Hotel Investment Strategies

Separating Lookers From Buyers

The number of hotel transactions has declined dramatically since September 2001. Over the past six months, HVS International has counted only 32 major hotel transactions in the United States compared to 63 sales for the same period the year before. This unprecedented drop off of sales activity has been blamed on a perceived gap between the bid that a buyer is willing to make and the asking price that a seller is willing to accept. While hotel brokers and investment bankers who make a living from an active market are naturally upset with this situation, it does represent an opportunity for those buyers who really understand the current market dynamics to participate in one of the best buying cycles since 1991.

Throughout the world, the global recession, coupled with the terrorist activities of September 11, has produced a major decline in travel that has adversely affected hotel occupancies, room rates and profitability. Many industry observers predicted massive defaults and bankruptcies with hotel owners forced to rapidly liquidate their holdings at fire-sale prices. For the most part, this scenario did not occur because hotel owners and lenders today have been more conservative in their underwriting practices, and the industry downturn was not severe enough to trigger a total collapse.

What has occurred is a huge exodus of hotel lenders who have a natural fear of uncertainty and are now on the sidelines waiting for the recovery to mature. No lenders means no new hotel development, which translates into a rapid recovery and a very low investment risk environment if you accept my observation that the only major risk of investing in hotels is the risk of too much development leading to overbuilding. Stated very simply: no new hotel development on top of an economic recovery and increased travel leads to higher hotel occupancies, followed by escalating room rates, then greater profits and finally higher values. If this happens, hotels will be exceptional investments for the next four to six years. Fortunately (or unfortunately), many potential hotel buyers don't agree with this outlook and are not willing to make sufficiently optimistic projections and offers to close the gap between the bid and the ask. At the same time, potential hotel sellers are not under sufficient economic strain to reduce their prices enough to narrow the gap. Since most sellers are not under pressure to unload their properties, the only way the gap between the bid and ask will narrow is for the buyer to take the lead and aggressively pursue these opportunities.

There are two types of investors who pursue hotel opportunities, "Lookers" and "Buyers." Lookers spend time and money on due diligence and walk away with nothing. Buyers actually close the gap between the bid and ask and successfully walk away with the property. Based on my observation of today's hotel market the following is my assessment of the difference between a Looker and a Buyer.

- A Looker will utilize the property's 2001 net income to price the bid; a Buyer will price off the higher 1999 or 2000 levels.
- A Looker will capitalize the net income at a 13%+ rate; a Buyer will be more aggressive and use a 10%-12% rate.
- On an unleveraged yield basis, a Looker will want a rate of return of 15%+; a Buyer will accept a 12% to 13% rate.
- Using leverage, the Looker will demand more than 25% equity yield; the Buyer will be willing to go as low as 18%-22%.
- A Looker will base financial projections on the trailing 12 months; the Buyer will use a forward-looking projection and factor in a short-term turnaround.
- A Buyer will have the funds available to bid an all cash price; a Looker will require a financing contingency in order to secure a mortgage.
- A Looker will insist on buying properties only in major gateway cities such as New York, London and Hong Kong; a Buyer will focus on the secondary and tertiary cities that are overlooked by most investors.
- A Looker will only buy chain-affiliated hotels; a Buyer will consider all types of hotels, including non-flagged properties.
- A Looker will only acquire hotel assets; a buyer will go after assets, notes, bankruptcies and workouts.

These are the strategies that paid off in the United States in 1991. It takes a contrarian point of view to make hotel investments under these circumstances, but those who do have made excellent returns on their capital. ◆

By Stephen Rushmore, *MAI, CHA, CRE, president and founder of HVS International, a global hotel consulting firm with offices in New York, Miami, Denver, San Francisco, Vancouver, Mexico City, London, New Delhi, Singapore, São Paulo and Toronto. Mr. Rushmore can be contacted at 1.516.248.8828 Ext. 204.*