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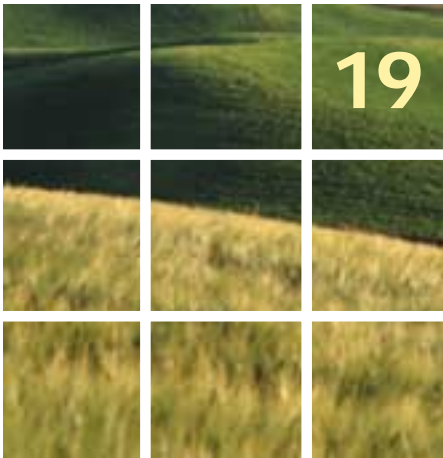
U.S. hotel capital markets have produced an array of challenges during the course of the last six months. From the precipitous decline in investor confidence in August 1998 to the moderate recovery in stock prices later in the year, hotel developers, owners and managers continue to face great uncertainty as they consider their capital plans for the coming year. The question facing the U.S.

- Meanwhile, interest charges remain low as a result of restructured debt from the roaring 1980's and much lower interest rates.

Mid-1990s

- The Hotel Real Estate Investment Trust (REIT) is reinvented to serve the management-intensive hotel business. New structures circumvent the "REITs

U.S. Hotel Capital Markets Will they recover this year ?



hotel industry is compelling. When will hotel capital markets recover, ending a credit crunch that at year-end extended from Wall Street to Main Street?

A quick look back

Before considering the capital market outlook in 1999, let's consider the tumultuous year we have just been through and the years that preceded it. To summarize the decade thus far, a brief refresher is in order:

Early 1990s

- The U.S. hotel industry loses several billion dollars in 1991 as occupancy bottoms out at 61 percent.
- Lenders and investors impose a strict capital diet for a few years as the economy turns around and demand begins to grow at twice the pace of supply.
- As occupancies rise along with GDP, room rates are driven up at twice the pace of inflation. Profit margins widen as this revenue drops to the bottom line, while operating costs are kept to a minimum.

cannot manage rule" through leasing to related third parties.

- New investors to the industry control management.
- Increasingly, large sums of mortgage capital from Main Street to Wall Street are raised and sold off to the public through the Commercial Mortgage Backed Securities (CMBS) market.
- A huge development pipeline of limited-service and extended-stay hotel product is produced with low-cost capital, concentrated in areas where the demand is growing the least in the center of the United States and in the Southeast.
- The pace of individual and portfolio property transactions steps up, fueled by a voracious appetite of the capital-advantaged REITs, with access to ever-rising equity markets and large credit lines.

Late 1990s

- Hotel companies are consolidated through merger and acquisition as the industry produces \$17 billion in net profits in 1997—more than in the



previous ten years combined.

- Finally hotels are accepted as a mainstream product in real estate investment circles after decades of rejection as too management intensive, too much of a business and too complicated.
- In the face of a credit crunch and a broad retreat from hotel stocks on Wall Street—the healthier hotel companies conserve cash, buy back stock and concentrate on the operating side of the business, while the weaker scramble to restructure.

1999

- As the decade comes to a close and we face the next millenium ...

A reprieve from overbuilding?

Let's begin with a look at the credit crunch and what it means for development in the hotel business. Full-service hotel product currently represents approximately 10 percent of new construction, whereas 10 years ago, it was far higher at about 40 percent. And just as financing for full-service product began to make a comeback early last year, it was stymied by the collapse of the credit markets. With approximately 150 brands in the industry, about one-third are in the full-service sector and the rest is limited-service and extended-stay. Consolidation was supposed to trim the numbers, but it hasn't. The outlook for many of the brands that haven't reached critical mass would appear to be gloomy.

As a measure of the rapid run-up in new construction activity during the last year, room supply grew by close to 4 percent compared to average annual increases of just 1.7 percent during the previous five years. And the credit crunch is unlikely to provide much relief this year. With 145,000 room completions in 1998 (up from 131,000 in 1997), the industry should see an additional 120,000 openings in 1999. So while the development cycle has been abruptly curtailed, it

will take a while for the current product under development to clear the pipeline.

