



US Financial Turmoil and the Hotel industry

The Wall Street Bull was created by Arturo Di Modica as a Christmas gift to the people of New York. It has become the symbol of aggressive financial optimism and prosperity. Today the statue might as well represent Sovereign-Wealth Funds

Since the subprime-mortgage fiasco unfolded last summer, the US economy has been under tremendous pressure. From the weakening of the US Dollar to the emergency sale of Bear Stearns, the 2001 Enron scandal now seems to be a blip in comparison. Today, the US economy is either in recession or near one.

While the Federal Reserve is battling to restore confidence, the hotel industry is already experiencing collateral damage. Hotel investors are experiencing the repercussion of the credit crunch, which is making banks less willing to lend money and spending has slowed.

What is the impact of the current state of the economy on the US hotel industry and what are the opportunities for foreign investors? Can we benefit from these troublesome periods?

HISTORY REPEATS

In early 2001, the signs of an economy slowdown were apparent and 9/11 accelerated the cycle – in a way shortening the recession. The situation was fundamentally much sounder with higher debt coverage ratios and lower loan-to-value ratios than we see today.

To find similar trends to the current situation, we have to go back to the 1991 crisis (Gulf War and concurrent recession of 1990/91). At the time, hotel assets were highly leveraged, with loan-to-value ratios well over 75 per cent and financing was very favourable to borrowers with very low debt-coverage ratios. In addition, many lending institutions that underwrote loans were themselves undercapitalised and unsound.

Defaulting on loans created significant downward pressure on hotel values. The market correction, which many had predicted, took place and the loan-to-value ratio decreased to around 65 percent and 70 percent, whilst the capitalisation rate rose as the result of changes in the lending environment. So what are the direct consequences and what can we learn from the past?

IMPACT ON HOTEL INVESTMENTS

Since the middle of 2007, the hotel investment market has ground to a halt, with buyers, sellers and lenders re-evaluating their strategies. Lack of liquidity and strict loan requirements are slowing down acquisitions on the buyer side. Estimating how much hotel values have decreased is still difficult as very few hotel sales have been made recently. According to global consultancy hospitality firm HVS, sales activity in 2007 declined by approximately 6 percent compared with 2006 figures and over 75 percent of sales in 2007 occurred during the first six months of the year. Currently most lenders are taking a ‘wait and see’ attitude, but the combination of higher capitalisation rates and impaired cash flow is expected to result in significantly lower hotel values.

Like in 1991, some hotels are expected to trade at liquidation prices and may represent an enticing prospect for opportunistic buyers. The main exceptions to this model are properties with strong track records (for instance:

trophy assets or hotels located in 'high entry barrier' markets). They will maintain a more robust cash flow even with the economic slowdown.

As a direct result of lower hotel revenues and values, we can expect more consolidation as hotel operators seeking to extend their penetration and distribution, and investors, institutions, banks, and private equity and investment funds strive to gain maximum exposure and seek to achieve economies of scale and maximise shareholder value.

OPPORTUNITIES FOR FOREIGN INVESTORS

As equity investors invest greater portion of the capital in the industry due to the limited activity of Wall Street lenders (for instance: Bear Stearns and Merrill Lynch), they will turn to other sources of financing (for instance: private lenders and pension funds); however, these US investors are

Some ways of maximising the chances of securing a profitable investment:

- Select cities with broad demand-based market segment: e.g. San Francisco was dependent of the '.com' companies and when the bubble burst in 2001, this market took a longer time to recover than others
 - As important as "location, location, location", is "DD, DD, DD". Due Diligence processes are a key. Understand what you are buying; what the property's condition is etc. Legal DD, Technical DD, Financial DD are all vital
 - Market research: focus on current and, most importantly, new supply. Cities with high entry barriers are the best options. Weaker markets with low entry barriers will face the largest declines in value.
- Trophy assets in major cities will have a small value decrease due to foreign interest, but investors would do better looking for opportunities in second-tier cities



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having difficulty in obtaining financing. This lack of liquidity provides advantages to foreign investors. Many investors from the Middle East or Asia are cash rich and on the lookout for good investment opportunities with the weaker dollar making buyout targets even more attractive.

Actually, most US hotel REITs (real estate investment trusts) are trading below their Net Asset Value, due to the depressed state of the equity market. We can expect that sovereign-wealth funds will express interest in these REITs and may acquire large portfolios. Whether individual assets or large portfolios are sought, the challenge will be to determine which opportunity offers the fastest upside and how to capitalise on the eventual recovery in share price.

- When you buy, plan your exit strategy: negotiate favourable terms to terminate the operator contract and buy out partners; minimise tax exposure

More than ever during this financial turmoil, asset managers acting on behalf of hotel owners should use their expertise to provide the best possible analysis of market conditions and potential acquisitions. They must monitor new investments very closely while maintaining high returns and ensuring that the ongoing management of current properties is exemplary.