

The Realities of Hotel Real Estate

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No matter what lenders say, most hotel real estate professionals believe there's very little money currently available for hotel transactions. "Banks are moving through the process a little more, but they're not yet ready to provide any debt on any project, no matter how worthy it may be," said Steve Marx, president of Hotel Source, during a recent roundtable discussion at Michigan State University.

Marx and a dozen other alumni of [The School of Hospitality Business at MSU](#) are members of the school's Real Estate & Development Advisory Board. During a two-day board meeting in late March, the group heard an update on the school's [Real Estate & Development Specialization](#) and results of the most recent L-MPI study of hotel markets. They also participated in a *Lodging Hospitality*-led roundtable discussion of hotel real estate issues.

Several panelists believe financing is beginning to loosen, particularly in the limited-service arena. As Nate Sahn noted, financing is available at the lower end of the business from some regional banks and through the SBA loan program. According to Sahn, a first vice president with CB Richard Ellis Hotels, the SBA 7(a) loan program for packages under \$2 million is especially vibrant.

"The SBA 504 program isn't as active in our markets because it requires a local bank piece on top of the SBA loan, and that secondary market just isn't there," he said. "However, the SBA has scaled back the fees it charges, and that has helped a lot."

Where money is available, loan terms vary from friendly to difficult, said the panelists. Sahn cited an off-market transaction he's working on for a non-performing, three-year-old limited service hotel. Sahn found a buyer who owns 10 hotels in the same brand family and was able to get a loan at 3.5-percent interest. But in a change from several years ago, the loan stipulates recourse.

Improvements Ahead

Despite the apparent freeze on financing, the panel showed optimism for the near-term future of the hotel industry.

"A lot of people got discouraged because they expected business to pick up in the fourth quarter (of 2009), but it didn't happen, and many of us budgeted downwards for this year," said Patrick McMonigle, vice president of the RockBridge Capital asset management and servicing group. "But we're seeing business pick up in our properties, which are mostly three- and four-star Hiltons and Marriotts and the like. But unfortunately while demand is recovering, rates are still depressed, and for me that's a big issue."

For some, the prospects for improvement are less tangible. Tom Ives, senior vice president of CB Richard Ellis Hotels, believes recovery involves emotions as much as it does numbers. "We're at

the bottom of the cycle and perhaps on the way back up a little,” he said, “but our emotions are lagging of what is happening quantitatively in the marketplace.”

The executives recognize that occupancy must improve before rates can rebound, but it may take time. Sahn of CB Richard Ellis says consistent job growth in the overall economy is needed to spur corporations and groups to travel more. “When that happens, it will trickle down to consumers and the leisure end of the business,” he said.

As Jason Rabidoux of The Hotel Group pointed out, when the hotel industry recovered from previous down cycles, it had to endure six-month lags between the rise in occupancy and corresponding increases in rates.

“There’s a hurdle of 60-percent occupancy we’ve got to clear before we can get some upward pressure on rates,” he said. “We’re starting to see some positive signs, but if we’re talking innings, I’m not quite sure we’re out of the first inning yet.”

Ryan Meliker, a vice president of Morgan Stanley, is less optimistic for the short-term. As he pointed out, the industry ended 2009 with a 55-percent occupancy, “but to get to 61 percent requires a 14-percent growth in demand.

“If we assume two-percent supply growth this year and one-percent in 2011, we need 10-percent real growth in GDP between 2009 and 2011 to get occupancies to a level where we can begin to raise rates.”

He’s more sanguine about the upper segments of the hotel industry. “There’s going to be a bifurcation in the market between the higher and lower ends,” he said. “Properties in the upscale and luxury segments have softer comps, they’ve been discounting to generate demand, and once occupancies rise they’ll be able to push rates.”

Lender Foot-Dragging

The panelist pondered why more lenders haven’t taken action against borrowers who’ve fallen behind in payments or have violated loan covenants.

“Everyone has been extending and pretending for a while, but the lenders are getting to a point at which they must make a decision soon on what to do,” said Richard Niedbala, senior vice president of the Plasencia Group. “One issue for the lenders is PIPs (product improvement plans). A lot of properties were built or acquired between 2004 and 2006, and they’re now four to six years old. We’ve seen a lot of high-priced PIPs come through that have befuddled lenders. And the brands are starting to push a little harder because they’ve relented for awhile.”

Steve Johnson, vice president of Driftwood Hospitality, added that lenders would rather sell a note on a distressed property than take title. “Then the next buyer would either have to deal with the PIP or change the brand,” he said. “The only deals we’ve seen where lenders have taken title are when the hotel can’t make payroll anymore. If a lender is putting money in to keep the property running, they’re going to assume title or at least install a receiver to operate it.”

On a more fundamental basis, Meliker pointed out lenders have little incentive to foreclose or sell on any assets with values lower than the notes the lenders hold. “While we’ve seen about a 40-percent drop in overall commercial real estate values since the peak of the market, there has been a little bit of recovery recently,” he said. “Once the value of assets reaches the value of notes lenders are carrying, they’ll be more willing to foreclose or sell. When that happens, you’re going to see a lot of opportunities for buyers.”

Transaction Action

The key question for many of the panelists is when hotel transactions will resume at meaningful levels. All agreed we’ve probably seen the bottom of the transactions market and that sale volume will pick up this year and next. Adam McGaughy, executive vice president of Jones Lang LaSalle Hotels, believes about \$3 billion in \$10-million-and-up transactions will occur this year, up from \$1.8 billion last year but still well off the peak of \$40-plus billion in 2007.

“We’re hopeful (transaction activity will pick up), but what’s still missing is the debt market, which is the biggest difference between now and how we emerged from the last down cycle in 2002,” said McGaughy. “However, while we don’t have a debt market, there are quite a few equity funds out there sitting on a lot of cash. That may spur competition in the marketplace, particularly for quality products.”

Publicly traded REITS, in particular, said Morgan Stanley’s Meliker, may soon become even more active in hotel acquisitions. “They’re poised to take huge advantage of these buying opportunities because they have the cost-of-capital benefit of raising public money and they have a tax benefit a lot of private equity investors don’t enjoy,” he said.

As McGaughy and others remarked, the level of transaction activity will rise as RevPAR improves. Once RevPARs increase, buyers can underwrite deals based on positive returns, unlike the last couple of years when they struggled to price deals based on significant declines in revenues and values.

Despite these positive signs, uncertainty remains among many hotel real estate professionals. As Marx of Hotel Source said, more deal will be done in 2010 than last year, “but because of the lead time in marketing hotels for sale, many deals will close until at least 2011.”