

If economy is recovering, why aren't more hotels selling?

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The concept of hotel profit is as simple as it can get for a property. It is not a series of complex algorithms multiplied over years and marshaled by tax codes. One person stays one night and it equals revenue. This simplicity has made hotels a sought-after investment in good times, but also a bellwether for the waves of economic health.

So if the economy is recovering, why aren't there more hotels selling? "I feel closer to the Big Bang, but I don't feel any heat yet," Prism Hotels' president and chief executive officer, Steve Van, says. This is because owners and borrowers alike are hoping that growing RevPAR will turn their properties around.

"We're not buying anything because properties are overpriced," Van explains. This is not a contrarian point of view, particularly for private investors. "Last year saw 4% RevPAR growth, which sounds okay until you realize that at 4%, we won't be back to '07 levels until 2016."

While growth is good, optimism can only get you so far. "Even though things are getting better, they're not getting better fast enough," he adds. "Not everybody can hold their breath until 2016."

The RevPAR growth, while a long-term positive, has caused some short-term consequences. Some owners who may have been inclined to sell or default on their property are now emboldened by the positive numbers, hoping to recoup some of their losses if they hang on for a little bit longer. And perhaps demand a higher price.

Ken Wilson, president and CEO of Capital Hotel Management, notes that the drop in value was roughly 30%, so that even 12% growth looks all right on paper for a seller. But many buyers are not convinced they can make value back.

REITs are not helping the matter. They have been active buyers, whereas a lot of private equity is either sitting cool on the sidelines or have been squeezed out. Robert W. Baird & Co. analyst David Loeb explains that REITs "have access to capital and a cost-of-capital advantage over private buyers." Consequently, REITs can take properties at a lower cap rate and snag hotels at prices that make private investors leery.

"REITs have been very aggressive in terms of making acquisitions where, when we look at their price, scratch our heads and say, 'What are they seeing in an acquisition at that price?'" says Glenmont Capital's managing partner, Lawrence Kestin.

Cheap access to capital allows REITs to indulge in a lower cap rate for their purchases, but there's more to it than that. "The returns are a bit lower," Loeb points out. "A private equity player might need more equity to get to the 20% long-term return. A REIT might also want a double-digit return, but its shareholders will be happy at 12%." Not to mention they can come into a deal with less debt, he notes, or find debt later so they can close quicker.

But REITs aren't completely squeezing out private equity, since most of the trusts are focused on the major markets: Boston; New York City; Los Angeles; San Francisco; and Washington, DC. And more so, they're looking at CBDs and stable properties, not a lot of the high-yield opportunities that many private investors are

hunting.

“I don’t know if REITs are driving prices higher, but they’re stalling prices in a lot of markets to a place where there’s going to be a lot of buyers,” says Wilson. His partner, Roger Clark, explains the halo effect of the REIT buys: “Everyone perceives that they’re underneath the halo, but that’s the bifurcation. There’s the REIT market, there’s us and there’s everyone else.” A struggling hotel in Iowa City doesn’t quite command the value of a Copley Hotel in Boston.

Wilson notes that this symptom stalled some of their deals at the end of the year, which they anticipate closing this quarter. “I feel like we climbed up the oiled pole at the beach,” he jokes. “We were all the way at the top, but we just couldn’t get the flag. But, we’re still on the pole.”

That puts a lot of the opportunity to buy and sell in secondary and tertiary markets such as Houston and Atlanta, for example. Loeb notes that oddly, Minneapolis has seen a lot of activity, as well as Philadelphia, but a few question marks remain in harder-rebounding cities. Phoenix and Las Vegas still have too much product and will for a while. “Orlando’s another market that REITs have not been active in,” Loeb says. “There’s just been so much supply over the past few years. But there are a lot of sellers willing to sell, so we’ll see who’s willing to buy.”

A couple of large sales happened in Universal City, CA and Alexandria, VA, when China’s Shenzhen New World Group Co. purchased the 451-room Sheraton Universal for a reported \$90 million and the 496-room Hilton Alexandria Mark Center sold for \$121 million to Crow Holdings through one of their real estate funds.

But much of the activity may not be as grand. “Especially in the smaller bite-sized distress acquisitions of less than \$10 million, deal volume is much lower than anyone would have liked, but it used to be nonexistent,” Kestin says. With RevPAR trending in the right direction, he notes, a narrowing of the bid-ask gap is anticipated as sellers and buyers get more comfortable with pricing.

Despite the late 2010 setbacks, there is optimism about the coming year. Van breaks it down to two transaction generators in 2011: “There are \$27 billion worth of loans that were made in 2007. Those that had five-year terms are coming due now.” And as we all know, there is not a lot of money going around to refinance all of these loans, many of which are non-recourse.

At the very least, borrowers that are underwater may be galled to pony up more cash to keep afloat a hotel with a low or negative LTV. “The banks and other lenders are still pretending there’s a Santa Claus, but not CMBS,” he says. The governmental rules and service agreements will make it too hard to pretend and extend, and the wave may finally arrive.

Loeb concurs, but notes that not every property will default. There are a few good extensions out there—the Hotel del Coronado in San Diego, for example. “That has excellent coverage because the interest rate is so low,” he explains. “It’s Libor based, plus a pretty small spread, and it’s CMBS.” He sees a maturity extension for this kind of property to be wise for the special servicer, since despite its low LTV, the value is growing relative to improving fundamentals.

But some hotel owners are going to run into a different problem. “Everyone’s gotten a hall pass for years from Marriot, Hilton and Starwood on product improvement plans and remodeling their properties,” Van says.

Word is that many of them are going to discontinue this courtesy and give properties mandates to meet standards or lose their brand. “They’re not going to let their brand deteriorate,” he explains. This could mean more defaults or property sales over the next year, as some owners will not be able to afford the revamps with a low RevPAR.

We heard all of this before, in 2008 about 2009, and again in 2009 about 2010. As Van points out, “If we’d had this talk last year, I would have said that same thing and it would have been wrong. I’m not Saint Jerome.”

So why should we believe it this time?

Regional banks are still in a lot of trouble. “There is an appetite for debt investment, but there is no appetite for development capital, and frankly, the less development there is, the better the fundamental outlook will be,” Loeb points out. “That will motivate investors and lenders to lend for existing product.”

Traditionally, development capital comes from regional banks, which are under incredible scrutiny from regulators. There remain issues with balance sheets, loan quality and debt. This will ostensibly stifle development indefinitely, which is good for everyone aiming for value. But when will the 2011 explosion happen?