For full-service hotels in urban markets, the credit and development crunch was timely in a sense. Just as full-service hotel development was getting underway on a potentially large scale, it has been halted in its tracks, extending the favorable supply-demand dynamics of this industry segment for at least several

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more years. For owners of and lenders to full-service properties, this is clearly good news. But the good news for owners is tempered by their frustrations in securing capital to grow.

The property market transitions

A year ago REITs dominated much of the U.S. hotel property market. The appetite for buying, however, has since virtually disappeared with their swooning stock prices. With the collapse of hotel capital markets, it is difficult to determine where the property transactional market stands today. While there are few significant deals to point to in identifying cap rate, pricing and value trends, the hotel property market has clearly been heading downward as pricing adjusts to some of the new realities. For buyers both of the strategic and opportunistic stripe, the issue will be whether sellers are prepared to dispose of their properties at market clearing prices—or “mark to market.” If they are, capital will likely surface, ready to take aim at opportunities to again finance assets at discounts from replacement cost.

Looking back at the feverish pace of the hotel property market in the last

several years, however, we should remember that it was primarily strategic buyers (such as REITs keen to build mass) that were frequently buying. And the sellers were often those who had previously been buyers in the early 1990s. These earlier players acquired property, squeezed out excess costs and pushed rates as much as the market would bear. Today's buyers must be

circumspect, as they consider upside potential in a soft-to-declining economy, recognizing that others have preceded them in maximizing bottom line profits.

In the varying twists of real estate cycles, this turn has been sharper than most. In the early to mid-1990s, conventional wisdom acknowledged that we were in a buyer's market. That quickly turned to a seller's market when the REITs exploded on the scene, snapping up as much hotel property as they could and bidding up pricing for hotel real estate to their late 1997 and early 1998 peaks. But as the market sensed “disconnects” in some of the industry's fundamentals, the downward pressure on hotel REIT stocks began. The final denouement occurred with the collapse in late summer last year. Despite the interest rate cuts by the Federal Reserve, REIT stocks were still left at one-half of their 52-week highs. And hotel C-corp stocks did not fair much better—off by at least one-third.

As underwriting standards weakened in the run-up to the peak, buyers (frequently suffering from memory loss) had conveniently switched from the “in-place” cash flow underwritings of the early to mid-



1990s, to that mainstay of bull market property investment wisdom, the projection. They will now probably revert back to believing only what they see.

Meanwhile on Wall Street, hotel stocks have been harder than usual to predict. Battered by global issues, changing industry fundamentals, the collapse of the CMBS market and a general unease with the direction of the economy, tracking hotel stocks has challenged even the hardiest of market players. It is

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also worth noting that the large volume of both real estate and lodging stock issued during the last five years has tested the breadth and depth of the lodging and real estate investment community. The large swings in the sector's stock prices appear to reflect the impact of so-called "momentum investors" who enter in a rising market and sell in a down market, in this way contributing to the big swings in pricing. The more traditional growth stock investors will clearly need to be attracted back to rebuild valuations. For these folks, however, the industry and the companies that lead it will need to show a growth story.

As a result of the fluctuating fortunes of public hotel companies, some have been under pressure to increase their liquidity by disposing of property that doesn't have a solid strategic fit. For those companies that acquired property in yesteryear's rising market, there isn't much appetite for selling at a loss. While it is hard to generalize, our sense is that hotel property cap rates may have increased by at least 200 basis points during the last six months as buyers have either disappeared or been caught in the flight to quality causing spreads to widen

across all investment vehicles. Transaction volume was significantly down in the last half of 1998—by as much as 70 percent in the large property category. Caught in this predicament, those hotel companies with asset-laden balance sheets may have quite a challenge in the property market this year. For sellers who used to take public hotel company stock (mostly REIT) as part of the purchase price, this is no longer an option. The primary currency of a portion of the hotel

property transactions market has thus now been pushed aside. Once again, cash is king.

One of the surprises of the latter part of the boom that ended last year was the emergence of some well-capitalized real estate investment funds. Arriving albeit late in the cycle, these funds nevertheless played a role in bidding up the market. For those funds that had a public market exit strategy, the plans will have to be shelved. A longer-term hold will now be required, and investors will of necessity have to shave their return expectations accordingly.

