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How capital stack changes affect value

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Although cap rates are down from the dramatic peak of 2008 and 2009, values continue to be roughly 12% off peak based on changes in hotel capital stack structures and returns.

Highlights

- Changes to a typical hotel capital structure coupled with varying return requirements for debt and equity investors has impacted hotel prices.
- The compound annual change in value between 2005 and late 2013 measures roughly 2.6%.
- The hotel capital markets are in full swing.

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Since the August 2011 Standard & Poor's downgrade of America's AAA credit rating, record budget deficits have shrunk; economic growth has accelerated; the U.S. dollar has rallied; stocks have climbed to all-time highs; and Treasuries have strengthened their hold as the world's preferred haven from turmoil. During the remainder of 2014, the pace of U.S. economic growth is expected to continue to gain traction, and the national hotel occupancy should recover to pre-recession levels.

With the demand for hotel accommodations reaching an all-time high during the past two years, the pipeline for new supply additions is beginning to increase. Major markets across the country including Austin, Texas; Dallas; Houston; Los Angeles; Miami; Nashville, Tennessee; New York; and Pittsburgh, are seeing meaningful increases in new competition, while secondary and tertiary markets are generally lagging behind.

Deal volume and pricing of U.S. hotel assets have increased each year since the downturn. Hotel investment is gaining momentum as institutional capital, high net worth individuals and family offices have been chasing risk adjusted yields in the sector, resulting in exponentially more hotel investment sales. As a result of limited capital expenditures during the past five years, value enhancement opportunities abound as a significant amount of U.S. hotel inventory exists that is in need of renovation and/or repositioning.

The recent price appreciation of U.S. hotels is evidenced by the following observations:

- Million-dollar-plus per room U.S. hotel pricing is becoming more prevalent than ever before as evidenced by six U.S. trades that occurred during the past 15 months including: Calistoga Ranch Napa in California ($1.1 million per room); the Park Lane Hotel New York ($1.1 million per room); the Setai Fifth Avenue New York ($1.1 million per room); the London West Hollywood ($975,000 per room); the St. Regis Bal Harbour Resort ($1 million per room); and the Standard High Line New York ($1.2 million per room).
- During 2013, the Boston Park Plaza Hotel & Towers was acquired by Sunstone Hotel Investors for $250 million, almost double the price it sold for two years earlier.
- Hyatt Hotels Corporation's $717-million acquisition of the 1,641-room Peabody Orlando in Florida during 2013 represents the largest sum ever paid for a single non-gaming U.S. hotel.
- The recent $130-million sale of a leasehold interest in the Hotel Vitale is the highest price per room amount ($650,000) ever paid for a hotel in San Francisco.

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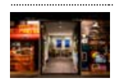

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An analysis of the variability in the amount and cost of hotel equity and debt, combined with fluctuations in net operating income, further illustrates the recent rebound in values. During the past five years, changes to a typical hotel capital structure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

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	Late 2012	Late 2013
DEBT												
Debt To Value	60%	70%	75%	80%	75%	65%	55%	55%	65%	65%	65%	70%
Interest Rate	6.00%	6.50%	6.20%	5.75%	6.50%	7.10%	8.00%	8.00%	6.50%	5.50%	5.25%	5.00%
Amortization	25	30	I/O	I/O	30	25	25	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%	7.19%	7.02%
EQUITY												
Equity To Value	40%	30%	25%	20%	25%	35%	45%	45%	35%	35%	35%	30%
Equity Dividend	10.00%	10.00%	9.00%	8.00%	9.00%	10.00%	11.00%	11.00%	9.00%	8.00%	8.00%	7.00%
Weighted Average Cost Of Capital (WACC)	8.64%	8.31%	6.90%	6.20%	7.94%	9.06%	10.04%	10.04%	8.42%	7.59%	7.47%	7.01%
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	$13,379	$14,264
% Change WACC From Previous Period	N/A	-3.80%	-17.00%	-10.10%	28.00%	14.20%	10.80%	0.00%	-16.20%	-9.82%	-1.53%	-6.20%
% Change WACC From 2005	N/A	N/A	-20.10%	-28.20%	-8.10%	4.90%	16.30%	16.30%	-2.60%	-12.14%	-13.48%	-18.85%
% Change WACC From Peak	N/A	N/A	N/A	N/A	28.00%	46.20%	62.00%	62.00%	35.80%	22.42%	20.55%	13.07%
% Change Value From Previous Period	N/A	4.00%	20.40%	11.30%	-21.90%	-12.40%	-9.80%	0.00%	19.30%	10.89%	1.55%	6.61%
% Change Value From 2005	N/A	N/A	25.20%	39.30%	8.80%	-4.70%	-14.00%	-14.00%	2.60%	13.82%	15.58%	23.23%
% Change Value From Peak	N/A	N/A	N/A	N/A	-21.90%	-31.60%	-38.30%	-38.30%	-26.30%	-18.31%	-17.05%	-11.56%

