Despite Age-Old Risks, Opportunities Abound in the Hotel Industry

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Generally, it's a great time to be in the hotel business—and a great time to be consulting in hotels-because everything you say is upbeat and good. No matter where you are in the world, it's almost universal that the hotel industry is doing well, particularly in the United States.

But there's always risk. Some of the major risks of investing in hotels are over-building, economic lifespan and natural disasters. We'll touch upon each of these issues briefly.

The first risk is over-building. People say the best thing for a hotel is location, location, location. I say it's barriers to entry, barriers to entry, barriers to entry. You want to be in a location where the competition isn't going to build another hotel. In the United States this could be anyplace on the coast, especially in California and the Northeast. The Southeast is not as good—it's very easy to get things built down there.

If you look at any of the downturns in the hotel industry, they're because of over-supply. The reason the hotel industry is doing so well now is because the supply has been in check for about the last five years. It doesn't look like we're going to get a whole lot of new hotel supply coming in on a macro basis in the United States. Some markets will get over-built, but for the most part it's pretty well under control.

A number of factors have led to this situation. First, it's very difficult to finance new construction in the hotel industry today. The cost of building a hotel, particularly a five-star hotel, is another barrier to entry because the chances are good that the developer could end up with a hotel that costs more than its economic value.

The Battle Against Obsolescence

Then we have economic lifespan, or the fact that hotels suffer from physical deterioration, external obsolescence and functional obsolescence. Take, for example, the original Waldorf-Astoria Hotel built at Fifth Avenue and 34th Street just before the turn of the 19th century. It was torn down to build the Empire State Building only 34 years later. So the original Waldorf-Astoria in New York lasted less than four decades. It was moved over to Park Avenue and has been there ever since, but what's interesting is the concept of economic life.

My company verified a study that found the economic life of most hotels is about 41 years. That sounds fairly reasonable, but consider the standard deviation. That is the risk of investing in hotels (see Table 1). You don't know within one standard deviation whether your life is going to be 20years or 60 years. Therein lies the problem.

Table 1: Economic Lifespan

	Life in Years	Standard Deviation
Hotels	40.91	20.63
Motels	31.00	6.87

Other significant problems are external and functional obsolescence. Motel-type properties built through the decades are rather obvious. The exteriors really date the properties, which means hotels that are more than 20 to 30 years old need major external renovation.

When you go inside the hotel you can also date it by what the decor looks like. When you really think about it, has the interior of a typical hotel room changed? You walk in, you have a bathroom on the left, a closet on the right. You walk in a little bit farther and have a bedroom with a bed and dresser and table and so forth. Things haven't really changed; what changes is the decor. Maybe it's a conspiracy of interior designers to constantly change the style of hotels, but this is the reality that hoteliers face so they have to constantly put money back into their properties.

Natural Disasters Can Be a Boon to Business

The industry has experienced many hotel disasters recently. In New York City, the Sept. 11 terrorist attacks damaged numerous properties, but HVS studies show that a hotel disaster can actually be good for a local area from the hotel point of view. The research also indicated that travelers are very resilient. The New York City attacks made an impact on the city for about three months. After that the city went through a huge recession, but it had nothing to do with the attacks.

Other hotel disasters had only a two- or three-week impact. Certainly the December 2005 tsunami decimated that part of the world, but most of the hotels have been rebuilt and they're all doing well. Once the SARS virus was under control in Hong Kong, the hotels filled up again. So things happen and turn around very quickly after a hotel disaster.

Another example is Hurricane Katrina, which hit New Orleans in September 2005. By the end of 2005, the value of a typical hotel on a per-room basis went up about $11,000. Why? Because the hotels were filled; not with travelers, but with FEMA employees and insurance adjusters.

Luckily, the French Quarter is still vibrant, and the future is very bright for the hotel business in New Orleans because almost every group in the United States is saying: “We have to go and support New Orleans.” In the next five to 10 years, tourism should increase, so it’s an excellent place to invest in hotels. The same is true in other hurricane-ravaged cities around the United States. Hotels that are still standing after a hurricane do extremely well. Owners just have to get them up and operating to benefit from everyone who’s coming in to help recover.

Values Increasing in Most U.S. Markets

Now for the numbers (see Table 2). These figures are somewhat U.S.-centric—HVS tracks the values of a typical hotel in 65 U.S. markets—but show the value change on a per-room basis, a percentage change and a change per room for a typical U.S. hotel starting in 1987.

