Hotel Owners Need To Constantly Evaluate Their Options

For those of us who have been around awhile in the hospitality industry, you learn that good times never stay good and bad times never stay bad, hence, market cycles. Right now, times are good. Occupancy and rate are increasing in virtually every market. Cap rates are down, and more than $40 billion of both debt and equity capital is available to the hotel sector.

How long will it last? No one knows for sure, but as oil prices soar, interest rates rise, labor issues loom and inflation continues to inch up, one thing is for sure: there will be a market correction and the only question is when. Hence, a savvy hotel owner should consider his or her options. The following are a few.

• **Sell Or Refinance.** The capitalization rate trend over a period of time shows that cap rates for all types of hotels have declined, on average, 20% during the past five years. The availability of quality assets, value-add plays and good hotel real estate in general has declined in 2006. Those who had assets to sell, have sold them, hence, the market is stretching, looking for yield where it would not have looked just 24 months ago and looking at limited-service hotels, development deals, you name it.

In fact, the new rally cry seems to be: "have return, will buy." That said, one could take advantage of the "froth" in the market and sell at a premium. Not sure what to do with all that money? Don't want to pay taxes right now? Consider refinancing your assets. Yes, interest rates have gone up, but the spreads on rates have come down.

Additionally, lenders are getting more aggressive on loan-to-value ratios, which are up to 75% of appraised value. Mezzanine

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lenders are willing to go up to 85% of LTV and some are up to 90%. Cost of mezzanine has also come down, with market for mezzanine currently in the 12% to 14% range and fixed with interest only. That is cheaper in the long run than equity, although selling off a portion of your ownership position or, in other words, structuring a joint venture, also has benefits. A jv allows you to free up cash, retain an ownership position in order to ride the upside and, in many cases, retain management. An added benefit of a jv structure is that many investors bring below market debt to the table, which provides lower cost of capital to the new partnership.

• **Build.** Replacement cost for hotels continues to skyrocket, as the cost of steel, concrete, labor and other materials and services continues to climb because of soaring demand from Asia as well as the reconstruction of the Gulf Coast. A national building boom in speculative residential development also has forced up the cost of goods and land.

Build now? Only if you have a great site with the right product, such as one of the select-service products from Marriott International, Hilton Hotels Corp. or Starwood Hotels & Resorts Worldwide, Inc. It will be hard to get a new-build full-service hotel to pencil out without a mixed-use flavor, such as residential, retail or another component. However, you wouldn't want to be coming online with a new product when the bubble bursts on the speculative residential market or when the market performance of the hotel industry starts going into a decline.

Still, you give a developer money and what is he going to do? Build. You can't blame a cheetah for having spots. Developers are what they are, and we love them. The smart play is to build when the current bubble pops. Currently, there is massive concrete and steel production capacity being developed in Asia, and in two or three years, this may have the effect of reducing costs of these items. If we can get through a

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couple more hurricane seasons without a major disaster, that too will reduce the cost to build. Start tying up good sites, but we would advocate waiting to pull the trigger on building so you will open when the market is coming out of the next recession.

• **Buy.** You can still find opportunities to buy in the current environment. There are no bad deals, only investors with higher cost of capital than the next guy. If you can settle for a leveraged internal rate of return in the 14% to 18% range on a five-year hold, you will find deals that will produce those results. If not, better to wait for the inevitable downturn and be prepared to move fast.

Numerous hotel loans are maturing in 2007 and 2008. If improving operating results do not bail out many overleveraged owners, then selling will become a necessity, which may facilitate the return of selective, smart deals that can be had by those waiting to get back in the game.

Regardless of strategy, keep in mind the majority of investment capital always chases the same thing: major markets, full-service or premium brand and value-add conversions. In the alternative, think about the middle market, and especially deals in the $5-million to $30-million range in secondary markets, and you will always find opportunity with a ready buy-sell market regardless of the macro trends.

Good luck and good hunting.

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