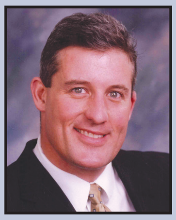
Hotel

Like a fully loaded freight train leaving the station, transactions take a while to get up to steam

James O'Connell



HREC Investment Advisors

We have been able to look back and choose the third quarter of 2015 as the absolute peak of the last real estate cycle for hotel pricing and transaction activity. As the train pulled into Year End 2015, publically traded REIT's were pounded by Wall St. analysts and their stock prices and valuations fell like snow in a "nor'easter." When public companies vacated the transactions market, higher return expectations from private equity investors pushed direct capitalization rates up. As cap rates rose, values declined and seller's retreated to the sidelines.

Net Operating Income	7.0% Dir Cap	8.0% Dir Cap	9.0% Dir Cap
$2,000,000	$28,571,428	$25,000,000	$22,222,222

In 2014 and into 2015, hotel owners of quality, upscale select service hotels were being told that their hotels would trade for approximately a 7% direct capitalization rate. Many investors took advantage of historically low return expectations based upon very low interest rates. Those investors who waited to sell their assets, for whatever reason, and then decided in 2016 to market their hotels, were greeted with a 100 – 200 basis point spread in return expectations from private investors. Despite continuing to possess strong cash flow, sellers were rewarded for their efforts with a drop in value of between $3.5 million to over $6 million for the very same cash flow produced in 14' and 15'.

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From 2010 through 2016, Revenue Per Available Room (RevPAR) has continued to increase year over year. However, the "rate" of that increase has decreased in 2015 and 2016. That train is running out of steam. No one expects it to come to a complete stop. Experts that monitor hotel performance expect that the rate of RevPAR improvements will mirror Gross Domestic Product (GDP). GPD growth has been anemic over the past few year and hotel revenue growth is expect to continue at approximately 1%-2% per year. No one expects hotel performance to fall off a cliff. Just a slow, flat, boring run up a slight grade for the next few of years.

Before anyone draws comfort in this slow steady pace, investors must determine what impact new hotel supply will have on their markets. Many cities around the country such as NYC, Nashville, and Portland, have a freight train full of hotel rooms coming their way in the next couple of years. Actually, according to a report done by Pinnacle Advisory Group of Boston, investors should be concerned about the number of hotels under construction and in the pipeline in the Boston and suburban marketplace. Thousands of hotel rooms are permitted and in the pipeline. Recently, a new +1,000 room hotel is proposed for the Seaport area. That's impactful and not in a good way, for existing Boston hotel investors.

It seems as though every real estate cycle brings new efficiencies to the market. After being burned many times, this cycle seems to show that lenders are out in front of the pending supply increase issue and have begun to tighten controls on new construction lending for hotels. Several of the major hospitality lenders have turned off the debt issuance faucet. Debt reduction is the only way to avoid an over-supply situation.

Budget season is upon us and many hotel companies are predicting flat revenue performance for 2017. Normally, this would be a major cause for concern, but for many owners, it is more like an embarrassment of riches. Hotel occupancies are at +80% with +$100 RevPar performance. However, pushing rates higher "just because we can" has been met with resistance and prospective guests are seeking alternatives and pushing back. The rapid increase in the growth of AirBnB as a hotel alternative is one result of strong hospitality performance. We do not see a broad scale decline in guestroom demand. "Slow and steady wins the race" is the new normal. Now that this "new normal" is being accepted by owners and investors across the country, our expectations for increased transaction activity has risen.

As the leaves fall we hope that this summer's drought will bring on record setting snowfall and as the snow piles up, so will the number of hotel transactions!

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