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# The Repercussions Of September 11<sup>th</sup>:

## What Is the Future Of Hotel Values?

Anne R. Lloyd-Jones

### **HVS INTERNATIONAL**

372 Willis Ave.  
Mineola, NY 11501  
516.248.8828 ph  
516.742.3059 fax

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## **The Repercussions of September 11<sup>th</sup>:**

### *What is the Future of Hotel Values?*

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While all of America has been affected by the horrific events of September 11<sup>th</sup>, no industry has been more directly impacted than the travel industry. The problems facing the airlines have been well publicized; the impact on the hospitality industry is also enormous. With travel activity fluctuating wildly, and the status of transactions that were pending on September 11<sup>th</sup> uncertain, the question: what is the future of hotel values? is weighing on our industry. As experts in the field of hotel valuation, we at HVS International believe it is incumbent upon us to formulate some response to this question.

The income levels experienced by virtually all hotels in the US have been adversely affected by the terrorist attack, as most travel was suspended in the first weeks following September 11th. HVS sees this downturn as a temporary situation. Reports of a rebound in travel are already circulating. Markets that had reported a 60% to 70% decrease in occupancy in the week immediately following the attack have since seen some occupancy recovery, and are anticipating further increases over the coming weeks and months. The outlook for convention activity and leisure travel is becoming clearer and more positive. After a spate of cancellations for September and October, bookings for November and December are holding strong, and many of the cancelled trips have been rebooked for late in 2001 or early 2002. And business travel has already begun to return, albeit at lower levels than in prior months.

The larger question facing the industry is how we will weather the recession. Even before September 11th, many hotels and market areas were experiencing a softening of occupancy and average rate as the economy slowed and a recession neared. The terrorist attack has helped to accelerate our entry into recessionary conditions. To a

certain extent, this is good news, in that a recession is a prerequisite for a recovery. Current surveys of leading economists indicate consensus on the expectation that the third and fourth quarters will see negative GDP growth – one of the key definitions of a recession. There is a diversity of opinions as to whether the recovery will begin in the first or second quarter of 2002, but the experts agree that the recovery will be well underway by the end of that year. Given these expectations, we anticipate an uptick in net income levels by mid 2002. This improvement will be driven both by increases in revenues and improved cost and operating controls. Looking at the recovery pattern from the last recession, demand decreased in only one year – 1991 – after which demand growth resumed, rising quickly to levels in excess of 2.0% annually.

The anticipated increases in revenue will be enhanced by greater stability on the supply side. Even prior to the events of September 11<sup>th</sup>, the pace of supply growth had been decelerating markedly, in response to the overbuilding that had occurred in the preceding five years. Following these events, we expect that supply increases will come to a virtual halt, as the heightened perception of the risks associated with the hospitality sector make financing for new construction almost impossible to obtain. In the near term, we anticipate that projects currently under construction will be completed and delivered; subsequently, we expect supply increases to decrease dramatically. The supply growth evident in the years immediately following the 1990/91 recession reflects this pattern, and is likely to be repeated in the near term.

**Let's look at the history.** The Gulf War and concurrent recession of 1990/91 provide the closest model to current events, although there are several material differences between that cycle and this one, which will be discussed.

HVS International established the HVI (Hotel Valuation Index) as a measure of trends in hotel values in 46 major markets and for the nation as a whole. The HVI is developed through an income approach, using market area data provided by Smith Travel Research and operational and capitalization rate information from HVS International. Consequently, the value trends reflected here incorporate the influences of both income

and capital on the valuation equation. The following table sets forth the HVI for the US from 1987 to 2000. Data compiled by Smith Travel Research reflecting the changes in supply, demand and occupancy is also included.

<b>Year</b>	<b>U.S. HVI</b>	<b>Change in HVI</b>	<b>Change in Demand</b>	<b>Change in Supply</b>	<b>Occupancy</b>
1987	1.00000				63.4 %
1988	1.04071	4 %	4.8 %	4.6 %	63.4
1989	1.29299	24	5.2	3.7	64.3
1990	1.16617	-10	2.3	3.6	63.5
1991	0.84296	-28	-0.9	1.7	61.9
1992	0.85427	1	2.1	0.9	62.7
1993	1.01400	19	1.9	0.4	63.6
1994	1.23528	22	3.1	1.2	64.8
1995	1.58258	28	2.1	1.6	65.1
1996	1.89853	20	2.2	2.5	65.0
1997	2.44742	29	2.8	3.6	64.5
1998	2.43833	0	3.0	4.2	63.7
1999	2.50861	3	3.3	4.0	63.3
2000	2.89509	15	3.8	3.1	63.7

Source: HVS International, Smith Travel Research

A review of the national HVI data indicates that, in 1990, hotel values fell by 10%. In 1991, with the recession in full force and the Gulf War underway, hotel values fell by 28%. Values stabilized in 1992, rising by a minimal 1%. 1993 saw the beginning of a five year surge during which hotel values increased at an average annual rate of well over 20%.

In general, we expect the same pattern of decline, stability and growth to emerge over the next several years. However, we do not expect the decrease in hotel values to be as dramatic as was seen in 1991, for several reasons. First, and perhaps most influentially, is the significant difference in the capital structure of our industry. In 1991, many hotel assets were highly leveraged, with loan to value ratios well over 75%, and very low debt coverage ratios. Equity investors had little (if any) capital invested and many owners had a limited long term commitment to the hospitality industry. Exacerbating these circumstances was the fact that many of the lending institutions that had underwritten

these loans were themselves undercapitalized and unsound. The failure of the Savings and Loans, and the RTC's subsequent wholesale disposition of hotel assets at fire sale prices put significant downward pressure on values and contributed significantly to the dramatic decline reflected in the HVI data.

