Hotel Capitalization Rates Bottom Out

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By Suzanne R. Mellen, MAI, CRE, ISHC, FRICS

Hotel capitalization rates, defined in for purposes of this discussion as the ratio of a hotel's net income to its sales price, have bottomed out, as rates of return remain at record low levels and NOI upside has begun to subside. This article updates hotel capitalization and discount data that was presented in a previous article on hotel capitalization rates (see: *Allure of Hotel Investment Expected to Moderate Rise in Capitalization Rates as Rebound Takes Hold,* Jan 19, 2005, by Suzanne Mellen, in the Library at www.hvsinternational.com)

Since 1988 HVS International has been tracking overall "going-in" capitalization rates, free and clear discount rates and equity internal rates of return for hotels that sell at the time of our appraisal. The following chart sets forth the trend in these rates of return.

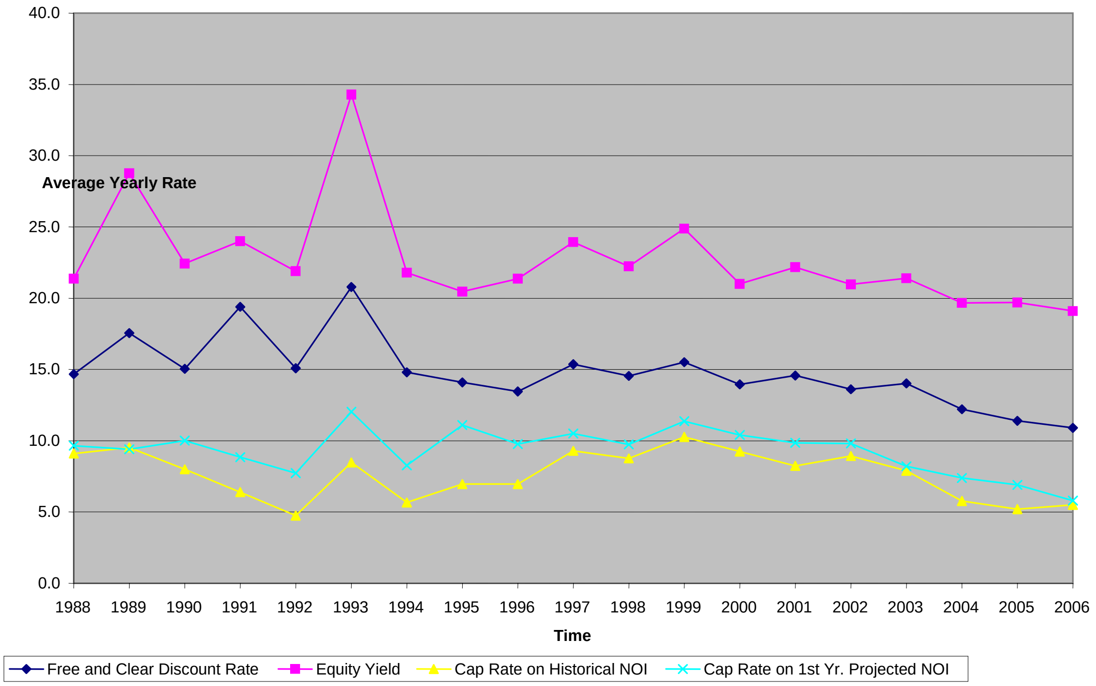
Derived and Projected Derived Capitalization and Discount Rates - Select Set of Full Service Hotels

	Cap Rate based on Historical NOI	Cap Rate based on 1st Yr. Projected NOI	Free and Clear Discount Rate	Equity Yield
2006	5.5	5.8	10.9	19.1
2005	5.2	6.9	11.4	19.7
2004	5.8	7.4	12.2	19.7
2003	7.9	8.2	14.0	21.4
2002	8.9	9.8	13.6	21.0
2001	8.2	9.8	14.6	22.2
2000	9.2	10.4	14.0	21.0
1999	10.3	11.4	15.5	24.9
1998	8.8	9.7	14.5	22.2
1997	9.3	10.5	15.4	23.9
1996	7.0	9.8	13.5	21.4
1995	7.0	11.1	14.1	20.5
1994	5.7	8.3	14.8	21.8
1993	8.5	12.0	20.8	34.3
1992	4.8	7.7	15.1	21.9
1991	6.4	8.9	19.4	24.0
1990	8.0	10.0	15.1	22.4
1989	9.5	9.4	17.6	28.8
1988	9.1	9.7	14.7	21.4

Source: HVS International

The data are graphed in the following chart:

