What You Need to Consider Before Buying a Distressed Property

By Li Chen and Michael E. Brophy, Aug 21, 2009

Poorly performing hotels are an unfortunate casualty of the recession, which is causing an increase in the number of distressed sales. Here we examine the tools you need to employ to maximize investment in a distressed property.

In general, distressed real estate represents properties hurt by unusually high vacancy levels that cause a sharp and swift decline in a property's rental income.[1] According to a consensus at the Hunter Hotel Investment Conference in March of 2009, ten percent of all U.S. hotel debt will be delinquent before the recession ends. Currently, the percentage of delinquent loans is less than two percent. Thus, a buying spree for distressed hotel assets is expected to get underway late this year or early next, with everything leaning heavily toward a buyer's market.

Where can a buyer find distressed properties? The best way is to speak with hotel brokers who track local hotels going into foreclosure. Banks that have a department to manage the REO property inventory can be an excellent resource as well. Local business journals may publish lists of distressed properties. Lastly, organizations such as the Association of Commercial Real Estate and groups active on LinkedIn and other professional networking sites allow members to advertise and stay on top of listings of distressed properties.

Declining performance statistics and other factors affecting property value can bring down the sales price of a distressed property substantially, creating a strong incentive for buyers. Caveat emptor, however, still applies. Here are some items of which a buyer needs to be aware before investing in a distressed property.

I. Discover and Analyze Relevant Property Factors

Physical Condition, Zoning, and Contracts

Dated facilities, or facilities in disrepair, can negatively influence property performance in terms of occupancy, average rate, and revenues; therefore, a thorough inspection is needed to determine the extent of necessary repairs or renovations. This includes the property's roof, exterior, ventilation and air-conditioning systems, plumbing, parking areas, landscaping, stairways, elevators, guestrooms, and guestroom bathrooms, as well as public areas such as a pool, meeting space, the dining area, the exercise room, and corridors. The inspection helps determine whether the property is below market standards and how much of a capital deduction should be set aside for renovations and repairs.

Buyers also need to know the local zoning requirements for the property site and consult building permit records to assess the risk of construction liens popping up after closing. Moreover, the buyer needs to carefully review various property documents, including the environmental site assessment, the survey, the franchise agreement, the third-party service provider contract, and property tax bills. A current Phase I environmental site assessment is a requisite to a commercial real estate acquisition. If the inspection reveals environmental problems, a Phase II assessment may be required.

A survey can reveal a great deal to the buyer, including the disclosure of any easements the property might have. If the distressed property is franchised with some major hotel chain, the buyer needs to know the terms of the agreement, whether it can be renewed, and what brand standard the property needs to meet in order for the agreement to be renewed. In the third-party service provider contract and tax bills, the buyer should note whether the service charges and taxes are paid up to date.

Property Management

It should come as no surprise that smart, efficient hotel managers can enhance a property's profit potential in myriad ways. Conversely, poor management practices can erode revenues and performance levels. As a buyer, you need to review management's strategies and understand any deficiencies in the way the hotel is operated.

This includes going over the operational expenses line by line: Are there any extraneous charges at the property? Are expenses in the Rooms, Administrative & General, and Utilities categories more than they should be? You also need to compare the subject property's RevPAR with market trends to find out where the hotel stands versus its competitors. Has management positioned the hotel's average daily rate appropriately for the market? Has management sufficiently marketed the hotel?

By evaluating management's successes and failures, you can find out where money can be saved and whether the current management team should be retained or replaced.

Market Drivers

About Li Chen

Li Chen is a Vice President with the HVS Dallas office. Li earned her Master's degree from Michigan State University's Eli Broad College of Business and has extensive hotel experience, including front office and accounting department experience at the Renaissance LAX. Li travels and works extensively in the southwestern U.S. for the D/FW team. Contact Li at (310) 755-8293 or lchen@hvs.com.

About Michael E. Brophy

Mike is the Director of Operations for the HVS Atlanta office. Mike earned his bachelor's degree in Hotel and Restaurant Management from East Stroudsburg University and has over 25 years of experience working at hotels and convention centers. He is a certified general appraiser in Georgia and surrounding states. Please contact Mike at mbrophy@hvs.com or +1 678-628-6577.

Recent Consulting & Valuation Articles

Florida Newsletter - Summer 2011 Spotlight on the Miami-Dade Hotel Marketplace: Miami's Hotel Perfo... (Download file) By examining trends in visitation, occupancy, average rate, and transactions, this article...

Is Change Stressing Out Your Workforce? (Read article) In this era of reduction, the employer must get creative to ensure their employees feel valued. But...

Can New Technology Bolster HR Strategy? (Read article) Sophisticated technologies improve HR efficiencies but also warm the hearts of CEOs and CFOs as...

Canadian Monthly Lodging Outlook May, 2011 (Download file) The hotel industry has seen great benefits from the increase in hotel education however, the...