Whither the economy?

For many observers of the U.S. hotel industry, the fundamentals could not be simpler: "so goes the national economy, thus goes the health of the industry." Notwithstanding the short- and medium-term anomalies of the real estate cycle, the relationship over the long-term between swings in real Gross Domestic Product (GDP) and the hotel industry's operating profits is close. But don't look to the hotel industry as a predictor of the economy. It normally lags the economy by at least six months. So the begging

question is this. Where is the U.S. economy going? The share price gains of the 1990s and easy credit have fueled a consumer boom that now finally has consumer spending growing faster than the nation's savings. This is not a healthy alignment and to some market observers suggests an economy bound to fall and the longer such a fall is delayed, the harder it will be. Meanwhile, the Federal Reserve has continued to reduce the cost of money. All of this leaves capital providers to the U.S. hotel industry with a heightened degree of uncertainty that will hardly be dissipated by the occasional flurries of enthusiasm on Wall Street. This suggests that the credit crunch that arrived in mid-1998 looks set to last at least through the summer of 1999 and perhaps beyond.

One degree of separation—the unpairing of hotel REITs

For REITs, the ride through the hotel sector of the last five years has been nothing short of extraordinary. Finally constructed to deal with the management intensive hotel business, hotel REITs became the grand acquirers of hotel property and industry consolidators as well. But their reign in these dual roles was to be a limited run. With their stock prices in retreat, they could not continue to dominate the market as they have in previous years.

Some would have government believe that the "paired-share" structure of a handful of grandfathered REITs provided a competitive advantage in the acquisition of hotel property and companies. Whether or not this was the case, the argument quickly became academic when the enactment of the IRS Restructuring Bill last summer set aside the special status for any going-forward growth activities. For some, the special status did produce extraordinary growth. For others, however, it led to big challenges as highly priced corporate acquisitions were hard to digest and



exacerbated other problems, mostly associated with capital.

The reality check now imposed on many of the hotel REITs also is reflected in the adjustment of valuations to underlying net asset values. Last year most REITs were trading at 25-30 percent premiums to their net asset values. With REIT prices in retreat, the premiums have disappeared and, in some cases, left significant discounts to underlying value. For some market observers, the “natural pricing” over the long term for these asset-based companies is about plus or minus 10 percent of the net asset values. This begs the question as to why a growth company in the hospitality industry—unless it had significant taxable profits to protect—would use this type of vehicle. REITs are obligated to “dividend out” 95 percent of earnings to retain their special tax status. And when stock prices are depressed, it is difficult for companies to come back into the market to raise more equity capital for growth. For now, hotel REITs as well as most public hotel companies organized as C-corps, will need to concentrate their efforts on improving earnings at their current hotels. So-called “same-store growth” will be the watchword for many on Wall Street. Companies will be making sure they get the economies of scale from all the bulking up of property in recent years. But if occupancies continue to decline, and room rate increases are moderate, it may be difficult for some companies to satisfy the expectations of some of their growth-oriented investors who have bought into the hotel industry story in recent years.

This growth story also made quite an impression on some management teams. Ever confident of their growth and rising stock prices, they sold “equity forward” to various banks who would advance funds to be repaid in stock at a later date, typically one year forward. As stock prices declined, these contracts became quite problematic and were either repaid

with the payment of cash or restructured.

Given the challenge of the property market, some investors may avoid asset-intensive companies and focus instead on those with franchise value and management depth. On its face this attitude may be consistent with the issues outlined in this article. It may also lead to investors overlooking some companies that have concentrated on

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full-service product in urban areas—a sector with strong medium- and long-term promise.

For those investors in both REITs and hotel C-corps who were new to the industry and who have not since bailed out, expectations for growth will clearly need to be adjusted downward. As the current pipeline of supply growth is absorbed, we will probably be entering a period of relative equilibrium—characterized by moderate growth, economic conditions permitting, that will take getting used to.

