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# Checking in on the Hotel Market

A bifurcated lodging industry may be fixing to stay awhile

**MUCH OF THE PRESS REGARDING THE** hotel industry makes it appear that the hotel sector is recovering and that profitability is returning. Although average daily rates, occupancy and revenue per available room (RevPAR) have increased from their 2010 values in many markets, the majority of hotels are running significantly below their performance of a few years ago. The industry is also finding it difficult to shave expenses, and labor, utilities and amenity creep are eroding net operating income, despite increased business.

Commercial mortgage brokers who know what's happening in the hotel industry — where deals are being made and why — can help their investor clients make the best decisions about new and existing properties.

## The state of the market

The hotel industry is improving from some of the worst times it has experienced in decades. Every market possesses its own characteristics, but most hit bottom in 2009. Although buyer competition exists for certain property types in specific markets, many hotels cannot find a buyer at any price.

Obsolescence issues are becoming more pronounced, franchise requirements are increasingly stringent and many cities no longer need as many hotel products as already exist. Although some niche investors are seeking hotels to convert to senior housing or extended-stay accommodations, these buyers are few and far between. The lack of new development in the pipeline is among the best news for existing owners.

## What hotels are trading?

Publicized hotel sales are a main reason behind the perceived optimism in the hotel world. Because many of the anticipated

foreclosures and distressed situations have not occurred, when a hotel that meets the parameters of the real estate investment trusts (REITs) and opportunity funds hits the market, everyone wants it. Fiercely competitive bidding is causing trophy properties in gateway cities to trade at high prices with low capitalization rates. Hotel funds and REITs have large sums of equity at their disposal and can afford to buy debt free or with low leverage.

Most hotel properties are not located in gateway cities, however. Non-trophy assets in secondary and tertiary markets are still difficult to finance, largely because they are turnaround situations. If a hotel is highly profitable, the large amount of equity required to purchase the property often makes the deal not feasible. The lack of hotels penciling out coupled with the still large disparity between buyers and sellers is making the hotel transaction market less robust than expected.

Additionally, consumers are changing what they are looking for in a hotel. To many travelers, hotels have become a commodity, partly because third-party booking engines make price the key determining factor in booking a room. Loyalty programs offered by the top brands are another major influence. Business travel has decreased, and other travelers have traded down from full-service hotels to limited and select-service offerings. It is still unclear if these travelers will return to full-service hotels when the economy recovers further. Although numbers certainly have increased in select areas, most markets are nowhere near where they were in 2007.

## What are lenders financing?

Many investors and lenders forget that hotels are market and product-type specific. Why

are lenders eager to finance limited-service hotels located on interstates where the only demand generator is drive-by traffic? In this instance, lenders focus almost solely on the strong net operating income and franchise affiliation, failing to notice that: the selling price is close to replacement cost; franchise agreements are nearing their end; and demand generators are not diversified.

At the same time, lenders may decline a turnaround situation — even with a differentiated product in a market with varied demand generators, where even after renovation the base price can be half the replacement cost. It seems that lenders are more focused on recent historical performance and sometimes ignore longer-term chances of success.

Today, opportunities in the hotel industry are available to investors who know that a hotel is more of an operating business than real estate. The new hotel owner will find the upside in the business — whether it's in increasing revenues from a franchise change, property enhancements or improved operations. The biggest challenge may be forecasting when lenders will once again embrace hotel financing, for trophy and non-trophy assets alike. ●

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