Source: LW Hospitality Advisors

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The top part of the chart demonstrates the fluctuation of the weighted cost of capital and highlights the fact that hotel capitalization rates bottomed out in early 2007 when typical loan-to-value ratios were upward of 80%. Coupled with the availability of sub-6% interest only financing, and single-digit equity dividend rates, cap rates dropped significantly from 2005 through 2007. Subsequently, hotel cap rates rose dramatically during 2008 and 2009 due to the major economic downturn that ensued. More recently, cap rates have eased and are now approaching low levels demonstrated during the prior peak.

Measuring the implied value of $1,000 of net operating income throughout each point in time illustrates U.S. hotel values declined roughly 38% off peak levels during late 2008 through late 2009. This calculation solely reflects the changes in typical hotel capital stack structures between debt and equity and the required returns for each position. Although cap rates are down from the dramatic peak of 2008 and 2009, values continue to be roughly 12% off peak based on changes in hotel capital stack structures and returns. Thus far, the analysis does not factor in any changes in NOI.
The following table layers into the analysis positive and negative changes in NOI at increments of 5 percentage points to determine the implied value of $1,000 over time.


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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%	Late 2012 7.47%	Late 2013 7.01%
25.00%	$14,469	$15,043	$18,116	**$20,161**	$15,746	$13,793	$12,445	$12,445	$14,852	$16,469	$16,724	$17,830
20.00%	$13,891	$14,442	$17,391	**$19,355**	$15,116	$13,241	$11,947	$11,947	$14,258	$15,811	$16,055	$17,117
15.00%	$13,312	$13,840	$16,667	**$18,548**	$14,486	$12,689	$11,450	$11,450	$13,663	$15,152	$15,386	$16,404
10.00%	$12,733	$13,238	$15,942	**$17,742**	$13,856	$12,138	$10,952	$10,952	$13,069	$14,493	$14,717	$15,691
5.00%	$12,154	$12,636	$15,217	**$16,935**	$13,226	$11,586	$10,454	$10,454	$12,475	$13,834	$14,048	$14,977
0.00%	**$11,575**	**$12,035**	**$14,493**	$16,129	**$12,597**	**$11,034**	**$9,956**	**$9,956**	**$11,881**	**$13,175**	**$13,379**	**$14,264**
-5.00%	$10,997	$11,433	$13,768	**$15,323**	$11,967	$10,482	$9,458	$9,458	$11,287	$12,517	$12,711	$13,551
-10.00%	$10,418	$10,831	$13,043	**$14,516**	$11,337	$9,931	$8,961	$8,961	$10,693	$11,858	$12,042	$12,838
-15.00%	$9,839	$10,229	$12,319	**$13,710**	$10,707	$9,379	$8,463	$8,463	$10,099	$11,199	$11,373	$12,125
-20.00%	$9,260	$9,628	$11,594	**$12,903**	$10,077	$8,827	$7,965	$7,965	$9,505	$10,540	$10,704	$11,411
-25.00%	$8,682	$9,026	$10,870	**$12,097**	$9,447	$8,276	$7,467	$7,467	$8,911	$9,882	$10,035	$10,698

Source: LW Hospitality Advisors

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Using a 20% change in NOI as an example, the implied value of $1,000 during 2005 was $13,891 compared to $16,404 as of late 2013. While hotel income and values have fluctuated dramatically during the most recent eight-year period, the compound annual change in value between 2005 and late 2013 measures roughly 2.6%.