More Articles

A thorough market analysis guides you in determining whether a property is still a viable competitor, or how much it will cost to make it so. Here's what you need to consider:

- Is the market politically stable? With terrorism around the world on the increase and many political, religious and legal implications, it is essential to invest in a politically stable market.
- What are the major demand segments in the market? Who are the market's major demand generators? Is the property located proximate to one or more of the area's major employers, an airport, a convention center, or a tourist attraction? If not, does the hotel have the potential to capture overflow demand from such sources?
- Is the market economically stable? Has any large company entered or moved out of the market over the past two or three years? Such events can upset the balance between supply and demand, and you need to reevaluate the prospect of filling rooms, despite how strong occupancy has been in the past.
- Are there considerable infrastructural, commercial, or residential developments being made to the area?
- Has the market been overbuilt? Have most competitive properties undergone major renovations? Have any competitive hotels been converted from an independent to a branded property or changed flags in recent years? The relationship between competitive hotels is volatile, and you need to fully understand what effect a new, expanded, or re-branded property will have on yours in the ensuing years.

Answers to these and other pertinent questions help you determine whether, and under what parameters, an investment in a distressed hotel is worthwhile.

II. Solutions for the Distressed Property

If after due diligence you've decided to invest, it's time to figure out solutions to the property's shortcomings in order to maximize its profit potential.

Healthy Market, Ailing Hotel

Renovations may be able to revive an older property in a healthy market, but you need to weigh the expense against the yields that a renovated property will bear. If the property is functionally obsolescent, for instance, it may need to be demolished and rebuilt to meet the current market standard. Most hotel brands require renovations according to a property improvement plan (PIP), with which franchisees must either comply or lose their hotel's flag.

Once renovations are completed, it's essential to invest in marketing and advertising to promote your upgraded hotel. Owners of independent properties should consider franchising with a major hotel chain, which can bring an increase in occupancy and average rate, along with access to a central reservation system and other conveniences. Likewise, renovations may make a branded property eligible for a more lucrative flag and accordant benefits.

Ineffective Management

If ineffective management is hindering a property's penetration levels and/or mishandling expenses, you'll need to hire someone new. This should be someone who thoroughly knows your market and your hotel's asset class (limited-service, select-service, or full-service).

Hotel operations are exceedingly complex and very different from other types of commercial real estate. Consultation with hotel industry experts is essential before venturing into hotel management.

Market Volatility

A market undergoing change may affect the highest and best use of the land on which a hotel sits. If the land value and the costs to demolish the existing property are more than the property's value, the highest and best use of the land may be something other than a hotel. Likewise, legally allowable, physically possible, and financially feasible uses of the land all need to be considered before converting the hotel or motel to a different type of commercial property.

Conclusion

With so many distressed hotels seeking buyers or going into foreclosure, the barrier to investment is low—but the risks can still be high. Seek out the help of a reputable, hotel-focused firm to analyze the market, the management, and the property itself before making a purchase, and stay vigilant when it comes to operating and promoting your new hotel.

For consultation on distressed hotel assets or other services related to hotel investment and valuation please contact Mike Brophy (mbrophy@hvs.com, 678-628-6577) in the HVS Atlanta office.

---

1 Anglyn, Ted. "Distressed property valuation issues." Appraisal Journal. Spring 2005.

Filed Under Categories Hotel Investments & Ownership, Valuations & Market Studies, Hotels - Distressed

- Receive FREE Weekly Newsletter

Recent Articles from Li Chen

HVS Market Intelligence Report: California's Antelope Valley (Read article) Business is diverse and growing in California's Antelope Valley—a good sign for area hotels.

Economy Hotel Development Trends in Mainland China (Read article) Since the first opened in 1997, economy hotels in mainland China have spread far and wide, filling...

Demand Diversification Leads Markets to Higher RevPAR Levels (Read article) Communities that have developed a well-balanced array of demand generator types drive heightened...

- More Articles
- Receive FREE Weekly Newsletter

Recent Articles from Michael E. Brophy

HVS Hotel Market Snapshot: Atlanta (Read article) Like many major metropolitan markets, the recent recession left Atlanta hotels on unsure footing....

HVS Reflections on the 2010 Hunter Hotel Conference (Read article) As the economy slowly revives, demand, average rates, and property values of U.S. hotels are poised...

Brand Power: InterContinental Hotels Group (Read article) IHG's success owes much to creative brand positioning in markets worldwide.

- More Articles
- Receive FREE Weekly Newsletter

Recent Related Articles

Florida Newsletter - Summer 2011 Spotlight on the Miami-Dade Hotel Marketplace: Miami's Hotel Perfo... (Download file) By examining trends in visitation, occupancy, average rate, and transactions, this article...

HVS Hotel Market Snapshot: Colorado Springs, Colorado (Read article) Colorado Springs' hotel industry has been in business for more than a century, with a wide spectrum...

Market Intelligence Report: Nashville, Tennessee (Read article) New demand-generating developments and attractive investment parameters are putting the Nashville...

Making Sense Of Debt Yield Ratios (Download file) Steve Rushmore's June 2011 article for Lodging Hospitality magazine.

- More Articles
- Receive FREE Weekly Newsletter