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Hotel Market Factors Return To Normal Levels

As the hospitality industry enters the mature phase of its expansion period, rising costs and stricter underwriting will continue to change the lending environment.

BY CAMERON J. LARKIN

Despite some signs of change in the hospitality industry, Stephen Rushmore of HVS International and other hospitality industry experts predict that the sector's current strength will continue for another couple of years - and even then, the run is not expected to end as abruptly as past expansions have.

Absent a jarring shock such as a terrorism event or similar unpredictable catastrophes, I, too, suspect there are still good times to be had in the hospitality industry. In fact, the shrewdest hotel operators will likely keep succeeding well past the time when nontraditional hotel investors have been forced to exit the industry.

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The easy money has been made already in the hotel sector. Rising valuations make it difficult to find acquisitions that spin heady yields. Turnaround properties with a story can be mined for gold, but this is an arena for practiced developers.

After rising steadily for five years, average daily rate (ADR) growth rate started a predictable decline late last year. Similarly, occupancy growth began trending down in 2005 and is expected to fall in absolute terms this year.

This industry report is not dire. Moreover, the hotel industry has never been more resilient. Signs are evident we're simply moving toward more normal markets and entering that time in the hotel business cycle when experience and prior planning distinguish the winners from the losers.

Expansion's aftermath

Those who have lived through a full hotel cycle will recognize the predictable outcomes during the mature phase of an expansion:

First, costs continue to trend up as hoteliers face pressure on multiple fronts: energy, real estate tax, labor, franchisor/brand standard enhancement and construction costs. Also, ADR and occupancy growth appear to be easing with a lack of broader expansion in the economy and growing supply of new rooms entering many markets.

Finally, spreads, while still historically low, have edged up 10 to 15 basis points after the April bombshell reports by the largest rating agencies (Moody's, S&P and Fitch) put conduit lenders on notice that loose underwriting standards would no longer be accepted.

The realities of the next phase will test the soundness of past decisions - such as choice of franchise and segment, market, capital improvements, lender, type of financing and equity partners - but going forward, decisions may be even harder.

To understand the current hospitality lending environment, we need to first understand today's challenges associated with owning and running a hotel. Some of the most prominent challenges (and opportunities) are increasing guest demands and franchisor requirements.

Hotel guests continue to demand better (and free) services such as wired and wireless Internet access, hot and bagged breakfast options, up-to-date business and fitness centers, and 24-hour lobby coffee service, to name a few.

These services merely meet customer expectations these days, and only luxury hotels appear able to charge for them. Still, in order to justify steadily increasing ADR, owners need to continually bolster service levels and amenity offerings.

Similarly, guests demand product improvements that quickly become expectations for which they are unwilling to pay a premium. Franchisors such as Hilton, Marriott, Starwood, Intercontinental, Wyndham and Choice respond by ratcheting up standards in efforts to win the coveted business traveler: cozier

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beds, flat-screen TVs, upgraded linens and duvet covers, ergonomic desk chairs and tasty new breakfast options housed in a constantly redesigned breakfast nook.

These expensive upgrades are increasingly frequent now that franchisors have largely sold off company-owned properties and no longer directly feel the economic pain of their own brand requirements.

Franchisors are bent on differentiating their brands based on quality and consistency. Property owners out of sync with required improvements are being cast out of the network in greater numbers. Re-flagging a bumped hotel with a lesser brand can be disastrous to ADR and occupancy.

Increasing costs

Energy costs have risen dramatically over recent years. Double-digit increases in utility costs represent the largest increase in a hotel's profit and loss statement. A limited-service hotel with energy costs of 3.50% of gross revenue just three years ago could easily see 5.50% on that line item today.

Hefty year-over-year increases are, at minimum, a near-term reality, as energy costs are largely uncontrollable. Whether the push for a green hotel promises future savings is yet to be seen.

