

What's Ahead in Hotel Investment?

Questions will outnumber answers this year, but opportunities are available for savvy owners, investors and operators, says a veteran hotel consultant

By Roger S. Cline

For most of us, the past tends to provide a context to project into the future. And while context is obviously important, it's hardly a match for content. What, then, can we realistically expect from a lodging industry that is in such a state of flux on a number of fronts?

Indeed, 2002 didn't paint a very encouraging picture: A wobbly economic recovery, an unsteady stock-market, few property transactions, cautious lenders, very little M&A, soft retail pricing, aggressive wholesalers and on-line intermediaries, wavering consumer confidence, threats of terrorism and war, an impoverished airline sector on a reduced schedule, the great business traveler disappearing act, rising insurance and security costs and continued over-capacity.

But for those with an eye for the half-full, there are reasons to be faintly optimistic. Supply growth has slowed down significantly, setting the stage for strong occupancy and rate growth once the recovery gets going. Interest rates have dropped down into the bargain basement. Developers, bless them, have started to think of where and what would be the next best thing.

But, as we now look out over the 12-month stretch that lies before us, it's worth looking at the industry's fundamentals to see how they might behave as the year progresses. First, we must acknowledge the outstanding job most operators have done in getting a grip on the business by adjusting their strategies, organizations and business models to today's market realities. Many managers appear to be on the ball and able to respond quickly to changing conditions.

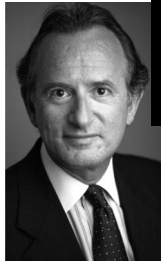
They also recognize that there is little room for error. Markets are not very forgiving. Customers expect value for money in good quality hospitality products. They seek brands they can trust and look for motivated and friendly service. And when hospitality businesses fail to deliver against these basic expectations,

they're left to pay the consequences.

While operators watch their businesses, hotel investors continue to be stymied by a tough transactional market. There clearly is no shortage of capital to invest, most of it anxious to realize the benefits of operating leverage as occupancies and rates rise in the next up-turn.

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sellers to "mark to market." The bid-ask spread on property prices that has been with us for a couple of years will probably continue to be a factor that controls the future pace of the market. The problem for many would-be sellers is their bad habit of reminiscing over the glory days of growing revenues and expanding margins. Faced with little room to grow their way out of an over-leveraged portfolio, however, some of the more highly leveraged hospitality companies with real estate on their balance sheets have been attempting to trim down and de-lever.

These efforts should begin to feed the transactional market this year.

Meanwhile, buyers wielding large new acquisition funds (albeit with moderated yield expectations) continue to troll the market looking for bargains based on today's market conditions. Not quite a dysfunctional scene, but surely not a place for the faint of heart. I expect a break in the logjam this year as return-driven investors, who have been holding on to their properties for longer than planned, are now facing significant capex requirements and market conditions that are not improving as quickly as anticipated.

Given these realities, some owners may prefer to take

what they can in the face of flat trading conditions and move on. There is already evidence of this as some of the more active funds of the mid- to late-1990s now begin to trim their portfolios.

With their conservative underwriting criteria that produce low loan-to-value ratios, high debt service coverage requirements and more recourse, hotel lenders are looking to put money into the market, even as they continue to be quite selective. Underwriting against the trailing 12 months tends to reduce loan proceeds, which is not very helpful for marginal borrowers.

For those players with stable operations, the prospect of a solid turnaround or a special niche development opportunity, the road to low-cost credit is not as challenging as it has been. As always, however, strong sponsorship is a key requirement for success.

With fewer lenders in the game, however, larger deals tend to be more difficult to finance than smaller ones. In the meantime, some of the loans made to the hospitality sector in the mid- to late-1990s will be watched carefully by those concerned with declining coverage, faltering covenants and defaults of one kind or another. A number of hotel mortgages embedded within CMBS (commercial mortgage backed securities) pools will also be on the watch-list this year.

Beyond the first mortgage folks, there is an array of players currently active in the so-called "mezz" business, including some of the banks themselves. Mezzanine financing allows a borrower to layer on top of a conservatively leveraged first mortgage an additional slice of debt to bridge the gap between the first mortgage and the equity. Such financing is also useful for those property owners with expensive pre-payment

penalties on their first mortgages who are looking for additional capital. Along with interest rates, mezz financing costs have trailed down over the past year. Mezzanine funds tend to look for low- to mid-teen returns on their money.

With the poor-looking results of 2002 behind us, the conventional wisdom is that we're not going to see a full-blown recovery until 2004, and it is largely dependent on positive trends in the national economy and an absence of any external event like war or terrorism.

The question for many hospitality industry executives is when will we see the rates of yester-year? With some looking back three or

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four years for rate guidance, it may well be a slow road back to the heady days of 1999 and 2000.

Some of us may be better off looking at the peak of the boom as an aberration that is unlikely to be repeated any time soon. Slow and steady seems to be a far more sensible scenario for today's underwritings than any notion of a hockey-stick style curve in 2004 and '05 as demand takes off with supply growth trailing. Yet, well-capitalized developers lucky enough to obtain financing and renovators with good credit ratings will see this year as a good inflection point in the cycle during which to invest, looking to catch the upturn in the cycle a couple of years from now.

For operators, the focus this year will be watching the pennies and finding new and innovative ways to improve processes. A "continuous improvement" culture will find its way into many organizations. Costs will continue to be trimmed with care taken not to cut too far into the service bone.

Like it or not, customers have become accustomed to quality and are less tolerant these days of being short-changed in service. Thus, it would be short-sighted to cut down on hospitality at the expense of customer loyalty.

Branded hotel companies that have assisted the development process with financial participation and credit enhancements in the past tend to be less willing to do so these days. It is hard, however, to see how some will resist the need to foster the growth of their brands with a view to increasing market share and revenue per available customer. The economic agenda may have changed for this year, but the marketing fundamentals have not. Market penetration, price-point coverage and cross-selling, brand loyalty, share of wallet are all concepts that

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remain at front and center for the large hospitality companies.

In sum, the outlook for hospitality in '03 is anything but clear. Market conditions are challenging for operators, marketers and capital providers, and the economic recovery that will underpin any turnaround is still very much up in the air. While investors, lenders and operators will tend to deal with this in different ways this year, in the end will hopefully come together to build for a more prosperous future. As they do so, some relationships are likely to become strained, while others may even break. It is unlikely to be easy but for those with patience and the ability to see their way clear to a more stable set of business conditions, it may well be worth the wait. ■■■

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