PKF Capital brokered the sale of Hotel Vintage Plaza in Portland, Ore. (shown here)

VACANCY RATE

THE PRICE OF OIL IS AFFECTING THE ECONOMIES OF NORTH AMERICA—AS WELL AS THE HOSPITALITY INDUSTRY—AS THE PRICE OF FUEL, FOOD AND, SUBSEQUENTLY, AIRLINE TICKETS RISE. BOB EATON, EXECUTIVE MANAGING DIRECTOR OF PKF CAPITAL—A REAL ESTATE INVESTMENT ADVISORY FIRM FOR THE HOSPITALITY AND LEISURE INDUSTRIES—SHARES HIS INSIGHTS ON WHAT'S IN STORE FOR 2008 AND BEYOND.

HOTELS are a unique form of commercial real estate. Existing to meet the needs of the public traveling for both business and pleasure, the economy's health directly affects their demand—as an economy grows or contracts, so goes the need for lodging. This relationship affects the day-to-day business of hotel operations and, similarly, any related real estate investment.

Virtually all forms of commercial real estate rely on lease commitments to provide income stability over extended periods of time. Hotels have to "re-lease" their premises daily and the hotel's tenancy is continually evaluating alternatives in light of a changing economy. Often those alternatives include new properties, which create more competition and dilute a market area's occupancy and room rates.

The cyclical nature of the lodging industry and the economy enables us to forecast the performance of North American hotels. We know that eventually market performance will revert to long run average levels. What goes up must come down and vice versa. Investors in lodging at any level must consider these macro economic trends and apply them to specific local market supply and demand conditions.

Just a short time ago, investment in hotels and resorts was relatively straightforward. There was abundant and cheap debt available and all the industry fundamentals were positive. Lodging was the darling of the financial and investment markets, as it provided a premium return over more mundane investments in industrial facilities, office buildings and shopping centers. Record numbers of transactions took place as existing owners enjoyed their profits and new owners were poised to continue the trend.

That all changed last year with the collapse of the commercial mortgage-backed securities market and the subsequent infection that has spread throughout our financial and property markets.

Now, investment in hotels and resorts is more difficult and complex. As the lodging markets' performance flattens, debt becomes more difficult to source. The result is hotel values across the U.S., on average, are off at least 10 percent, the mortgage market is thin, and transaction volume is far below 2005-2007 levels. According to Real Capital Analytics, hotel transactions nationwide are off by as much as 70 percent this year.

In the United States, PKF Hospitality Research (PKF HR) reports that first quarter occupancy rates have dropped 2.7 percent, however room rates during the same period are up nearly 5 percent, resulting in overall RevPAR (revenue per available room) being up nearly 2 percent. The firm actively tracks 50 major U.S. lodging markets for average daily rate and occupancy. One indicator of a given market area's strength is expressed by the relationship of projected RevPAR growth compared to a CPI (consumer price index). Of the major markets, 35 were projected to have RevPAR growth above CPI levels in 2008 with only nine markets expected to fall below. In just a few months that outlook has changed. According to Mark Woodworth, head of PKF HR, "Only 22 markets (less than half) will surpass CPI growth in 2008 and of note, an almost equal number, (21), will fall below CPI pricing increases this year."

The North American lodging industry is continuing a recovery that began in 2002, accelerated dramatically in 2004, and began to slow near the end of 2006. In this cyclical industry, it was assumed that this dip marked a low point and the industry would be headed toward new highs. Not so. A second dip came at the end of December 2007, largely due to the weak economy and the subprime mortgage debacle. PKF expects this second dip to run through November 2008. It's a challenge for owners and operators today to get capital for renovations and joint ventures and partnerships may be formed on the ownership side to counteract the industry being over leveraged.

Moreover, the near doubling of crude oil prices has helped keep travelers closer to home and made airlines add surcharges, such as fees for extra baggage. And what affects the airline industry certainly affects the hotel industry. According to data from PKF HR, hotels in the United States could face a decline in lodging demand greater than that experienced during the turmoil after 9/11. In a worst-case scenario, a 1 percent decline in the number of seats flown within the U.S. will result in a 0.39 percent decline in the demand at the nation's hotels.

"Many industry participants have been speculating about the spillover effect a deteriorating airline industry will have on hotels," says Woodworth. "Our research measured the historical relationship between these two components of the travel industry. This allowed us to project just how much business hotels stand to lose given the cutbacks in capacity announced by the major airlines."

One reason the markets have been able to remain relatively stable is the absence of massive new supply, which usually follows periods of prosperity in lodging. With rising construction costs making some major hotel development projects difficult to rationalize, a number of developers are combining luxury hotels with a strong residential component for a more feasible model.

In some of these developments, individual guest rooms are sold as condominiums, enabling the owners to occupy the units at will but also share in any operating profits by leasing them to hotel guests. According to Smith Travel Research, there were 55,411 condo/hotel units in the active development pipeline nationwide in 2007. Many of these "hybrid" hotel development projects feature major brand names like Ritz-Carlton, W Hotels and Resorts, and Four Seasons Hotels and Resorts.

"Those properties will all do very well because these names are the gold standard," explains Hank Wolpert, PKF Capital's senior managing director based in Dallas. "Where you run into problems is when everybody starts doing it." In the central business district of Dallas, Wolpert says there are approximately 10 high-rise condo projects, several of which include hotel components going up at the same time and only a few, he feels, will be successful because the construction is outpacing the absorption rate.

A similar story is evolving in Seattle, where over the past five years, lenders willingly financed the developers of a number of condo towers with a hotel component. There's now a glut of these residential condo units unsold and the developers have resorted to renting the units. At others, such as 1 Hotel and Residences, construction has stopped altogether.

