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Capital velocity and the rise of US hotel values

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Story Highlights

- U.S. hotel values declined roughly 38% off peak levels during late 2008 through late 2009.
- Values continue to be roughly 18% off peak based merely upon changes in hotel capital stack structures and returns.
- Given that prices have risen faster than property incomes, initial yields on hotel investments in major coastal markets are relatively low.

The United States is experiencing a tepid and fragile economic recovery. However, hotel fundamentals continue to dramatically rebound resulting in heightened transaction activity. Against a backdrop of a recovery in corporate travel and increasing group meeting business, new supply of U.S. hotel rooms is relatively muted.

Major urban 24/7 cities are once again perceived as darling hotel investment markets with assets trading at relatively low trailing-12 capitalization rates that are still below replacement cost. Publicly traded hotel real-estate investment trusts, which are flush with cash and have been highly acquisitive, as well as private capital all are competing to invest in the current up-cycle. Debt for cash-flowing assets with perceived upside has become more readily available for existing hotels situated in high-barrier-to-entry markets, while construction financing continues to remain elusive for all but the most prime projects.

Deal volume and pricing of U.S. hotel assets is rising and gaining momentum as investors who were able to hang on during the downturn now bring assets to market, and sponsors who acquired properties at the bottom of the market execute exit strategies to cash out and realize robust returns. Dramatic examples of recent rapid price appreciation are evident by two recent transactions:

- The Q1 2011 acquisition of the 494 room JW Marriott in New Orleans for US$93.8 million by Sunstone Hotel Investors. The asset was purchased from a joint venture between Clearview Hotel Capital and Starr International USA Investments who previously acquired the hotel in Q1 2008 for US$67.5 million from Ashford Hospitality Trust;
- The Q1 2011 acquisition of the 221-room Best Western Plus Tuscan Inn at Fisherman's Wharf in San Francisco for US$52.5 million by Walnut Hill Group. The asset was purchased from Abacus Lodging Investors who previously acquired the asset less than one year ago for US$34 million.

An analysis of the variability in the amount and cost of hotel equity and debt, combined with fluctuations in net operating income, further illustrates the recent rebound in values. During the past five years, changes to a typical hotel capital structure coupled with varying return requirements for debt and equity impacted hotel prices as exemplified in the following table.

Hotel Capital Stack Returns/Price Movements

	2005	Early 2006	Late 2006	Early 2007 (Peak)	Late 2007	Mid 2008	Late 2008	Late 2009	Late 2010	Mid 2011
DEBT										
Debt To Value	60%	70%	75%	80%	75%	65%	55%	55%	65%	65%
Interest Rate	6.00%	6.50%	6.20%	5.75%	6.50%	7.10%	8.00%	8.00%	6.50%	5.50%
Amortization	25	30	I/O	I/O	30	25	25	25	25	25
Debt Constant	7.73%	7.58%	6.20%	5.75%	7.58%	8.56%	9.26%	9.26%	8.10%	7.37%
EQUITY										
Equity To Value	40%	30%	25%	20%	25%	35%	45%	45%	35%	35%
Equity Dividend	10.00%	10.00%	9.00%	8.00%	9.00%	10.00%	11.00%	11.00%	9.00%	8.00%
Weighted Average Cost Of Capital (WACC)	8.64%	8.31%	6.90%	6.20%	7.94%	9.06%	10.04%	10.04%	8.42%	7.6%
Implied Value of $1,000 NOI	$11,575	$12,035	$14,493	$16,129	$12,597	$11,034	$9,956	$9,956	$11,881	$13,175
% Change WACC From Previous Period	N/A	-3.80%	-17.00%	-10.10%	28.00%	14.20%	10.80%	0.00%	-16.20%	-9.8%
% Change WACC From 2005	N/A	N/A	-20.10%	-28.20%	-8.10%	4.90%	16.30%	16.30%	-2.60%	-12.1%
% Change WACC From Peak	N/A	N/A	N/A	N/A	28.00%	46.20%	62.00%	62.00%	35.80%	22.4%
% Change Value From Previous Period	N/A	4.00%	20.40%	11.30%	-21.90%	-12.40%	-9.80%	0.00%	19.30%	10.9%
% Change Value From 2005	N/A	N/A	25.20%	39.30%	8.80%	-4.70%	-14.00%	-14.00%	2.60%	13.8%
% Change Value From Peak	N/A	N/A	N/A	N/A	-21.90%	-31.60%	-38.30%	-38.30%	-26.30%	-18.3%

Source: LW Hospitality Advisors

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Click chart to enlarge.

