

## Liquidity and Risk - The Party's Over - By Scott Smith MAI

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In the 2007 edition of Hospitality Investment Survey PKF Hospitality Research (PKF-HR) stated that, 'the lingering question on investors' minds is how to maximize yield in a capital induced frenzy of lowered revenue growth expectations, increasing upward pressure on operating costs and questionable exit expectations further on the horizon'. In 2008, it is evident that liquidity in the market has been drastically reduced, RevPAR expectations have been revised downward, and transactions have slowed considerable.

The second quarter 2008 Hotel Horizons forecast of PKF-HR called for U.S. hotel RevPAR to increase just 1.5 percent in 2008. This pace of RevPAR growth is below the long-term average of this performance indicator. Declining economic fundamentals, fueled by the turmoil in the capital markets, portend a much weaker domestic economy for the months ahead.

The forecast RevPAR gain of 1.5 percent should translate into a 1.0 percent gain in total revenue for the average hotel in 2008. Hotel managers will do their best to control their costs, but we are projecting an anemic 2.9 percent increase in unit-level profits for the year.

### **Survey Results**

With an outlook for sluggish operating environment in 2008, PKF-HR surveyed active hotel lenders, developers, and investors to monitor their perception of current and future conditions in the hotel investment marketplace. The following paragraphs highlight the findings of PKF-HR's 2008 Hospitality Investment Survey.

The average capitalization rate for hotels of 9.43% increased 30 basis points from the last year. The increase is mostly attributable to the lack of liquidity in the capital markets.

Discount rates, or un-leveraged IRR's, for hotels increased to 13.13%. The 3.7% spread between the over-all capitalization rate and discount rate suggests owner's expectations for growth in net operating income over the rate of inflation.

Debt coverage ratios increased significantly to 1.45 suggesting that lenders are more cautious in their underwriting.

Loan-to-value ratios decreased from the previous year indicating that lenders are looking to protect themselves from potential delinquency and default.

Interest rates remain close to historical lows as the Federal Reserve continues to lower their base rate charged to commercial banks.

### **Capital and Transactions**

Much as been written about the credit crisis that began in earnest in early 2008. The transaction market for hotels in early 2008 has been significantly impacted by the lack of liquidity in the capital markets. There is now a major resetting and de-leveraging in real estate markets based on the problems in the bond markets related to the sub-prime housing problems. Loan-to-value ratios are decreasing, debt coverage ratios are increasing, and the resulting capital stack costs are on the rise. Although floating and fixed interest rates remain attractive, the required rate of return on a larger portion of equity and the increased cost of mezzanine financing results in upward pressure on capitalization rates. Additionally, where there may have been a potential of 10 or 12 debt/equity participants for any given transaction in 2007, now there are only three or four participants actively seeking each transaction.

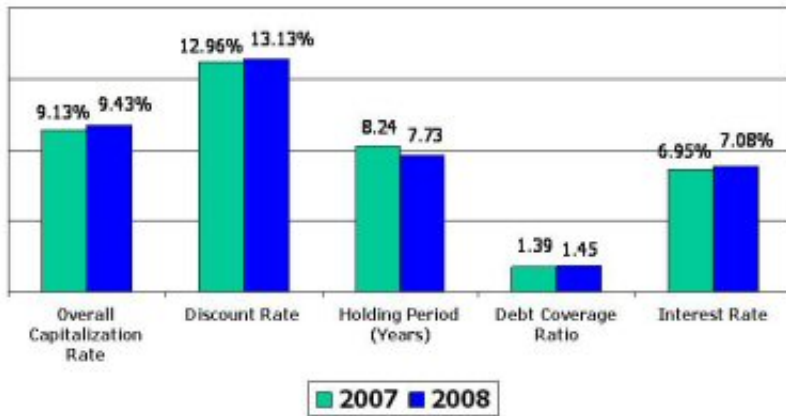
The uncertainty of the capital markets and the declining growth in income projected for the hotel market has increased the perceived risk premium for most hotel investors. As a result, the difference between current hotel owners/sellers expectations and buyers today is very wide. Investors are fearful of near-term downside risk and see uncertainly and unreliable upside. This will result in fewer transactions in the near term.

As the capital markets begin to stabilize and attendant risk premiums begin to moderate, we anticipate an accelerated pipeline of new transactions. It will be up to the sellers to determine if they want continued dividends (hold) or redeploy capital (sell). As investment bankers have exited the market, traditional commercial banks and institutional money will provide the majority of capital for hotel investors. This will limit the size of any one transaction forcing portfolio and large dollar (\$50 million+) transactions to occur in late 2008 or 2009. Property appreciation, as seen during the past several years, is not expected to be realized in the short term.

### **Summary**

As one respondent indicated, 'the party is over'. Most investors indicated that this time around, the downturn in the lodging sector will be short-lived due to moderate increases in supply and continued upward pressure in construction costs. Once the liquidity crunch/crises moderates, market fundamentals such as supply/demand balance and anticipated growth in NOI will be the focus of hotel investors. The expectations favor capitalization rates to rise and that hotel values in the short term will decline. Only those sellers that have to sell - will, and at a discount. As in past downturns, distressed hotel sales taint the overall health of the hotel investment market. Those owners with good quality assets in premium locations will hold for dividend yield and wait for the next cycle.

## SELECT INVESTMENT CRITERIA FOR U.S. HOTELS



Source: PKF Hospitality Research, 2008 *Hospitality Investment Survey*

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