In sum, 1999 will be a challenging year for hotel REITs as they deal with the prospect of limited growth through acquisition and the need to deliver earnings growth in a potentially recessionary environment. Over the longer term, the tax advantages of the REIT format are very compelling. While the industry may have some problems during 1999, hotel REITs will continue to play an important role in the real estate-intensive hotel industry.

The lenders

For lenders who were getting quite comfortable with the hotel business in the late 1990s, last year proved to be a

watershed. Earlier in the year, underwriting standards had clearly slackened as the boom market for hotels seemed to be set for another record year. But by late summer, the sector had turned on a dime. With rate spreads widening following the collapse of the CMBS market and loan-to-value ratios under pressure, the hotel lending market shut down. The irony in today’s hotel credit

crunch is that hotel property continues to perform well on the ground. Compare this to the last crunch in 1991, when financial institutions finally gave up on the sector, but only after they had been bloodied by innumerable defaults across all segments of the industry.

With the demise (for now) of securitized real estate financing in the public capital markets, the hotel sector may eventually have to revert back to its traditional relationships. But who might these players be this time around—the commercial banks, insurance companies, pension funds or private capital?

As to the large banks, it is hard to see how they individually or in syndication will produce the requisite volume of funding to reinvigorate the liquidity in the sector in the short term. The recent flurry of bank mergers cannot help, as decision-making becomes concentrated in fewer and fewer hands. Additionally, foreign banks that stepped into the vacuum left by the withdrawal of the commercial banks during the last down-cycle also cannot be counted on for the kind of activity required to maintain liquidity. There will, however, probably continue to be local bank financing driven by local relationships for small-to-medium, individual



property deals, unless the economy drives even these providers to the sidelines.

For most lenders, the hotel sector has always been considered to be riskier than the average credit. As a result, when investors fled to quality in the face of financial market turmoil, it was difficult to consider the lowly “Double B” hotel sector when much of the market was looking for Triple A ratings. Even for those financings organized on a pooled basis with other property types, there is a limit to the amount of hotel property that the pool can accommodate. Many lenders already have enough hotel exposure in pooled or single transactions; they are not in a position to consider doing more.

The Japanese banks have all felt the pressure during the past year to come to grips with the economic realities of their hotel holdings. They were once big lenders to well-located prime properties in Hawaii and in major mainland cities such as Los Angeles, Chicago and New York. For some, the strategy of holding on during the value-added 1990s in retrospect looks smart. But with the struggle to reform the banking system and revive the Japanese economy, most banks are under pressure to finally rationalize (read sell-off) their U.S. holdings. It is unfortunate for some that they missed the window offered by the peaking of property prices early last year.

The U.S. pension fund community, with its huge capital reserves, has occasionally been viewed as a potential savior for real estate over the long term. But pension funds, and more importantly the firms that advise them, have rarely been big fans of the business-intensive hotel sector. The insurance companies, with their management of separate accounts for and on behalf of the pension fund community and their own general accounts, have been making some efforts to return to the hotel sector. Much of this, however, would appear to be a case of “too little and too late” to make

any real difference in the current environment. And for some insurance companies, the painful memories of the last downturn in the late 1980s and early 1990s, which left many with huge REO portfolios, remain fresh. As interest rate spreads widen and yields improve, however, we may see some further activity in the coming year, as some of these companies, attracted by yield, scout for new opportunity in the vacuum left by others.

For borrowers, the dilemma is clear. With cap rate spreads on hotels rising, values declining and lenders setting more

real estate were largely ignored as spreads narrowed. And some hotel projects financed in the CMBS market were of questionable provenance—destined for markets that eventually would become saturated with limited-service or extended-stay product of every conceivable stripe. For the bankers, bigger was better with multi-billion dollar deals becoming the order of the day. In such huge poolings of mortgages, hotels could be embedded without much difficulty. On their own, these projects would undoubtedly have been less acceptable.

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conservative loan-to-value ratios, the available funding is frequently insufficient for the purposes required. Of course at a price, most things are for sale, including capital. For the moment, however, capital providers remain unsure where to set the pricing. Rather than make a mistake, they are preferring to hold back until the timing seems right. Borrowers, accustomed to being in the driver’s seat during the bull market run on Wall Street, now find themselves in a lender’s market, a turn of events that will take some getting used to.