Table 2: Value Change—United States

	1987	1988	1989	1990	1991
Value Per Room	$37,000	$37,000	$38,000	$37,000	$27,000
Percentage Change		0%	3%	-16%	-16%
Change Per Room		$0	$1,000	($6,000)	($5,000)
	1994	1995	1996	1997	1998
Value Per Room	$37,000	$45,000	$50,000	$59,000	$60,000
Percentage Change	12%	22%	11%	18%	2%
Change Per Room	$4,000	$8,000	$5,000	$9,000	$1,000
	2001	2002	2003	2004	2005

Value Per Room	$52,000	$52,000	$51,000	$65,000	$82,000
Percentage Change	-25%	0%	-2%	27%	26%
Change Per Room	($17,000)	$0	($1,000)	$14,000	$17,000
	2008	2009	2010	2011	2012
Value Per Room	$107,000	$107,000	$102,000	$98,000	$94,000
Percentage Change	5%	0%	-5%	-4%	-4%
Change Per Room	$5,000	$0	($5,000)	($4,000)	($4,000)

We saw a slow increase, then a recession and over-building had an impact in the early ’90s. We had a period of very good growth from 1992 to 2000, with some years such as 1995 going up about 22 percent. The events of Sept. 11 coupled with a recession caused a decrease in typical hotel value of about 25 percent by the end of 2001. The year 2002 was flat and 2003 saw another slight decrease. In 2004, a typical hotel went up 27 percent; 2005 values increased about 26 percent.

So the hotel industry is definitely on the rebound because the economy is strong, people are traveling and the number of international travelers to the United States is growing. The most important factor, though, is that we’ve had very few new hotels constructed. As a result, occupancies go up and rates go up.

Looking to the future, the big questions are: When will the downturn hit, the supply increase or the demand slow down? HVS is projecting that will occur somewhere between 2010 and 2012. But compared with some of the 25 percent downturns, it should be a soft landing. Values will go down fairly slowly because supply shouldn’t increase rapidly. Nevertheless, increases should grow faster than demand, and occupancy will go down.

Overall, the average value of hotels in U.S. cities should increase about $21,000, with more significant increases in top 10 cities (see Tables 3 and 4.) Value in only one market-Norfolk-is projected to decline.

Table 3: Change in Value per Room: 2005 – 2010

Rank	Top Cities		Rank	Bottom Cities	
1	New York	$272,000	57	St. Louis	
2	Oahu	$168,000	58	Albuquerque	
3	San Franisco	$161,000	59	Syracuse	
4	Miami	$137,000	60	Pittsburgh	
5	Washington, DC	$136,000	61	Indianapolis	
6	West Palm Beach	$129,000	62	Sacramento	
7	Long Island	$128,000	63	Houston	
8	Boston	$125,000	64	Tallahassee	
9	Los Angeles	$105,000	65	Rochester	
10	Chicago	$94,000	66	Norfolk	
54	USA Average	$21,000			

Table 4: Percentage Change Value: 2005 – 2010

Rank	Top Cities		Rank	Bottom Cities	
1	Cleveland	180%	57	Las Vegas	26%
2	Denver	102%	58	USA	25%

3	Auston	93%	59	Pittsburgh	20%
4	Tucson	92%	60	Syracuse	19%
5	New York	86%	61	Indianapolis	14%
6	Charlotte	85%	62	Rochester	13%
7	Dallas	83%	63	Sacramento	12%
8	San Jose	81%	64	Houston	12%
9	Long Island	81%	65	Tallahassee	10%
10	San Francisco	79%	66	Norfolk	-4%
58	USA Average	25%			

Volatility Index Hints at Good Investment Markets

Another thing to consider is what HVS calls the index of volatility: the standard deviation of value over a 20-year period of time. To calculate this index, we take the standard deviation of value change for a property or market and divide it by the average value in that market. Right now, the average index of volatility for a typical hotel in the United States is 16 percent (see Tables 5 and 6). So in stock market terms, that's the beta. If you assume volatility is a reflection of risk, the less risky markets are below 16 percent, and the more risky markets are in the 25 percent to 55 percent range.