The third table again illustrates that solely resulting from 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 during late 2008 through late 2009 at roughly 38% below peak levels. More recently, hotel weighted cost of capital has declined 300 basis points from the depths of the Great Recession resulting in values 26 percentage points above the trough, or 12% lower than the most recent peak. Layering into the analysis modest increases in NOI as experienced by most hotels during the recent past, an asset that hypothetically experienced a 12% increase in profits, combined with capital stack changes, results in a rebound of property value 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%	Late 2012 7.47%	Late 2013 7.01%
25.00%	25.00%	-2.40%	-14.50%	**-22.80%**	-22.80%	-7.90%	2.11%	3.69%	10.55%
20.00%	20.00%	-6.30%	-17.90%	**-25.90%**	-25.90%	-11.60%	-1.97%	-0.46%	6.13%
15.00%	15.00%	-10.20%	-21.30%	**-29.00%**	-29.00%	-15.30%	-6.06%	-4.60%	1.70%
10.00%	10.00%	-14.10%	-24.70%	**-32.10%**	-32.10%	-19.00%	-10.14%	-8.75%	-2.72%
5.00%	5.00%	-18.00%	-28.20%	**-35.20%**	-35.20%	-22.70%	-14.23%	-12.90%	-7.14%
0.00%	**0.00%**	**-21.90%**	**-31.60%**	**-38.30%**	**-38.30%**	**-26.30%**	**-18.31%**	**-17.05%**	**-11.56%**
-5.00%	-5.00%	-25.80%	-35.00%	**-41.40%**	-41.40%	-30.00%	-22.40%	-21.19%	-15.98%
-10.00%	-10.00%	-29.70%	-38.40%	**-44.40%**	-44.40%	-33.70%	-26.48%	-25.34%	-20.41%
-15.00%	-15.00%	-33.60%	-41.80%	**-47.50%**	-47.50%	-37.40%	-30.57%	-29.49%	-24.83%
-20.00%	-20.00%	-37.50%	-45.30%	**-50.60%**	-50.60%	-41.10%	-34.65%	-33.64%	-29.25%
-25.00%	-25.00%	-41.40%	-48.70%	**-53.70%**	53.70%	-44.80%	-38.73%	-37.79%	-33.67%

Source: LW Hospitality Advisors

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Although the overall economic recovery from the Great Recession has been slow and sluggish, the up cycle in the hotel space is well underway. With interest rates still relatively low, improving property fundamentals and rising property prices, the hotel capital markets are in full swing and competition is heating up between lenders to land deals. Given market uncertainty and the industry's inherent volatility, now is the time to lock in long-term financing. Barring any unforeseen downturn or extraordinary event affecting hotel industry metrics, continued strong investor interest lies ahead. Single asset and portfolio selling prices are at record highs, and in numerous submarkets during the near term it will be cheaper to build new than to buy existing assets. The bulk of the nation's new supply comprises select-service hotels, the majority of which are prototypical branded projects of less than 200 rooms each.

Tepid group meeting demand growth continues to be a significant challenge for full-service hotels although the industry is experiencing strong group bookings for years beyond 2014 into 2018. Large conventions and meetings that were able to lock in recession-era low rates through 2010 will be burning off this year and will allow for improved sector average-daily-rate pricing power. The increasing use of online travel agents is complicating how the hotel industry records group versus transient business. Many organizations and companies are now utilizing OTAs to book rooms for their representatives and employees attending large group functions, which are typically catalogued as a transient customer. Furthermore, many small groups are suggesting their attendees book rooms independently with an OTA, rather than booking as a block. Further support of this observation can be gleaned from the fact that transient hotel demand has exceeded prior peak levels.

The national hotel occupancy rate is re-approaching peak levels, which coupled with record demand for U.S. hotel accommodations and a muted level of new supply, has the industry in position to increase ADR above inflationary levels.

During the past 32 years, Mr. Lesser has specialized in real estate appraisals, economic feasibility evaluations, investment counseling, and transactional services of hotels, resorts, conference centers, casinos, and timeshare properties on a worldwide basis. He provides services to corporate, institutional, and individual clients and municipalities 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. He is President & CEO of LW Hospitality Advisors. Previously he served as the Senior Managing Director-Industry Leader of the Hospitality & Gaming Valuation Advisory Services Group which he established at CB Richard Ellis Hotels. For eleven years prior to joining CBRE, Mr. Lesser founded and led the Hospitality & Gaming Group at Cushman & Wakefield. Mr. Lesser was a member of the original team at HVS International when it was launched, spending thirteen years there expanding the firms practice. Prior to his hospitality advisory and transactional experience, Mr. Lesser held operational and administrative positions with Hilton Hotels Corporation and Eurotels-Switzerland. Mr. Lesser can be reached at 212.300.6684 X 101 or Daniel.lesser@lwhadvisors.com

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