Where and how you do business, however, can make all the difference.

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The bread-and-butter business of Chris Burdett, senior managing director at PKF Capital in Seattle, is hotel transactions that range anywhere from $5 million to $25 million. That continues to be the bulk of the transactions he is seeing in this current market.

In the last three years, Burdett says the Seattle/Portland, Ore., market produced more than $250 million in these transactions. He was the broker in the sale of the Hotel Vintage Park in Seattle and the Hotel Vintage Plaza in Portland. These assets went to the Newport Beach, Calif.-based Clearview Hotel Capital LLC and Westbrook Partners LLC of New York City.

The Northwest region of the U.S. is somewhat insulated from the problems plaguing other North American markets because of employers like Microsoft, Boeing and Amazon.com. Burdett doesn't expect any changes in the next two to three years, although bookings overall in the region are down a bit—the average hotel occupancy in Seattle fell about two points in the first quarter of 2008 compared with the same period last year.

He notes, however, that growth in other industries, particularly the cruise industry, is contributing toward stronger hotel revenues. Cruise ships call to port in Seattle 270 times a year now, and each visit means $1.2 million spent on lodging, shopping and restaurants.

"We've had that for eight years, but it keeps growing," he says.

Texas, too, is flush with opportunity.

There's talk that Liz Lamburt, owner of the boutique Hotel San Jose in Austin, may add another property in Houston. And a massive 517,000-square-foot city block of downtown Houston containing a Marriott Courtyard, Residence Inn, an apartment tower, street-level retail and a parking garage, has just been put on the market and is expected to sell quickly.

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While the national lull put some investors in a holding pattern, others are taking action and spending where deals can be made, Wolpert says. Investors, who normally might try for product in California or the East Coast, are seizing the inexpensive opportunities in his region.

"It's interesting because if you go to the industry conferences, you hear some major players say, 'we're focusing on the East Coast and West Coast, or high end resorts,'" Wolpert says. "But we still see a lot of interest for Texas due to lower property costs, the easier regulatory environment and weather that allows for faster construction timing. Texas is a good place for many buyers today, including those seeking 1031 exchanges from the coasts." Also promising is the Barnett Shale natural gas field just west of Dallas. It's the biggest source of natural gas in the country and, Wolpert notes, will contribute mightily to the region's long-term growth.

The Canadian hotel market reports healthy RevPAR growth, increasing at a compound annual rate of 5.3 percent since 2003. Western Canada continues to realize strong growth, particularly Alberta, as a result of the thriving economy bolstered by the oil and gas sector. British Columbia has also enjoyed strong growth as the province prepares for the 2010 Winter Olympics, as have Saskatchewan and Manitoba given their diversified economies driven by the energy and grain sectors. Although Ontario, Quebec and the Atlantic provinces haven't seen as robust growth, they continue to witness positive trends thanks to the controlled supply growth. "We are seeing growth in RevPAR this year, but it's been tempered, given the impact of the slowdown in the world economy," says Alam Pirani, executive managing director of Colliers International Hotels.

He adds, "While transaction volume has no doubt slowed due largely to the impact of the debt markets, the appetite for hotels remains strong in Canada because of positive fundamentals. Hotel construction, which has largely been in the select or focused service sector, has slowed with lenders being very selective on projects and sponsors."

In markets like Vancouver and Toronto, there are several mixed-use luxury hotel-condominium projects under construction. Pirani singles out Montreal as the exception. "There's a Westin Hotel that's currently under construction and an Embassy Suites Hotel that recently opened in the downtown core. Those are anomalies, as luxury or full-service hotel developments don't pencil out unless you have a 'for sale component' like residential condominiums that improve the economics of the project." He says that Montreal, which has a unique and distinct European feel, has always attracted investment capital.

Pirani's partner, Bill Stone, executive managing director of Colliers International Hotels, sees 2008 as very active with two- to five-star assets coming to market. "Assets that are at the end of their investment cycle, or requiring refinancing or rebranding, are prompting owners to sell. Today's acquirers include REIT's (real estate investment trusts), pension funds and private investors, as they tend to be well-capitalized and have deep lending relationships that transcend the difficult financing environment," he says. Stone expects limited downward pressure on pricing as the overall operating fundamentals of the Canadian lodging market remain stronger than its U.S. counterpart.

Down the coast in San Francisco, Mark McDermott, senior managing director of PKF Capital, says the city "has risen well above the nadir of its dotcom bust days and is now thriving." Severe restrictions on the availability of land for new hotel development, a dynamic economy being pushed by bio-tech giants like Genetech, an expanded and efficient convention center, and increasing international tourism have all contributed to a lodging market whose performance has been well above national trends. According to PKF's first quarter *Trends in the Hotel Industry*, San Francisco's RevPAR is up 12 percent over last year's. McDermott adds that the San Francisco airport market has shown a 23 percent RevPAR increase during the same period.

Investors are also looking for great deals in harder hit areas such as Miami, Las Vegas and Phoenix.

And the economy continues to show signs of slow, steady growth. No one knows for sure if there's going to be an unprecedented triple dip, but experts remain optimistic. PKF Captial has examined the economic forecasts of Moody's Economy.com, which predicts recovery, and translates that into rising demand and occupancy from 2009 through 2010. At that point, when long-term occupancy levels have been reached, pricing power will shift back to hotel management and average daily growth rates should begin to accelerate.

Investments in hotels will always be tied to local economic conditions and the availability of capital. With a return of a strong financial sector and a recovering economy, people will continue to travel for business and pleasure and the outlook for North American hotels will be rosy into the next decade.