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# Is It The Right Time To Invest In U.S. Hotels?

*The Covid 19 pandemic has caused many issues for real estate investors. In the lodging sector, in particular it is making it more challenging than ever to properly evaluate hotel investment opportunities. Uncertainty associated with forecasting future operating performance levels has pushed many of the conventional hotel debt and equity capital sources to the sidelines. We believe that this uncertainty, however, affords private capital investors a unique opportunity to bring experienced and attractively priced capital solutions to the U.S. lodging sector. As such, we believe that if you are knowledgeable and selective,* ***this period will prove to be an excellent time to buy U.S. hotels****. This article will highlight specific investment evaluation considerations of critical importance to investors.*

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The relative dearth of investment capital and liquidity today for U.S. hotel investment opportunities is a direct result of pandemic-induced uncertainty about the future. There is a growing pipeline of distressed hotel debt and equity investments under pressure and workouts with lenders, and it should be no surprise that much of the current focus among conventional hotel capital providers is on legacy investments and not new originations.

***"Patience may now finally pay its reward, for the past five years it has been difficult to find a value argument in the hotel space. The prudent investor has been very cautious, but now the winds are at the investor's back."*, says Robert Boykin, CEO of Boykin Management Company.**

The current state of the U.S. hotel market presents private capital investors with a timely opportunity to invest into carefully analyzed debt and equity investments that offer the right combination of downside protection and yield. Given the generally accepted outlook for a prolonged recovery for the U.S. hotel market, coupled with numerous potential speed bumps along the way, new lodging investments warrant careful evaluation. This includes fencing in potential risks through structural funding features, without foregoing attractive returns, and working with at least two motivated and consenting parties (the existing owner and the current lender). Certain U.S. hotel owners appear increasingly willing to explore outside capital solutions that offer the flexibility designed to act "in the best interest of the property" and provide an opportunity to "live to see another day". Private capital investors should selectively explore these opportunities.

***"We're already seeing a generic 15% to 20% decline in hotel values from pre-pandemic numbers. We are, however, only at the front-end of this. Near-term, hotel purchase cap rates are going up", says* Tim Dick, co-Leader of Hospitality Asset Management & Investment Services at CBRE.**

*"Location, location, location"*, as coined by British real estate tycoon Harold Samuel, is once again proving to be an accurate predictor of U.S. hotel operating performance and value. Locations across the U.S. in drive-to markets are currently showing relative strength, as leisure and corporate travelers alike pursue limited domestic airline travel in favor of road trips. Hotels in these drive-to markets therefore are performing comparatively better than properties located in high-cost, urban, and gateway fly-to markets. We do not expect to see a meaningful change in this situation until mid-year 2021.

There are additional important considerations when evaluating hotel investment opportunities. Product segmentation being one. The U.S. lodging market is currently exhibiting noteworthy differentiation in performance among hotel segments. At one end of the performance spectrum, Extended Stay hotels appear to offer more predictable cash flow in today's pandemic market. In its *"The 2020 Mid-Year U.S. Extended-Stay Hotel Market Report"*, lodging industry consultant The Highland Group reports that *"extended-stay hotels' occupancy premium (to overall hotel occupancy) is at a record level"* and that *"extended-stay hotels' renewed focus on longer-term guests during the recent contractionary period has resulted in the widest differential between extended-stay and overall hotel occupancy we have ever reported."*

At the opposite end of the spectrum, larger corporate group meeting and convention hotels are struggling. The lack of corporate and association business has rendered many of these large hotels as temporarily obsolete and the path to recovery is projected to be protracted. Some full-service hotels, in particular those that are located in high cost urban areas, will likely be repurposed, others may never re-open. We do not see this juxtaposition prevalent in U.S. hotel segmentation ending any time soon. We therefore suggest that private capital investors in U.S. hotels should avoid investing in properties substantially reliant on meeting & group business. Hotel segmentation should be viewed as a critical investment evaluation consideration. More so today than perhaps ever before.

The choice of a hotel operator has never been a more important than it is today when evaluating an investment decision. Over the past 10+ years of U.S. economic expansion, selecting a hotel manager may at times has been reduced to a minor consideration for some owners and investors. Hotel cash flows and values appeared to be on a never-ending upward trajectory. To some, there were limited perceived performance differences between the top 25, or even top 50 U.S. hotel managers.