Table 5: Index of Volatility: Relative Risk

Rank	Top Cities		Rank	Bottom Cities	
1	New Orleans	11%	57	Wilmington, DE	25%
2	Albuquerque	12%	58	Boston	25%

3	Buffalo	12%	59	Oahu	27%
4	San Antonio	12%	60	Los Angeles	27%
5	Pittsburgh	12%	61	Austin	27%
6	St. Louis	12%	62	Oakland	29%
7	Sacramento	13%	63	San Francisco	31%
8	Syracuse	13%	64	Miami	37%
9	Cincinnati	13%	65	San Jose	40%
10	Indianapolis	13%	66	New York	55%
20	USA Average	16%			

Table 6: Low Volatility Index, High Change in Value, 2005-2010

Volatility Index		Change in Value Per Room
11%	New Orleans	$61,000
12%	San Antonio	$55,000
13%	San Diego	$76,000
14%	Seattle	$52,000
14%	Baltimore	$52,000
14%	Santa Fe	$49,000
15%	Jacksonville	$57,000
16%	Tucson	$87,000
16%	Tampa	$54,000

HVS also tracks major transactions-single-asset sales of more than $10 million. The peak was in 1997 with 280 major transactions. As of September, 2006 has seen about 160. About 180 major transactions had taken place through September 2005 so we're a little bit below where we were last year. In all, 237 major transactions occurred in 2005. Per-room values also increased each year. Last year, the average price per room was about $160,000; this year the average transaction is about $204,000 per room (see Table 7).

Table 7: Major Transactions History

Year	Number of Hotels	Number of Rooms	Avg. Price Per Room
1990	130	40,053	$136,000
1991	56	16,489	$96,000
1992	70	26,751	$82,000
1993	53	20,026	$93,000
1994	108	38,579	$81,000

1995	147	48,619	$80,000
1996	227	77,916	$106,000
1997	280	82,867	$117,000
1998	241	78,865	$136,000
1999	128	34,408	$148,000
2000	148	38,759	$125,000
2001	117	29,608	$153,000
2002	105	31,626	$111,000
2003	121	33,292	$138,000
2004	178	56,822	$141,000
2005	237	71,531	$160,000
2006	160	50,816	$204,583
January-September			

Major transactions this year include the Four Seasons Resort on Hawaii's Big Island, which sold for more than $2 million a room; the Drake Swissotel in New York—sold as a tear-down to be rebuilt as condominiums—which went for $888,000 a room; and the Mark Hotel in New York, which sold for $847,000 a room and is going to be converted to condominiums (see Table 8).

Table 8: Largest Sales, Price Per Room; January-September 2006

Year	Individual Hotel	Location	Roon
1	Four Seasons Resort Hualalai	Ka'upulehu-Kona, HI	243
2	Drake Swissotel	New York, NY	495
3	The Mark Hotel	New York, NY	117

4	Ritz-Carlton	Dana Point, CA	393
5	Chatham Bars Inn on Cape Cod	Chatham, MA	205
6	Four Seasons	Washington, DC	211
7	Holiday Isle Resort	Islamorada, FL	151
8	Hilton Times Square	New York, NY	444
9	JW Marriott	Orlando, FL	998
10	Ritz-Carlton	Orlando, FL	584

Markets where I would buy hotels: New Orleans, San Francisco, Boston, San Diego, Washington, D.C., Santa Fe, San Antonio. All of these areas have low supply, high barriers to entry and will do well over the next five to six years. I would sell if I had hotels in Norfolk, Houston or Tallahassee. Values either will go down, or they won't go up very fast. I would be cautious if I had hotels in Phoenix, Portland, Indianapolis or Sacramento.

I would build in Oahu and any location where market value is 10 percent to 20 percent higher than construction costs. Markets with that difference between market value and construction costs are rare.

Boutique and Condo Hotels Gain Popularity

A recent trend in the industry is the boutique hotel, where the rooms have large beds, plenty of comforters and pillows, stylish decor, and the lobby has a trendy lounge and restaurant with a celebrity chef. One of the most famous chain boutique hotels is the W Hotel. That company does a lot of conversions of regular hotels into W hotels and their properties tend to be larger than typical boutique hotels, which have about 150 rooms, but they do extremely well.

There's a W in New York City's Union Square—not the best location—that's under contract and will sell for somewhere between $1.1 million and $1.4 million per room. The cap rate is about 6 percent, so if you figure 6 percent on $1.1 million per room, that's a lot of cash flow to come out of what is considered probably a four-star hotel.

Another trend is the condo hotel, and there are three different types. Two are usually good investments and work well; one usually isn't. The most important element of a condo hotel is its ownership structure.

One type of condo hotel sells individual rooms of an ordinary hotel. The owners take an old hotel and fix it up, then sell each room as a guest room. They don't call it an investment because that would require registering it with the U.S. Securities and Exchange Commission, but they sell to people who want to rent their units and get an income. I wouldn't invest in this structure.

