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Hello! Where is the sky falling? Despite the credit crunch, hotel investments remain solid

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Boston: HELLO! Could someone in the hotel business tell me exactly WHERE IS THE SKY FALLING? C'mon people! The clouds have thickened but please come in off the ledge! Those predicting a collapse in the hotel investment markets just aren't focused on the numbers because the numbers just don't show a collapse.

There are several differences between the present and the last downturn the industry suffered, namely the post 9/11 disaster through the first half of 2003. New hotel room supply and a drop in corporate and leisure hotel room demand caused the industry to drastically cut room rates. This coincided with the proliferation of website portals such as Hotels.com and Priceline.com where hotel owners gave up control of their rate structure by dumping excess room inventory into the laps of wholesalers and discounters. None of these issues appear to be in play this time around. The credit markets are in chaos, but for hotel owners, that might be a good thing.

Historically, just about the time the bulge of new room supply begins to hit the market, the national economy begins to slow down. In this particular phase of the real estate cycle, new room supply does not appear to be a large negative factor. Huge construction cost increases during 2006 and 2007 slowed down the new construction of hotels. The tight lending markets have caused developers to push out their start dates even more or postponed them all together. This has allowed existing hotels to profit throughout the cycle. It is expected that these existing hotels will hold their value better, without the scepter of new supply hanging over the market like a dark cloud. According to Smith Travel Research, the new supply of hotels in 2008-09 is projected to increase by 2.0% - 2.5%. Those same +/-2.5% increases are projected for 2010 and 2011.

The experts like Randy Smith of Smith Travel Research and Mark Woodworth of PKF point out that demand for hotel rooms has been slowing, however the rates hotels charge for rooms has continued to increase. They expect "short term softness", not a collapse. Smith Travel Research and PKF conducted a presentation in March that stated that the hotel industry was "going to be down a bit, but not that bad." Across the country, occupancy was down approximately 1.7%, but average daily room rates would be UP, 5.0%, continuing a positive trend for RevPar growth that has lasted for over 4 years.

Corporate demand for hotel rooms remains strong. If we do go into a recession, it is expected to be a "consumer led" recession. However, the weak dollar across the world actually makes leisure travel to the United States a bargain. Canadians are flocking across the borders. The Canadians will help make it a great summer for hotel owners in New Hampshire, Maine and Cape Cod. Now if we could just get them to tip the bartenders and waitresses! Gas prices and increased domestic airfares will make "drive to" resort areas preferred vacation options for Americans as well.

In 1999 to 2002, there was a dramatic shift of how hotel rooms were sold over the internet.

Hotels.com, priceline.com and other portals acquired huge inventories of supposedly "excess" hotel inventory. The hotel companies soon learned that these discount prices eroded their capabilities to manage revenues. Marriott, Hilton, Intercontinental and others raced to regain control of their product and by 2004 the brands cracked down on the use of these portals and many hotels took the proactive step of hiring "revenue managers" that monitored their room rates and occupancies daily.

Buyer's investment return requirements haven't changed. They continue to require leveraged returns in the mid-teens. Unfortunately, there will be a resetting of prices for hotel investments. It is going on right now and will continue through 2008. It costs more in equity and fees to acquire a hotel. Since lenders can't layoff the risk to bondholders they look back to the owners for comfort. Loans are being underwritten the old fashioned way. There has to be a decent amount of equity into the deal (typically 30%) and some guarantees. No more free rides (until the next brilliant scheme comes along). Interest rates will remain low, but Debt Service Coverage ratios and Loan to Value percentages have been squeezed higher.

We expect to see Capitalization Rates increase about 100 basis points. As an example, if an upscale suburban hotel had an EBITDA of $2 million, the value at an 8% direct cap was approximately $25 million. At a 9% direct cap rate, the value of that cash flow is now $22.2 million or roughly a 12% drop in value.

Sobering, yes. Catastrophic, no. We don't expect to see any "steal of a deal" scenarios this time. We do see some very good investment opportunities with strong fundamental foundations getting done throughout the rest of 2008. So, you can tell Chicken Little that the sky might be falling, but if it does, it should only drop a few inches!