CMBS—when will the market come back?

The CMBS market has been in a category all its own during the last year. This market—virtually created from scratch in the mid-1990s—took the concept of real estate securitization to new and unexplored heights. CMBS came to epitomize the roaring financial markets that fueled much of the excesses in the hotel property market. For investors, the traditional risk premiums associated with

When the CMBS market ground to a halt in August, Wall Street was reportedly left with close to \$30 billion in unsold inventory on its books. Not that these bonds couldn’t be sold at the right price. The issue for many involved has been how low is the floor? How long will it take to clear this inventory out? The estimates seem to range anywhere from two months to a year—time will tell. But clear, that inventory must, if this critical liquidity vehicle is to work its magic once again in the credit-starved hotel sector. If the CMBS market does come back this year, it will probably involve offerings of smaller size, which will make it harder for hotel product to get placed owing to concerns about product concentration.

Another prominent feature of the CMBS era was so-called mezzanine financing—a high yielding tranche of capital that stood between debt and equity in the capital hierarchy. For both borrowers and lenders, this smart-sounding item allowed the leverage to increase at a time when most would have otherwise foresworn the risks of too



much debt. It would seem doubtful that this will be a prominent feature of any turnaround in the markets, at least initially.

Industry consolidation falters

As we have reported previously, it is the consolidation of the industry that has been one of the most notable features of the capital-enriched period of the late 1990s. Over the last several years, the “paired share” REITs and a few of the

Those companies that played the hotel real estate commodity game in the 1990s will need to acknowledge the new realities and focus on three key factors—management, management and management.

public company C-corps led the way in the consolidation of the industry. This process of consolidation has now clearly faltered with the current instability in the capital markets.

To take a measure of the volumes that have been involved, hotel mergers and acquisitions amounted to \$29 billion in the first half of 1998 of which Starwood’s acquisition of ITT represented close to one half of the total. The remainder (16 deals) averaged less than \$1 billion each. For 1999, it is hard to see how the pace of consolidation can be kept up, given the problems in the credit markets. To the contrary, we will probably see a period of some disinvestment as companies that bulked up in the late 1990s begin to rationalize their portfolios in order to generate liquidity. This is where we may see increased involvement of private capital anxious to step in whenever the yields are high. But private equity capital will likely be quite cautious, wanting to avoid the risk of being caught on the wrong side of the cycle. There are also

few large systems and brands left to be acquired. Such systems have largely been accounted for in a variety of transactions in recent years. But this is a restless industry, and we may see some unexpected mergers or acquisitions produced by the least expected players. And for the large public companies that are required to show growth, we should anticipate some major merger and acquisition activity. But that can occur only if the credit markets loosen, or if in

rationalizing previously acquired real estate, capital is freed to fund more strategic expansion.

Reorganizing for success

As the capital markets landscape has changed during the last year, there have been some notable switches in the corporate structures used for conducting business. Notable are Starwood’s switch from a paired share REIT to a C-corp, the merger of CapStar Hotels (a C-corp) and American General (a REIT) into the first lodging “paper clip” REIT, and Host Marriott’s proposed conversion from C-corp to REIT. Despite the problems that REITs have had during the past year, the tax advantages of the REIT form are clearly just too significant for some to ignore. And while the motivations for the switches in form vary, the message for investors and capital providers appears clear—market-savvy managers will continue to realign their organizational form to ensure it is “in sync” with their evolving market and capital strategies.

So will hotel credit markets recover this year?

A great deal will depend on the economy. In the meantime, the hotel industry’s fundamentals remain generally positive. If confidence can be rebuilt, some equity and debt providers can be expected to return, but only on a very selective basis. They will be fairly demanding and will price capital accordingly. These capital providers will tend to avoid overbuilt markets and product types, and will generally favor full-service product in markets with high barriers to entry and resorts that are expensive to replicate.

Companies that have franchise value and management depth should be the first to benefit, while asset-intensive companies may, depending on their product type, have a longer wait. Those companies that played the hotel real estate commodity game in the 1990s will need to acknowledge the new realities and focus on three key factors—management, management and management. For those who don’t, the wait for capital may be quite a long one.



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