Capitalization and Discount Rates – Select Set of Full Service Hotels



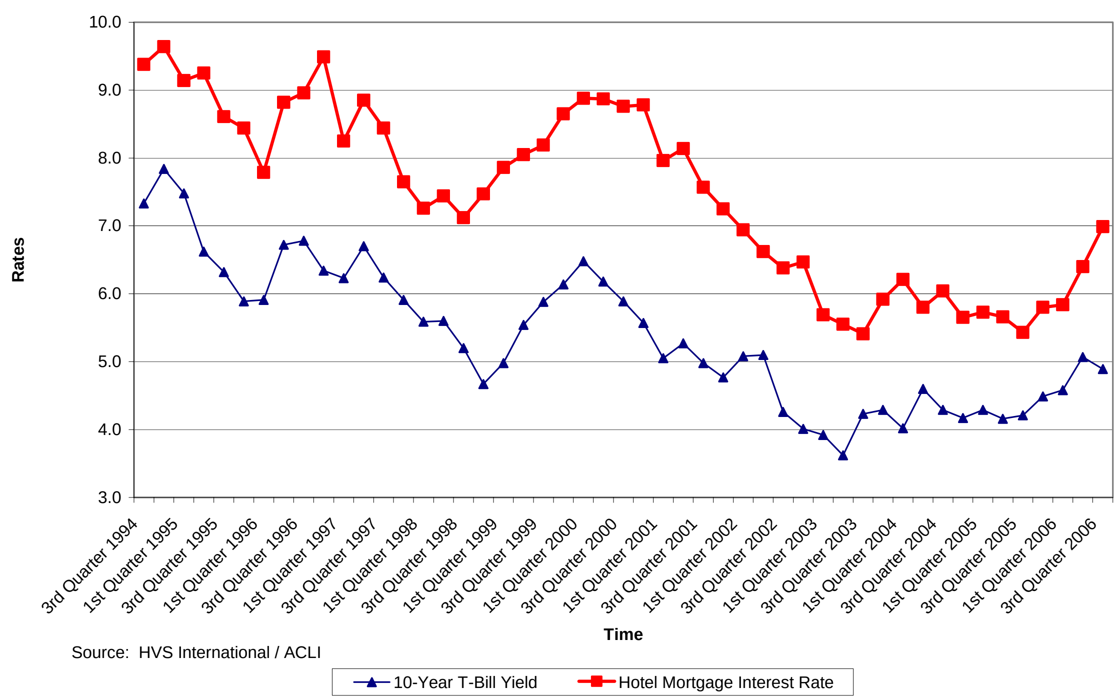
The blue line reflects capitalization rates derived from sales based on trailing twelve or the most recent calendar year NOI, while the red line reflects capitalization rates derived from sales based on 1st year projected net income. Given the perennial optimism of hotel investors, projected net income is generally higher than historical net income. These two rates align or cross over (i.e. projected net income is below historical net income) when the market is wary of flat or declining net income, as was the case when the market was bracing itself for a recession in 1989, when hotels are operating at their peak, as occurred in 2000, or when external factors make the possibility of a rebound in NOI uncertain, as was the case in 2003. For the last two years capitalization rates derived from historical net income have been 100 to 200 basis points below the rate derived from first year projected net income, reflecting the anticipation of improved net income levels. Capitalization rates derived from historical net income hit their historical low in 2005, at 5.2%. In 2006 we started to see these two rates begin to converge, as the expectation of further improvements in operating performance has moderated.

For the first time since HVS International has maintained this data, free and clear discount rates have declined below 11%; the preliminary derived yield rate was 10.9% for 2006 (data still being accumulated). It should be kept in mind that these yields are a product of the type of full service assets being sold and appraised at a given point in time, and thus can be skewed upward or downward, depending upon the characteristics of the hotels that form the basis for the rate calculation.

While the yield on 10-year Treasury notes reached their quarterly low of 4.16% in the 2nd quarter of 2005, hotel mortgage interest rates on loans made by insurance companies which report to the American Council of Life Insurances Companies reached an historic low of 5.43% in the 3rd quarter of 2005, while the yield on 10-year Treasury notes reached their quarterly low of 4.16% in the 2nd quarter of 2005. As is evidenced by the graph, the spreads between the 10-year Treasuries and hotel mortgage interest rates derived from the ACLI data has tightened over the past two years, and reached a low of 126 in the 1st quarter of 2006. Data for the 3rd quarter of 2006 indicates a marked increase in the average hotel mortgage interest rate to 6.9%, while the yield on 10-year treasuries actually declined. Due to the limited hotel mortgage data reported during the ACLI's 3rd quarter bulletin, we consider this to be an aberration. Brokers and lenders we have interviewed indicate the lending environment continues to be very aggressive, and spreads over 10-year treasuries remain at historic lows of 115 to 125 for high quality hotel assets. Nonetheless, hotel interest rates have witnessed a slight rise since their recent low in 2005.