By contrast, the current capital situation is structurally much more sound. Lending practices since the last downturn have been more controlled, with higher debt coverage ratios, lower loan to value ratios, and real equity dollars invested. Moreover, a significant amount of hotel real estate is owned by entities that are hospitality companies as well as investors and have a long term commitment to the industry. These companies are for the most part financially sound and, given the anticipated brevity of the sharp downturn that immediately followed September 11<sup>th</sup>, should be able to weather a period of recession. Further, the financial institutions and vehicles that have underwritten the hospitality sector are much less vulnerable than were many of the Savings and Loans.

Offsetting these positives is the increased uncertainty associated with the terrorist attacks and the on-going war on terrorism. One of the most obvious differences between the Gulf War and the current situation is geography: the Gulf War was fought on the other side of the globe, and the September 11<sup>th</sup> terrorist attacks occurred in our front yard. However, as it relates to travel patterns, this difference is not as significant as it sounds. In 1991, the downturn in travel was essentially the result of the fear of terrorist attacks on US planes; this is the same concern that is primarily influencing travel today. While the immediacy of the September 11<sup>th</sup> attacks has had a dramatically negative affect on the travel industry in the short term, more recent evidence indicates that travel activity is resuming, albeit at levels below those experienced prior to the attack. Whether travel activity ultimately returns to the levels experienced in 2000 remains to be seen, and will likely be influenced more by the recession than the attacks. What is clear is that travel patterns will likely change at least in the short term, with drive in destinations achieving renewed popularity among leisure travelers. Those destinations that are heavy with government or military activity may also benefit in the short term, as government spending associated with the war on terrorism supports increased activity in those markets.

Assuming that no further attacks occur on American soil, here is our outlook for the future of hotel values.

**In the near term, hotel values will fall.** We expect hotel values to drop over the balance of 2001. Obviously, the shaky performance of the industry in terms of occupancy, average rate and net income throughout the past year is one cause of this decline. But even more influential is the lack of liquidity that we are already seeing. In the weeks immediately following September 11<sup>th</sup>, virtually all transaction activity came to a halt, with buyers, sellers and lenders re-evaluating their investment strategies. At present, most lenders are taking a “wait and see” attitude concerning loans to this and many other real estate sectors. In this environment, the transactions that are likely to occur would reflect capitalization and discount rates well in excess of historical norms, mirroring both the high level of uncertainty currently affecting the sector as well as the cost of low or unleveraged transactions.

The combination of higher capitalization rates and impaired cash flows is expected to result in significantly lower values, which we believe can only be characterized as liquidation values. Market value requires both a willing buyer and a willing seller and, in the prevailing investment climate, we do not expect to see many willing sellers. Any owner not under duress is not likely to contemplate a sale until the market stabilizes and financing becomes more widely available. Most of those transactions that do occur in the balance of this year will likely involve those owners or assets that were already under stress, for whom the current situation is the last straw. These assets are expected to trade at liquidation prices, and may represent a prospect for opportunistic buyers.

There will be exceptions to this model. Properties that have strong track records, and that demonstrated some durability in their cash flows as the economy slowed in the months prior to September 11<sup>th</sup>, may be attractive prospects for both lenders and equity investors. While value adjustments will be necessary to reflect the current economic conditions, the availability of capital should limit any downward pressure on the value of these assets.

**In the mid-term, hotel values will recover.** In 2002, we expect to see a dichotomy in terms of hotel values. Those properties that succumb to the financial pressures of the recession will likely trade at prices that represent a discount to both pre-2001 values and construction costs. However, we do not expect to see the number of deeply discounted transactions that occurred in the early 1990's. Many of those transactions involved properties that had been aggressively underwritten, and were ripe for default. The more responsible underwriting criteria of the past five years should help limit the sector's vulnerability, although properties underwritten on the basis of their financial performance in 2000 may face some difficulties. Moreover, competition for any disposition assets is expected to limit downward pressure on prices. Recognizing that history can repeat itself, a number of opportunistic funds are already on the lookout for properties that may succumb to the current financial pressures. Competition between these funds, of which there are many more than was the case in the early 1990's, should limit the magnitude of the discounts ultimately realized.

For those properties that are not overly stressed by the recession, including those that benefit from changing travel patterns, we expect that values and transaction activity will pick up in 2002, as the recovery gets underway and net income levels improve. While financing from traditional sources may be slow to return in force, some financing will be available. The lodging industry continues to be the highest yielding real estate sector, and history has shown that there is always an appetite for these high yield loans. Spreads are likely to increase, but with the recent cuts by the Federal Reserve, the hospitality sector should be able to tolerate some increases.

**Over the long term, hotel values will increase to levels at or above those achieved in the past three years.** The prospect of demand growth and limited additions to supply will support increases in net income levels. Moreover, operating efficiencies can be expected to increase, as operators work to control expenses during the current downturn and continue these cost control measures as revenue levels improve. Financing will become more readily available, as lenders under pressure to generate loans are lured by high yields and attractive market performance. Competition for hospitality properties

will gain momentum on both the debt and the equity side. The net effect of these influences will be a continual increase in values, which we ultimately expect will equal or exceed the levels achieved in the past three years.

As always, any analysis of the national lodging market represents an aggregate of numerous individual markets. The national trends are rarely experienced by individual markets, which are much more subject to local influences of supply and demand. Consequently, some markets may be more adversely affected by the current situation, while others may benefit from current activities. The purpose of this assessment is to provide an overview of hotel value trends on a national level. In future publications, we will focus on some of the top hospitality markets and the value trends anticipated for those areas.