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## The glass is still half full for investment in the hotel industry

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In August of 2011, we questioned are hotels "hot" again and over the past sixteen months the resounding answer has been yes! According to Real Capital Analytics, transaction volume for hotel sales in 2011 was over \$20 billion in comparison to \$3 billion in the depth of the recession in 2009. The pace for 2012 points towards a year end transaction volume in the \$17 to \$18 billion range, an indication of continued demand for product and liquidity for hotels. There have been limited, attractive options for institutional real estate investors as they scramble to chase yield in multi-family and core retail properties and office opportunities continue to be a challenge to underwrite with high vacancies in many markets. Many portfolio managers have been attracted to potential higher yields in hotels and the compelling story of improving fundamentals. Rebounding from the worst single year downturn on record where hotel Revenue per Available Room (RevPAR) dropped 16.5%, the recovery has been strong with RevPAR increases of 5.5% in 2010, 8.2% in 2011 and 6.9% through October year-to-date 2012 versus prior year. Most forecasts point towards RevPAR growth of around 5% in 2013, reflecting a continued positive trend and a shifting stage in the cycle. The question for many investors today is whether it is too late to invest in hotels and is the glass "half empty" or "half full" for the next two to four year outlook?

Both optimists and skeptics are concerned about the resolution (or lack thereof) of the Fiscal Cliff crisis and, under worst case scenario, what the impact might be on the economy and hotel room night demand with the prospect of broad cost cutting measures on the horizon. This is an uncertainty that has many experts cautious about growth in 2013, particularly when coupled with a deep European recession and slowing growth in Asia. These considerations lead many to point towards a glass "half empty" outlook where hotel occupancy stays relatively flat and hotel operators will be challenged to push room rates with weakening overseas demand and the impact of budget cuts and government per diem business. These concerns warrant consideration but I am an advocate of the glass "half full" thesis as I believe we are set up for continued strong performance in hotel fundamentals.

There are several drivers of this optimism which merit explanation:

\* The resilience of the U.S. economy - The strength of the high-tech, energy and auto sectors in the U.S. economy has contributed to a moderate but steady trend in job growth, real GDP growth and increasing consumer confidence. The pace of recovery has been slower than expected but we are still headed in the right direction and, according to Moody's, many markets including New York, Dallas, Houston, Los Angeles and San Francisco are expected to have significant job creation in 2013. In addition, there are signs that the housing market recovery is beginning to accelerate and this alone could fuel higher than expected GDP growth which usually correlates to growth in hotel RevPAR and Average Rate (ADR).

\* Demand growth continues to outpace supply growth - Hotel supply growth has been limited since

the downturn and this trend is likely to continue for the near term. According to PKF, hotel room supply is forecasted to grow 0.5% in 2012 and 0.8% in 2013. Historically, these are very low numbers and it is usually a positive indicator when demand growth (forecasted at 3% in 2012 and 1.8% in 2013) exceeds supply. If the housing market recovers and GDP growth picks up then the pace of supply and new construction will accelerate; however, in the current moderate growth cycle, supply appears to be in check for the next two to three years.

\* Cautious lending environment for new construction - while the market for hotel financing has vastly improved from the depths of the downturn, lenders are still being conservative in terms of how they size loans for hotels. Banks, life companies and CMBS shops are all lending again but they want a reliable stream of cash flow and most lenders are limiting financings to 60% of value at albeit very low, historical interest rates. This cautious approach on lending is magnified for any new hotel construction project equating to an important supply constraint that will continue to exist in most markets and will extend the expansion phase of this cycle.

\* Global demand increasing - Despite the recession in Europe and slowing growth in Asia, global demand for hotel rooms continues to increase in the gateway markets of the United States including Boston. Growth in India, South America, Russia and Mexico is contributing to this positive trend.

In my opinion, the above factors outweigh concerns over Europe and that of the Fiscal Cliff. I am optimistic about the near term for hotels and there will be some important factors to consider when evaluating new investments including what is the right market and product to invest in? As in other commercial real estate, the fundamentals point towards specific "leader" and "laggard" markets. Like New York, Miami and San Francisco, Boston is a clear "leader" market that peaks cycle to cycle and has high barriers to entry and limited new supply.

Other markets to consider investing in this stage of the cycle include Phoenix which may finally benefit from a housing recovery, Denver which is benefitting from quality of life desirability and above average job growth, and Seattle which is similar to Boston with high barriers to entry and a diverse demand base for hotels.

Throughout the US, the hotel product that is garnering more interest from investors is urban select-service properties (e.g. Courtyard by Marriott, Residence Inn, Hilton Garden Inn) that offer a comparable room product and in many cases a better guest experience than older full-service hotels. These properties will continue to be the hottest investment segment in the hotel market as investors recognize this positive trend.

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Luchars has over 25 years of experience in the hotel business and commercial real estate.