STR Summary

10-Year T-Bill Yields and Hotel Mortgage Interest Rates



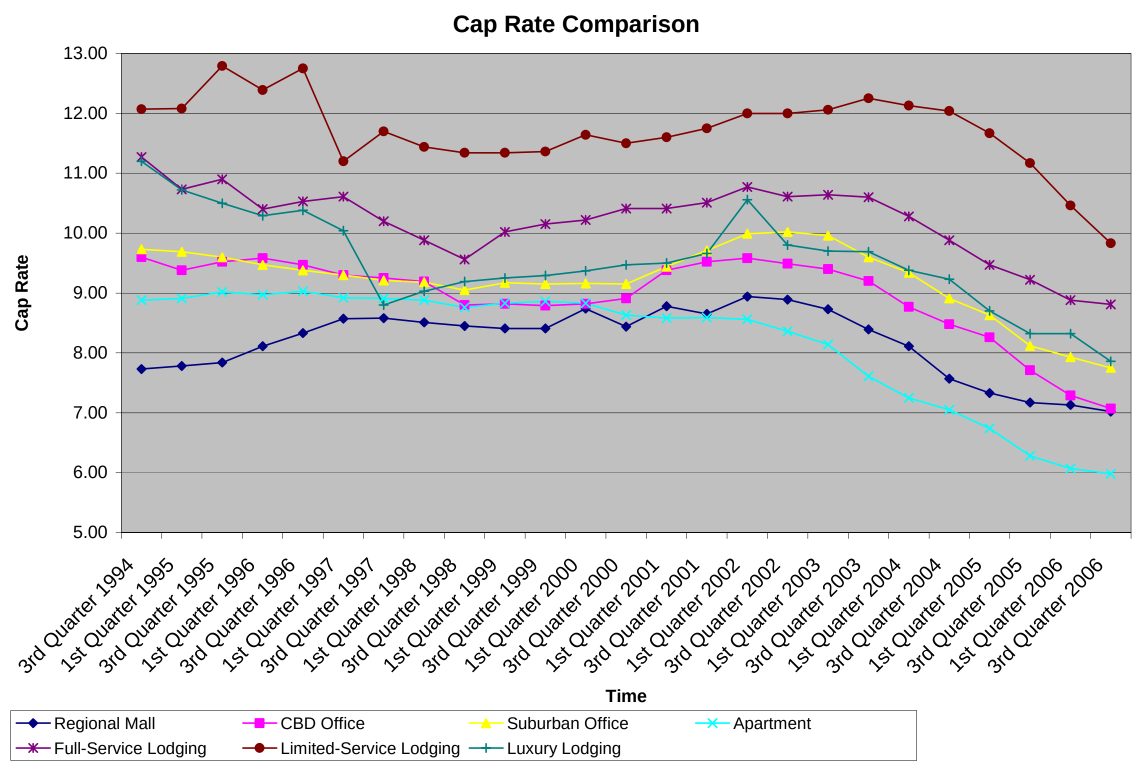
Source: HVS International / ACLI

Pension fund managers, private equity funds and other institutional investors continue to enter the market for hotel investments as they look to allocate a greater portion of their investment portfolio to real estate than in the recent past. While hotel capitalization rates are moderating as the rebound transitions to a more stable operating environment, lodging investments are still very appealing due to their yield relative to other real estate investments. The potential for above-inflationary average rate growth and the positive operating leverage that results continue to make hotel investments particularly appealing.

The following comparison of capitalization rates for limited service, full service and luxury hotels relative to those of other more traditional real estate investments illustrates the positive differential.

Capitalization rates for hotel investments in the Korpacz Survey have slid 200 to 250 basis points over the past four years, paralleling the decline in rates of return for other real estate, other than apartments, which have seen an even greater decline. Relative to other forms of commercial real estate, hotels continue to generate a very attractive yield. As of the 3rd quarter 2006, cap rates for full and limited service hotels were roundly 100 and 200 basis points, respectively, above the cap rate for suburban office buildings. Cap rates for luxury hotels have paralleled those for suburban office buildings since the 3rd quarter of 1997. As of the 3rd quarter of 2006, for the first time, cap rates for limited service, full

Real Estate Investment Capitalization Rates – Korpacz Real Estate Investor Survey Data



service and luxury hotels declined below 10%, 9% and 8%, respectively. While the survey data indicates a continuing downward trend, sales data and our conversations with market participants indicate that cap rates have now bottomed out and may begin to show a slight rise as net incomes continue to improve. We find that the survey data tends to lag the market by one to two quarters, which would explain the most recent decline in cap rates, which we believe was in evidence in market transactions six to twelve months ago.

The conclusion of our first article on this topic two years ago remains valid today. As the net operating income of hotels improves over the next few years we can expect "going-in" cap rates derived from sales transactions to slightly rise due to the reduction in the rate of future net income growth. However, given the significant interest in hotels by new entrants into the hotel investment market, low interest rates, high loan-to-value ratios and the abundance of floating rate and creating financing vehicles, capitalization rates will likely stabilize at a significantly lower level than in previous cycles due to low interest rates and the vast amount of capital that will continue to pursue real estate over the foreseeable future.

About the Author

Suzanne R. Mellen is the Managing Director of the San Francisco office of HVS International. She has been evaluating hotels and associated real estate for 29 years, has authored numerous articles, and is a frequent lecturer and expert witness on the valuation of hotels and related issues. Ms. Mellen has a BS degree in Hotel Administration from Cornell University and holds the following designations: MAI (Appraisal Institute), CRE (Counselor of Real Estate), ISHC (International Society of Hospitality Consultants) and FRICS (Fellow of the Royal Institution of Chartered Surveyors).

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