Low Interest Rates and High Demand for Hotel Assets Fuels Value Gains

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The low interest rates which have characterized the hotel financing market over the past year, coupled with very strong demand for quality hotel assets, have lowered capitalization rates and are driving up hotel values. While the factors that are fueling this trend have been in place for the past year, it was only in the third quarter of 2003 that we began to witness value increases as measured by closed transactions. We attribute the significant pick-up in investor activity to the improving national economic outlook, the completion of the overt war in Iraq and the subsiding of the SARS epidemic. Investors can now confidently say that the worst is over. Hotel performance has bottomed out and the only direction for hotel earnings is up. The result is a reduction in hotel capitalization rates and discount rates to levels not seen since the Japanese went on a buying spree of hotel assets in the late 1980's. We are once again seeing hotel investments at free and clear discount rates as low as 11%, rates not seen since 1989. Other factors, however, reduce the applicability of the comparison to market conditions at that time. In 1989 inflation was averaging 5%, indicating a 6% real rate of return (11% - 5%). Compare that with the 2% to 3% inflation rate utilized today for most hotel transactions, reflecting an 8% to 9% real rate of return. We are also at the trough of the hotel earnings cycle, whereas in 1989 the long awaited recession had not yet occurred, and hotel earnings were on the precipice of a decline. The traditional mortgage-equity model explains the reduction in rates of return. Ten year fixed rate interest rates of as low as 6.5%, coupled with investor return requirements in the high teens, result in discount rates in the 11% to 12% range for hotels that are generally stabilized. Compare this with interest rates of 8.5% and investor yield requirements in excess of 19% two years ago, which resulted in discount rates in the 13% to 14% range. The following chart sets forth the change in investment parameters that have driven down capitalization rates to their current level. This example reflects the discount rates and capitalization rates derived for a high quality hotel asset in a major urban area that has performed well during the recent downturn and is operating at a stabilized level. **Capitalization Rate Derived - Stabilized High Quality Hotel**

The same investment parameters applied to a hotel that has been negatively impacted by the economic downturn result in a higher yield, due to the significant improvement in net operating income forecast for this asset. **Capitalization Rate Derived - Underperforming Hotel**

Utilizing the same investment parameters results in a markedly higher (+1.5 points) free and clear yield rate in the turn around scenario, where net income is forecast to almost double in five years from their current depressed levels. Successful hotel buyers are building significant upside into their earnings forecasts for those hotels which have been negatively impacted by the economic downturn. The result is that many hotels are transacting at "going-in" overall capitalization rates in the 5% to 7% range, based on current earnings. For those hotels which continued to perform well during this most recent downturn the upside being forecast is more moderate, with derived capitalization rates ranging from 8% to 9%. With discount and capitalization rates at or near their historical low, are hotel investors being adequately compensated for the risks associated with hotel investments? Only time will tell. The positive operating leverage generated by hotel assets during an upswing in revenues can result in dramatic gains in net income, as was witnessed during the mid to late 1990's. Conversations with the hotel buyers indicate that part of the rationale for purchasing these assets at such low capitalization rates is that returns remain attractive when compared with those being generated by other real estate assets. Prices are being driven up in all kinds of real estate, and many buyers have withdrawn from the

Summary

In this article the author explains how current low interest rates and high demand for hotel assets affect value gains.

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office, industrial, multi-family residential and retail sectors due to the low initial yields that have resulted from a highly competitive seller's market. Buyers bemoan the lack of a significant number of hotels for sale, but given current pricing we can expect that more hotel owners will find 2004 an opportune time to put their hotel on the market.

About Suzanne R. Mellen, MAI, CRE, FRICS, ISHC

Suzanne R. Mellen, MAI, CRE, FRICS, ISHC is a Senior Managing Director, based in San Francisco, California. She has been evaluating hotels and other hospitality real estate assets for 40 years, has authored numerous articles, and is a frequent lecturer and expert witness on the valuation of hotels and related issues. Ms. Mellen has a BS degree in Hotel Administration from Cornell University and holds the following designations: MAI (Appraisal Institute), CRE (Counselor of Real Estate), ISHC (International Society of Hospitality Consultants) and FRICS (Fellow of the Royal Institution of Chartered Surveyors). Contact Suzanne at +1 (415) 268-0351 or .