Real estate taxes are also on the rise as local governments catch up with reassessments based on prior or acquisition-year valuation.

The recent frenzied transaction environment, improved business conditions and significant property renovations since mid-2003 have resulted in real comparative data that municipalities are using to rationalize significant assessed value increases. Shrewd hoteliers will work to control increases through the appeals process.

Furthermore, supply growth, the eventual death knell of all hotel industry recoveries, is back in a big way. New hotel product is coming online at a brisk pace after several years where room demand significantly outpaced supply. Stick-built limited service and extended stay hotels can be constructed very quickly, changing the dynamics of a currently healthy market in short order.

Yet according to Smith Travel Research, supply is expected to grow by only 1.4% this year (versus long-term average growth of 2.2% per year) with nearly 120,000 rooms under construction as of April of this year.

Lodging Econometrics, however, states that the total construction pipeline - which includes projects in the planning phase - now sits at 4,281 projects and a total of 568,318 guest rooms at the end of the first quarter of 2007. That figure puts the hotel development pipeline about 15% higher than the peak reached in 1999.

Steadily increasing construction costs are holding back unbridled development for now. And according to Smith Travel, the average length of time it takes to open doors on a new hotel development has increased from 12 to 19 months over the past six years. New supply will predictably degrade existing hotel profitability, but mitigating factors appear to be dampening any sudden impact.

Spreads rise

While the residential and commercial debt markets are distinctly separate, the bursting residential subprime bubble appears to have spilled over into the commercial mortgage-backed security (CMBS) market. Consequently, both the rating agencies and commercial bond investors have begun demanding increased underwriting discipline.

Not only are lenders less willing today to lower spreads just to win deals, but the easy days of extended interest-only periods, phased-in furniture, fixture and equipment escrows, 80% loan-to-value, rate lock at application and other exceptions are generally over for the time being. Exceptions are certainly still possible, but skilled loan presentation and negotiation are more important than ever.

Overall, the changed underwriting climate over the past two months is palpable: Underwriters are questioning more, document requests are up, and negotiating every item is more difficult.

As recently as three months ago, we were securing spreads on top-notch limited-service hotels in the mid-to-high 90s basis point range. Even on lesser deals, negotiations started at 115 basis points and worked down from there.

Fast-forward to today, and the same deal is priced at 130 basis points over the 10-year Treasury. Conversations with several of our conduit lenders confirm a rise in spreads from between 10-15 basis points on hotel deals.

In addition, the underlying 10-year Treasury rose 49 basis points over the past two months from 4.66% in mid-April to 5.15% today. We recently had a deal spread re-traded on us by 10 basis points where the borrower had not opted for an early rate lock, and we are seeing borrowers losing loan dollars as the rising Treasury drops debt service coverage below 1.40.

While some lenders can be convinced to sharpen their pencils to further strip reasonable expenses to recover loan dollars, others are skittish about B-piece buyers kicking out all but the most vanilla deals. In order to maximize loan dollars, some hotel deals will be driven out of the CMBS market and into pricier conventional programs.

Nevertheless, I'm very optimistic that we will see an elongated stabilization period in the hotel industry through 2009. Numerous factors buoy my optimism:

■ Debt is historically inexpensive and available.

■ Hotels are increasingly viewed as a safer investment, due in part to abundant data provided by the likes of Smith Travel Research, PKF, HVS International and Lodging Econometrics - data not available a decade ago.

■ Investors can readily access these data to understand comparable hotel and market performance.

■ Franchisors employ increasingly sophisticated brand management to enhance guest experience consistency, induce additional demand, vet new franchisees and cull properties that no longer fit brand standards.

■ Construction costs and lender lessons learned from past expansions both conspire to keep new hotel supply in check.

■ Hotels are increasingly managed by a professional class of owners who understand that this is a management-intensive business with only 24-hour leases.

A return to more normal markets is probably a good thing. The hotel industry party is not over, just a bit more tame. ●

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