The top part of the chart demonstrates the fluctuation of the "Weighted Average Cost of Capital" and highlights hotel capitalization rates bottomed out in early 2007 when typical loan-to-value ratios were upwards of 80%. Coupled with the availability of sub 6% interest-only financing and single-digit equity dividend rates, hotel capitalization rates declined significantly from 2006. They then rose dramatically during the past two years, only to ease back close to where rates stood during 2006.

Measuring the implied value of US$1,000 throughout each point in time illustrates that merely through changes in typical hotel capital stack structures between debt and equity and the required returns for each position, U.S. hotel values declined roughly 38% off peak levels during late 2008 through late 2009.

With the recent loosening of the credit markets—hotel capitalization rates are back to 2006 levels—values continue to be roughly 18% off peak based merely upon changes in hotel capital stack structures and returns. Thus far the analysis does not factor in any changes in net operating income.

The following table layers into the analysis positive and negative changes in NOI at increments of five percentage points to determine the implied value of US$1,000.

Hotel Price Changes *(Implied Value Of $1,000 NOI)*

Change in Weighted Cost of Capital

Change in NOI	2005 8.64%	Early 2006 8.31%	Late 2006 6.90%	Early 2007 (Peak) 6.20%	Late 2007 7.94%	Mid 2008 9.06%	Late 2008 10.04%	Late 2009 10.04%	Late 2010 8.42%	Mid 2011 7.59%
25.00%	$14,469	$15,043	$18,116	**$20,161**	$15,746	$13,793	$12,445	$12,445	$14,852	$16,469
20.00%	$13,891	$14,442	$17,391	**$19,355**	$15,116	$13,241	$11,947	$11,947	$14,258	$15,811
15.00%	$13,312	$13,840	$166,678	**$18,548**	$14,486	$12,689	$11,450	$11,450	$13,663	$15,152
10.00%	$12,733	$13,238	$15,942	**$17,742**	$13,856	$12,138	$10,952	$10,952	$13,069	$14,493
5.00%	$12,154	$12,636	$15,217	**$16,935**	$13,226	$11,586	$10,454	$10,454	$12,475	$13,834
0.00%	**$1,575**	**$12,035**	**$14,493**	**$16,129**	**$12,597**	**$11,034**	**$9,956**	**$9,956**	**$11,881**	**$13,175**
-5.00%	$10,997	$11,433	$13,768	**$15,323**	$11,967	$10,482	$9,458	$9,458	$11,287	$12,517
-10.00%	$10,418	$10,831	$13,043	**$14,516**	$11,337	$9,931	$8,961	$8,961	$10,693	$11,858
-15.00%	$9,839	$10,229	$12,319	**$13,710**	$10,707	$9,379	$8,463	$8,463	$10,099	$11,199
-20.00%	$9,260	$9,628	$11,594	**$12,903**	$10,077	$8,827	$7,965	$7,965	$9,505	$10,540
-25.00%	$8,682	$9,026	$10,870	**$12,097**	$9,447	$8,276	$7,467	$7,467	$8,911	$9,882