***"As a hotel lender, we carefully review the experience and competency of the hotel manager. We see some of them struggling right now. As financing for the U.S. lodging market gradually improves, we expect this manager review will require an even deeper examination of the manager's future wherewithal", says Peter Morral, Co-Head Originations for Granite Point Mortgage Trust.***

Certainly, there are important manager considerations such as a manager's market coverage, corporate resources and infrastructure, experience negotiating and managing multiple brands etc. However, we don't subscribe to the view that any large manager can manage any property. There are new and equally important items that require increased consideration today. During the pandemic and resulting economic disruption, hotel managers are increasingly stretched thin, their monthly fee compensation is at or near a record low, while the duties imposed upon them by hotel owners has never been greater.

Some of these managers wrestle with substantial portfolios of hotels under management heading in the wrong direction performance wise, which cannibalizes the manager's time and internal resources. Other managers may fail a going concern test if a substantial number of hotels they manage are transferred back to lenders and their fee spigot is further reduced. For private capital investors it is imperative to strike the right balance between the experience and the continued ability of the hotel manager. For these reasons, and subject to proper vetting, today's market presents a particularly opportune and prudent time to carefully identify and hire the manager most suited to the situation.

As the U.S. lodging market moves further along the timeline of the current pandemic, evaluating hotel investment opportunities requires adherence to traditional valuation considerations with the addition of some needed refinements. The conventional hotel valuation by investors typically incorporates three complimentary valuation methods in order to establish and test the reasonableness of value: Comparable Sales, Cost, and Income Capitalization Approach.

The conventional Comparable Sales method provides limited benefit in today's pricing of hotels. There has been limited sales data points post-pandemic and the few sales that have occurred have typically been distressed in nature. While we expect hotel transaction volume to gain steam later this fall and into 2021, we expect many transactions will violate the basic principles of establishing a market value; an open, broad-based offering by a Seller free from duress.

*"U.S. hotel transaction volume is down substantially over the numbers we've become accustomed to in recent years. Overall, the market continues to exhibit a meaningful bid / ask spread. We believe, however, given changing market conditions, that this spread will tighten and transaction volume will increase. There will be opportunities for well capitalized investors to take advantage of in the coming quarters. ", says Lee Hunter, COO at Hunter Hotel Advisors.*

We also find that the Cost method is not relevant for majority of U.S. hotels, at this moment in time. However it often strengthens the case for investment when acquisition pricing is well below the cost to actually replace the asset. Due to recent years' rapid increase to hotel construction costs there is no longer a correlation with cost to build and the near- to mid-term outlook for hotel operating performance. While we already observe trends that costs of land and construction for hotels are course-correcting themselves downward, only certain hotel segments will warrant consideration for new construction projects. However, this will gradually change as the U.S. economy and lodging market recover and private capital investors should be prepared to pivot at that time.

The Income Capitalization Approach remains as the primary method by which private capital investors decipher today's market value or price for a hotel. It is as part of this approach the aforementioned location attributes, segmentation and operator profile pertinent to an investment opportunity can be incorporated. In today's market, the Income Capitalization Approach requires enhanced levels of thoughtfulness and caution that has not been practiced by many in recent years.

Because of the significant performance stress test underway across U.S. markets, hotels currently do not readily lend themselves to a simple, direct capitalization valuation of a single year's NOI. This valuation technique simply lacks the ability to properly capture real time recovery as well as long term performance. Moreover, it fails to consider potential current and future projected periodic shortfalls to hotel operating cash flow, which may impact a hotel's ability to pay current on operating expenses and interest payments..

Therefore, while the direct capitalization valuation may be applicable when examining the future, stabilized value of a hotel, it is not adequate for the purpose of today's purchase-making decisions.

Hence, the proper method for performing an Income Capitalization Approach for evaluating hotel investments today necessitates a thorough and cautious discounted cash flow ("DCF") projection. The analytical model should incorporate a longer-duration financial performance projection together with a detailed review of budgeted reserves for operating- and debt service shortfalls. Operating and interest reserves capitalized upfront to cure projected periodic shortfalls are generally very costly to equity on a time-value basis; but the alternative is usually even more punitive and challenging to execute on as follow-on capital calls require equity investors to reach into their pocket to protect their initial investment. The DCF analysis should be supported by a comprehensive analysis of break-even investment scenarios. We submit that private capital investors should only make hotel investment decisions if all of these analytical reviews have been performed.

In conclusion, despite perceived market weakness and negative headline risk, we see attractive risk-adjusted opportunities for private capital to invest in the U.S. lodging sector. With a focused, cautious, and experienced eye on specific investment evaluation considerations that include investment structure, hotel segmentation, investment selection, cash flow modeling, and hotel management selection, we believe the U.S. lodging market currently offers attractive risk-adjusted trades. In other words, if you are knowledgeable and selective, it should prove to be an excellent time to buy hotels in the United States.

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