As Hotel Values Decline- Huge Buying Opportunities Will Soon Surface

As the global lodging industry heads into another down cycle, hotel owners, lenders and operators are wondering how deep will recession get and how long will it last? Over the years the lodging industry has experienced cycles of peaks and valleys that have recurred every 7 to 10 years. Some of the recent down periods have been- 1973, 1981, 1991, 2002 and now again in 2008. Various factors have contributed to the low points in the cycle:

1973- Readily available financing from newly formed real estate investment trusts that caused severe overbuilding coupled with a travel cut-back because of the lack of fuel during the Middle East energy crisis.

1981- Recession leading to a decline in travel and falling hotel demand

1991- Readily available financing from the Savings and Loan industry that caused another period of severe overbuilding and a decline in travel due to yet another recession.

2002- Cutback in travel because of the security fears following 9/11 and the resulting recession.

Today we are facing a unique down cycle. While new hotel development was heating up between 2005 and 2007 it did not reach the point of overbuilding- so this downturn was not induced by an oversupply problem. While there was abundant and inexpensive financing available until mid 2007, it was the collapse of the credit markets caused by the defaults in the sub-prime residential sector that lead to a total evaporation of commercial financing which started to occur in late 2007. These events coupled with the ridiculous "marked to market" accounting practice caused lenders and investment banks to write-down billions of dollars of (perfectly good) mortgage loans which led to fears of bank defaults and loss of confidence. This perfect global storm sent stock markets around the world crashing and pushed many economies into recession.

Today, we are in the "deer in the headlight" phase of this downturn- industry players are frozen- they are on the sidelines doing nothing but waiting to see how bad it is going to get.

-While hotel values have fallen, owners have just started to feel the pain of declining travel and REVPAR. While they still have enough cash flow to pay their debt service during 2008- they are not yet thinking about selling their properties at a discount- this may change in 2009. Buyers sensing rapidly falling hotel values are looking at acquisition opportunities, but most are waiting for signs of a bottom. Lenders are on the sidelines laying off their mortgage origination staff and hiring work-out specialists. Some are selling their mortgage positions at discounts to raise capital which is great opportunity for hotel owners with capital to get unexpected help in paying down their loans.

Let's look at how hotel values are impacted by these events and how much of a decline we might expect over the next year or two.

The components that impact hotel value are the Net Operating Income (NOI Before Debt Service) and the Cost of Capital. Since hotels in the United States are typically financed, the cost of capital is the weighted average of the debt and equity. For example in Early 2006 the interest rate on a typical hotel mortgage was 7.0% and the amount of the loan equated to 70% of the property's total value. The equity representing 30% of the property's value was looking for an IRR of approximately 20%. The weighted average cost of this capital structure (WACC) was 10.9%-

Mortgage-	70%	x	7%	=	.049
Equity	30%	x	20%	=	<u>.060</u>
			WACC		10.9%

Once the WACC is determined it is called the capitalization rate. Dividing the NOI by the capitalization rate results in an estimate of value. Using the Early 2006 capitalization rate of 10.9% and NOI of $1,000- the value would be $9,174 ($1,000/10.9% = $9,174).

The following table shows what happened to the cost of hotel debt and equity components between Early 2006 and fall of 2008, the impact on the WACC and how this would effect value assuming $1,000 of NOI at each point in time.

Trends in Capital Parameters and Implications for Values

	Early 2006	**Late 2006**	**Early 2007 (Peak)**	**Late 2007**	**through mid 2008**	**Fall 20**
Mortgage						
Loan to Value	70%	75%	80%	70%	65%	
Interest Rate	7.0%	6.75%	6.5%	6.75%	7.0%	
Equity						
Equity to Value	30%	25%	20%	30%	35%	
Equity Yield	20.0%	19.0%	18.0%	17.0%	17.0%	1
WACC	10.90%	9.81%	8.80%	9.65%	10.50%	11
Implied Value on $1,000 NOI	$9,174	$10,191	$11,364	$10,363	$9,524	$
Change from previous period		11.1%	11.5%	-8.8%	-8.1%	
Change since 2006		11.1%	23.9%	13.0%	3.8%	
Change since peak				-8.8%	-16.2%	-2

Source: HVS Hospitality Services

In Early 2006 typical hotel financing was 70% loan to value with an interest rate of 7% and an equity yield of 20%. This produced a value of $9,174 for each $1,000 of NOI. By late 2006 and on into early 2007 mortgage financing became more competitive and loan to value ratios topped out at 80% with interest rates falling to 6.5%. Hotel equity was also more available through numerous private equity funds which aggressively pursued acquisitions lowering equity yields to 18%. At the peak that $1,000 of NOI created $11,364 in value which was 23.9% value increase from early 2006.

By the end of 2008, mortgage lenders were pulling back, dropping loan to value ratios to 50%-60% and increasing interest rates to 7.5% to 9%. In most instances, hotel mortgages were not even available. The value created by $1,000 of NOI declined to $8,850 by the end of 2008 which was approximately 22% lower than the value peak.

As we head into the depths of the recession during 2009 and possibly the start of 2010, I don't think we will see a further increase in the WACC- thus the 22% value decline caused by a higher capitalization rate will not increase. On the other hand we are now experiencing a decline in hotel REVPAR in many markets which usually translates into a drop in NOI. This will also adversely impact a hotel's value, but it is too early to tell at this point how much.

Heading into 2009 we are likely to see a great deal of economic pain for those hotel owners who over-financed their properties during the last several years. Particularly hard hit will be those who have expiring mortgage terms and must obtain new financing. While the underlying market value of hotels rarely declines more than 20% to 30% in down cycles, highly distressed owners and lenders will often dump their properties at deep discounts ranging from 40% to 60%. The resulting liquidation pricing represents huge buying opportunities for those with capital and the optimism that eventually things will get better.