

HOTELS

PASSION FOR HOSPITALITY



What's the Deal By Daniel Lesser *Daniel Lesser, president and CEO, LW Hospitality Advisors, New York City*

Hotels never stabilize

(The views and opinions expressed in this blog are strictly those of the author.)

"Hotels define cities," by Editor in Chief Jeff Weinstein, is a terrific article in HOTELS Investment Outlook's June issue. The article profiles Richard L. Friedman, president and CEO of Carpenter & Company Inc., a nationally recognized, award-winning real estate development firm based in Cambridge, Massachusetts. The piece includes an interview with Mr. Friedman, a prominent businessman involved in numerous business, civic, and charitable endeavors, in which he stated: "In the hotel business, there's no such thing as stabilization. There's a start-up period, but hotels never get stable, which is (not) a good or a bad thing."

I believe Mr. Friedman's observation is spot on. All types of real estate investments, including hotel facilities, have life cycles that reflect a rise and fall of net operating income during a property's economic life. A brand-new, renovated or repositioned hotel experiences rising occupancy and/or average room rate levels during the first two to five years of operation/ownership.

When underwriting a hotel asset, investors typically project income and expenses for the first several years of an assumed holding period up to and including a "stabilized" level of business. Beyond the initial years of a hotel's operation/ownership, a forecast of a "stabilized" level of hotel net income is estimated as a representation of an average annual level of anticipated profit over the remaining economic life of an asset. Actual realized net income typically

ascends for several years above the forecasted “stabilized” level of operation. Subsequently, a hotel’s net income then gradually diminishes between the seventh and 10th forecast year due to a combination of physical deterioration and functional or economic obsolescence.

Without a significant capital infusion, a hotel’s net income often declines once peak profits are realized. The economic life of a hotel can be lengthened or shortened depending upon the amount of maintenance and how often refurbishment or renovation occurs.

Given the unique nature of hotel operations, in reality they can never stabilize. Hotel facilities are more than bricks and mortar real estate; they are also going business concerns that house extensive amounts of furniture, fixtures and equipment, all of which are inextricably intertwined. A property’s primary inventory, namely available room nights, is sold on a daily basis, and with the technology available in today’s market, room rates literally change in nanoseconds.

Unlike other forms of commercial real estate, hotels do not benefit from long-term leases or credit tenancies. Furthermore, hotels are very labor-, capital- and specialized-management intensive with relatively high levels of fixed costs. In addition to guestroom sales, many lodging facilities include other “retail” businesses such as the sale of food, beverages, meeting facilities, recreational amenities and gift shop items. Many hotels are also improved with retail store space that requires leasing and property management.

The success of a hotel investment is heavily influenced by multiple parties, each of whom might have competing or complementary interests in the underlying property. Beyond the traditional interests of owners/sponsors and third-party equity investors and lenders, an additional layer of complexity is added from the interests of the property manager or brand affiliation.

While sophisticated hotel investors will project a “stabilized” level of operations, they realize that the notion of a “stabilized” hotel is erroneous. Hotel investors purchase upside; they do not acquire stable annuity-type income. Every hotel acquisition has a story relating to how a buyer perceives they can create value, whether through better management, a renovation, a reflagging and a repositioning, the leasing out of food and beverage operations, etc.

Hotel facilities are highly susceptible to immediate market changes, such as a continuously fluctuating economy, frequently shifting supply and demand trends, and regularly changing hotel brands and products. The fluidity with which hotel markets and assets endlessly evolve contradicts the concept that a hotel can ever be “stabilized”.

This, however, does not infer that when market participants formulate a discounted cash flow analysis, that they do not forecast income and expenses up to and including a perceived “stabilized” level of operation sometime in the future (typically years two through five). Hotel investors do forecast a projected “stabilized” level of operation, which essentially reflects what is perceived at a single point in time, as the average anticipated performance over the remaining economic life of the asset.

Therefore, for example, a forecasted “stabilized” occupancy of 75% by the third year of operation/ownership implies that from the third year through the remaining economic life of the building, a hotel is anticipated to average 75%, with some years achieving higher levels than that and some years lower. An investor’s sense of “stabilized” operations for a hotel changes with the passage of time, and rarely stays constant. Clearly, the perception of anticipated “stabilized” performance of any U.S. hotel was dramatically different on September 12, 2001, when compared with 48 hours earlier.

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