In another type, the condo is a primary residence. For example, the Ritz-Carlton in Boston sold condominiums as primary residences. The units don't go into a rental pool and residents benefit from the services of the hotel.

These types of units are usually branded by the hotel and the synergy works quite well.

Branding these condominiums—calling them the RitzCarlton Residences or Four Seasons Residences or W Residences—causes sale prices to increase 10 percent to 30 percent. That extra selling price subsidizes the hotel portion of the property because of the fact that most Four Seasons or Ritz-Carltons are worth less than what they cost to build. It makes economic sense.

The third type of condo hotel is common in resort areas, where the residential component is sold to secondary home users. The Ritz-Carlton Key Biscayne Florida is a good example. There, condo owners buy a residential component, use it part-time and put it into a rental program so they can collect income when they're not there. This can be an excellent investment and has synergies similar to the primary-residence model.

But the picture isn't completely rosy; let me give you an example. The Plaza Hotel in New York City was appraised recently at about $550,000 per room. A condo converter bought it for $839,000 a room. He'll convert most of the hotel into primary residences, where he's getting somewhere between $3,000 and $4,000 per square foot. So these condos will sell for around $3 million, and will include the privilege of putting it into a rental pool.

It doesn't make sense to me. Why would people pay $3 million when they could have bought the whole hotel for $839,000 per room at the most? To me, that's not a good deal, and this is an example of a condo hotel that could create litigation down the road. These people will pay $3 million and get maybe a 1 percent return on investment because they overpaid by six times or so. So that's the problem I see with condo hotels these days.

Challenges Don't Slow Industry Growth

Now let's consider future trends and challenges. Security is always an issue in hotels, particularly with increasing terrorism. Labor is an enormous headache in the hotel industry. A typical hotel will have complete turnover of lower-level employees every year. It's a huge problem, and nobody's figured out a solution yet.

Technology is always going to be an issue. Because of customer demand, expect to see faster, automated check-in with video monitors as well as Internet and all kinds of advanced communications in rooms. It's a very expensive upgrade for the hotel industry.

Building is going to increase for existing hotels and competitive properties. In Dubai, for example, condominiums are going up behind the Ritz-Carlton and surrounding construction is progressing at an amazing rate.

So what are some of the opportunities? On a global basis, most hotel companies are focusing on two markets: China and India. In these countries, particularly in India, a huge middle class has emerged and people want to travel, but there isn't infrastructure for traveling. So interstate highways and airports are under construction, and this huge middle class is starting to travel. It's just like the U.S. in the 1950s when the government built the Interstate highway system.

Motels are going to pop up at every intersection on the road from Delhi to Mumbai—a huge opportunity. Take that situation and multiply it by three, and you get a sense of what's happening in China. All the big players—the Marriotts, Hiltons, Hyatts, Starwoods-are looking at that part of the world.

In the United States, the big opportunity is the inbound traffic from China and India. The middle class of India and China are about 250 million people, and these people have enough money to start getting out and traveling. Compare this number with the total population of the United States, about 300 million, of which only 20 percent have passports. And the Indian and Chinese middle class will grow go to about 500 million through the next 10 years.

They're going to hit the road, and they're going to come to the United States, especially gateway cities such as New York, San Francisco, Las Vegas and Orlando. The opportunity to serve these people, with their unique needs, is enormous, and cutting-edge hotel companies recognize this. They're designing new hotels and hiring people who can cater to this huge market that's going to travel the world and definitely visit the United States.

Looking Ahead

Some of my observations and predictions:

- We have five to 10 years of very favorable hotel trends in the United States and around the

world. The hotel industry has a strong recovery after adversity, man-made or natural, so don't worry too much about the natural disasters. The industry will bounce back.
- Reinvest and upgrade during the good times. We're in good times now, so take care of external makeovers and upgrade guest rooms with decor and technology. Trendy designs in furnishings have short lives, so if you're emulating boutique hotels, be careful. Those designs may not be trendy five years from now.
- Unfortunately, the hotel industry will be the last industry to save the environment. Through the years the hotel industry has not adopted to environmental initiatives. The only thing hotels tend to do is ask if you don't want to have your towel washed, but that's a miniscule environmental initiative. Hopefully, the industry leaders will turn that around.
- If you sell a hotel room for more than its economic and intrinsic value, be prepared for litigation-a warning for all those condo hotels out there. If the room is not worth the economic value plus an intrinsic value, such as staying at a resort at your convenience, expect litigation.
- Finally, those who are prepared to welcome the middle class from around the world will reap great benefits.