

Happier Hotels Ahead

HOTEL FUNDAMENTALS are improving as panic and capitulation give way to a slow-growth environment. Yet, the global response to the economic crisis threatens to yield to sovereign risk in Greece and Spain and undermine a gradual, nascent recovery. These were the major messages at the Jeffer Mangels Butler & Marmaro conference Meet the Money: Unlocking the Game Changers for the Coming Recovery, held in early May in Los Angeles.

The conference, in its 20th year, brings together hospitality experts, advisers, operators, developers, and investors to assess the state of the lodging industry and its outlook for the future. Especially compared with last year, this year's gathering provided positive outlooks and reasons to believe the light at the end of the tunnel is growing brighter.

Hotels are different than other real estate assets in that they are operating businesses. With the inclusion of public lodging real estate investment trusts and the brand-versus-boutique dialogue, the sector has many moving parts all dependent on one another.

Hotel fundamentals have shown marked improvement over the past 30 to 90 days, said conference chair Jim Butler, chairman of the Jeffer Mangels Butler & Marmaro Global Hospitality Group in Los Angeles and author of the Hotel Law Blog. Financing once again is being based on the property's current cash flow and set at current underwriting standards, transactions are on the uptick, lenders and borrowers are beginning to address troubled loans and assets, and some commercial mortgage-backed securities transactions are taking place. And while he believes there are a lot of speed bumps on the road ahead, Butler says the industry is operating in a different and better environment than it was last year, and real improvement will come in 2011.

Across the industry, slight increases in revenue per available room (RevPAR), as well as the fact that first-quarter 2010 room demand is rising at its fastest rate since 1989, reveal growing transient demand despite sizable decreases in group demand, reported Greg Hartmann, managing director of STR Analytics in Boulder, Colorado. Whereas properties along interstates and in small metropolitan areas are lagging, suburban,

airport, and resort hotels are seeing moderate growth and urban locations have strong growth. This is especially true in the upscale and luxury sectors and, geographically, in the Northeast, with New York City and Boston leading in demand and RevPAR growth. In the end, Hartmann believes performance metrics are improving, or at least declining less, and demand is back, eliminating or reducing the need for discounting and resulting in pricing that is higher or at least not as low as in past recessions.

While Mark Woodworth, president of PKF Hospitality Research in Atlanta, believes unemployment will peak in the fourth quarter of this year and job levels not return to their past peak until the end of 2012, he also thinks the turning point has been reached. Among his observations are:

- ▷ Capital-market turmoil and depressed market values will keep hotel development at a standstill.
- ▷ There are signs that recovery might have begun to accelerate, but a buyer's market is still likely to persist into 2011.
- ▷ There will be profit growth in 2011, and it will stay well above average through 2014.
- ▷ Lack of liquidity and an absence of income growth caused the cyclical peak of cap rates last year.
- ▷ Cap rate compression is coming because of increasing profits and reduced risk premiums.
- ▷ Significant asset appreciation will begin next year and continue through 2014 as cap rates fall further in response to stabilizing incomes.

The shakeup of the past several years has changed the nature of stakeholders in the world of hospitality, affecting the range of responses and strategies from those of the recession in the early 1990s. On the investor side, Jonathan Roth, principal of Canyon Capital in Los Angeles, recognizes the changing face of debt and equity structures. In the 1990s, everyone in the capital stack was equal, with interests aligned and generally paid out on equal footing, he said. Today, however, real estate deals are structured in such a way that the financial players at the table are often competing with one another. The result is a lack of alignment of interests and an inability of most stakeholders to delay reconciliation processes if they are not satisfied with the outcome.

The current realities of complex capital stacks and competitive parties under the guise of cooperation trickle down to the hotel experience. Benoit Gateau-Cumin, president of the Los Angeles-based Boutique Search Firm, recognizes the changing face of hotel management. Before the 1990s, he noted, hotels were run by hoteliers who worked their way up the ranks within the organization. Now, they are run by finance and marketing generalists, treating hotels like widgets and ignoring opportunities to gain competitive advantage through truly hospitality-focused management. This has negative ramifications on hotel performance because the guest experience should be the primary driver of business, he said.

As is the case in most other industries, strategies for sales and marketing of hotel rooms are shifting to internet-based initiatives. With the internet allowing more detailed analysis of who is choosing what and when in the way of hotels, owners and operators are learning that consumers in general are researching hotels and using internet ratings rather than responding to direct hotel advertising.

Despite being quick to cut costs and control expenses in response to the downturn, brands are recognizing the importance of e-commerce and are devoting more of a substantial budget to website upgrades. Abid Gilani, senior vice president of mortgage banking at Marriott International, noted that Marriott.com is the number-seven e-commerce site on the internet across all industries. Forty percent of all online sales are related to travel, pointed out Bill Linehan, chief marketing officer of Denver-based Richfield Hospitality. This shift to the internet is fundamentally changing the nature of hospitality marketing.

Last year California, a potential bellwether for the national hospitality industry, saw several landmarks signaling the decline of the industry, and this year likely will bring some fundamental changes. In 2009, the state set records for annual decline in RevPAR, number of hotels for sale, and increase in the number of distressed hotels, as well as a low in number of completed sales, reported Alan Reay, president of Atlas Hospitality Group in Irvine, California.

But this year, "extend and pretend," which is not working for lenders, will falter, Reay

predicts. Sales volume will be up 50 to 70 percent, he said—still not constituting a wave of transactions because sales hit an all-time low last year. There will be a flight to high quality, with class B and C hotel markets continuing to face downward pressure. And, with the easing of extend-and-pretend strategies, lender and distressed deals will dominate the transactional market, he said.

Nationally, tremendous amounts of capital are amassed on the sidelines waiting for the opportune time for investment in real estate, including hospitality opportunities. Debt markets have reconstituted themselves, noted Patrick Deming, managing director of Santa Monica, California-based Eastdil Secured, providing additional opportunities for refinancing of viable strategies that can be executed. Cash flow is still the fundamental basis for underwriting, however, leaving hotel brands in the major markets in the driver's seat.

Nonetheless, at some point investors have to start taking chances, with or without brands on board, noted Tom Kennedy, chief operating officer and chief financial officer of New York City-based UrbanAmerica LP, a real estate investment advisory firm. However, it is proving difficult for those investors to commit to being the first out of the gate. Kennedy believes that as the industry looks forward to the end of this drawn-out slowdown, some transactions will take place in the fourth quarter of this year, but that significantly higher volume will start in the first quarter of 2011.

The industry is still walking on eggshells, said Ed Balazs, managing director of New York City-based Eurohypo AG. Not only is the hospitality sector heavily affected by economic gyrations and uncertainty, but also its fragility is amplified by pending government financial regulation bills, controversies such as investigations into Goldman Sachs, and the European fiscal crisis, among other external forces. Regardless of how these and other issues are resolved, future changes are assured in the realm of hospitality development and investment.

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