Source: LW Hospitality Advisors

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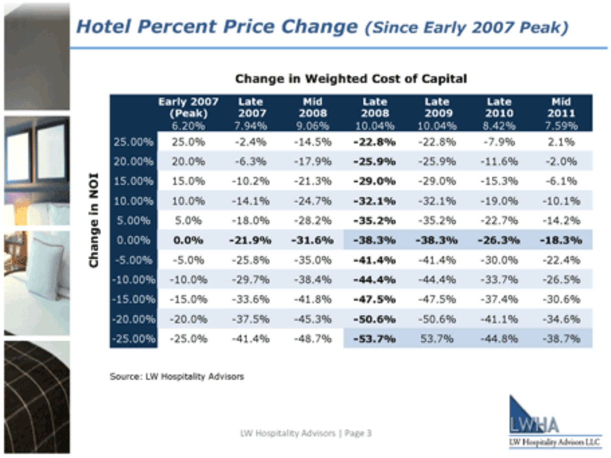
Click chart to enlarge.

The third table again illustrates that simply for the change in the capital stack structure and the returns for each position within the stack (with no change in NOI), hotel pricing bottomed out at roughly 38% lower during late 2008 through late 2009. More recently, hotel pricing increased 20 points to an approximate 18% decline from peak. Layering into the analysis modest increases in NOI as experienced by most hotels during the past year, an asset that hypothetically experienced a 5% increase in profits, combined with capital stack changes, resulted in a rebound in value to only 10% below peak. The table further illustrates that if the same asset's NOI is roughly 20% to 25% higher today than the recent bottom, based upon current capitalization rates, the property value would be roughly back to peak levels.



Hotel Percent Price Change *(Since Early 2007 Peak)*

Change in Weighted Cost of Capital

Change in NOI	Early 2007 (Peak) 6.20%	Late 2007 7.94%	Mid 2008 9.06%	Late 2008 10.04%	Late 2009 10.04%	Late 2010 8.42%	Mid 2011 7.59%
25.00%	25.0%	-2.4%	-14.5%	**-22.8%**	-22.8%	-7.9%	2.1%
20.00%	20.0%	-6.3%	-17.9%	**-25.9%**	-25.9%	-11.6%	-2.0%
15.00%	15.0%	-10.2%	-21.3%	**-29.0%**	-29.0%	-15.3%	-6.1%
10.00%	10.0%	-14.1%	-24.7%	**-32.1%**	-32.1%	-19.0%	-10.1%
5.00%	5.0%	-18.0%	-28.2%	**-35.2%**	-35.2%	-22.7%	-14.2%
0.00%	**0.0%**	**-21.9%**	**-31.6%**	**-38.3%**	**-38.3%**	**-26.3%**	**-18.3%**
-5.00%	-5.0%	-25.8%	-35.0%	**-41.4%**	-41.4%	-30.0%	-22.4%
-10.00%	-10.0%	-29.7%	-38.4%	**-44.4%**	-44.4%	-33.7%	-26.5%
-15.00%	-15.0%	-33.6%	-41.8%	**-47.5%**	-47.5%	-37.4%	-30.6%
-20.00%	-20.0%	-37.5%	-45.3%	**-50.6%**	-50.6%	-41.1%	-34.6%
-25.00%	-25.0%	-41.4%	-48.7%	**-53.7%**	53.7%	-44.8%	-38.7%

Source: LW Hospitality Advisors

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Click chart to enlarge.

Investor demand for U.S. hotels is showing early signs of moving beyond the coasts and spilling into the middle of America where pricing has been much slower to recover. Given that prices have risen faster than property incomes, initial yields on hotel investments in major coastal markets are relatively low. As debt markets continue to thaw and the availability of leverage becomes more widespread, more investors will enter the market and the velocity of capital deployed into the sector will boost further transaction volume and pricing of U.S. hotel assets.

Daniel H. Lesser is president & CEO of LW Hospitality Advisors, which provides services to corporate, institutional, and individual clients as well as public agencies on all facets of hospitality real estate including: litigation support and expert testimony, site evaluation, highest and best use analysis, appraisals for mortgage, acquisition, and portfolio management, workout strategies, operational analysis, property tax assessment appeal evaluations, economic impact studies, deal structuring, and fairness opinions. Mr. Lesser can be reached at 212.300.6684 x 101 or daniel.lesser@lwhadvisors.com.