once again migrating to the attractive cash-on-cash returns of the lodging sector. Yet, despite this momentum, opportunities to acquire assets at favorable prices and desired returns are not easy to come by in this market, leaving many private equity investors on the sidelines scratching their heads while hunting for deals. The reason - the market is more stratified today than ever. Opportunities vary considerably by deal profile and funding source, effectively limiting the universe of buyers and lenders.

For example, the recent transaction market in 2011 was largely dominated by well-capitalized REITs, acquiring stable, quality assets in major markets. These hotels offered lower returns, yet met the public investment targets of the REITS. By comparison, private equity requires higher rates of return through repositioning and performance upside. While some of these deals are out there, they are limited and require shrewd buyers with a proven strategy to identify the winners from the losers.

So where are the opportunities right now for private investment? While we believe the full-service market will come back over the next 6 to 12 months, particularly with more than $20 billion of hotel CMBS debt maturing this year, for the time being pricing has effectively stalled activity within this segment. The select-service product tier, however, is one that has experienced a recent surge in activity for acquisition in primary and secondary markets, particularly owner/operator deals where existing owners are getting pressured by the brands to reinvest significant capital to meet new brand standards. Instead, many are electing to sell. While these deals can be favorably priced, investors need to be prepared to underwrite and fund substantial PIPs (Property Improvement Plans) and lenders are requiring a forensic accounting effort to analyze financial reports maintained by these self-operated entities, the majority of which are not maintained in the uniform system of accounts. Well located hotels with a strong brand affiliation and life left on the franchise agreement are proving to be well-timed investments given pricing and the opportunity to ride this recovery. However, buying smart requires knowledge and an ability to look deep into the operation to fully vet the risks (capital and operational) and opportunities (revenue management, labor, etc.) to develop the business case and support required returns. Likewise, investors need a proven platform for taking over and transitioning assets, while implementing the strategy that supports the investment. Financing for this sector, while viewed as higher-risk on a global basis, has proven most effective at the regional and local level, working with lenders who understand the business, the markets, the quality of the sponsor and their ability to develop and execute on the business plan. These smaller deals appear riskier upfront, but with a sound underwriting strategy, professional management and active investment oversight, they can produce returns in line with current private equity requirements.

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