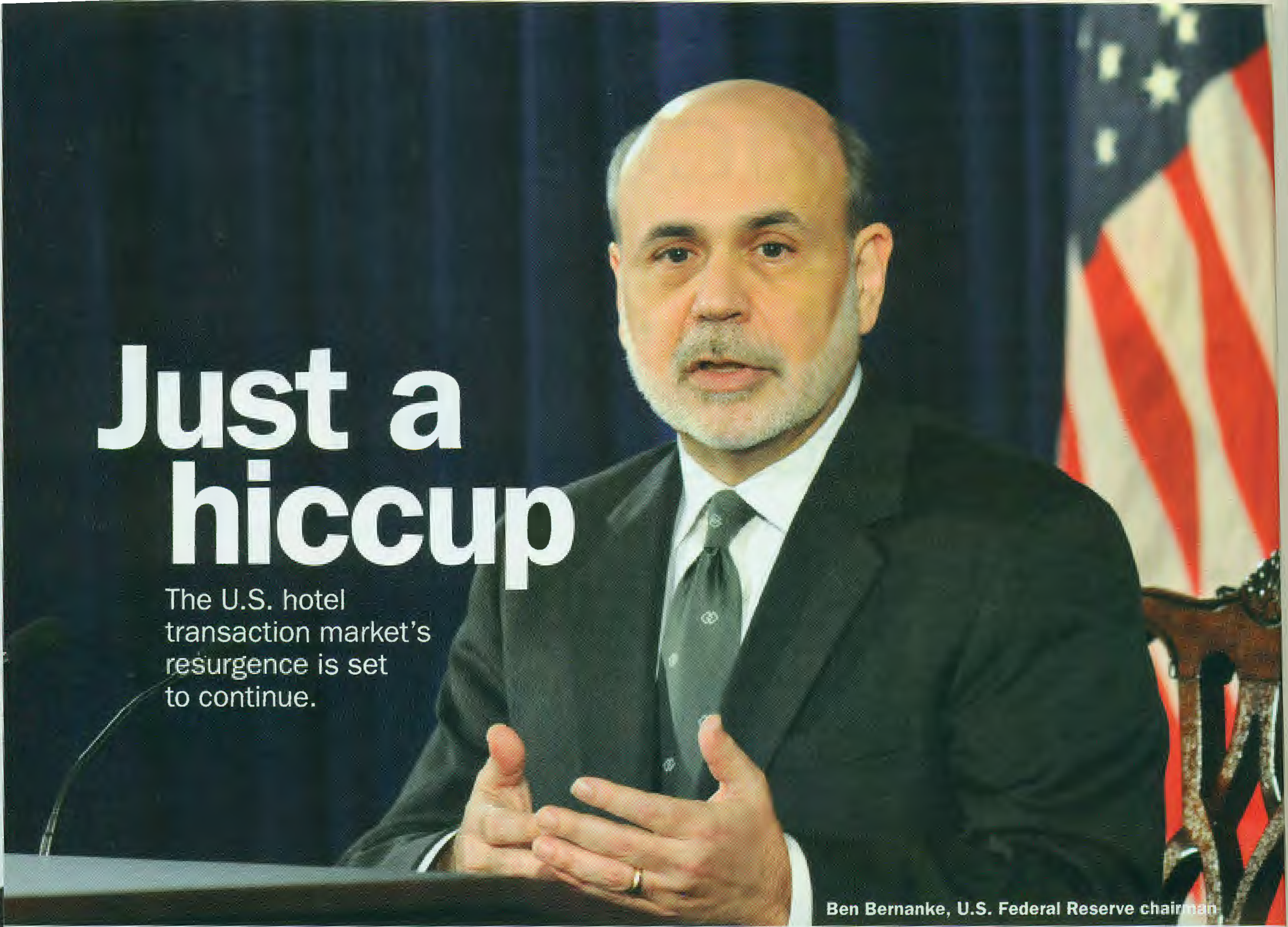

Just a hiccup

The U.S. hotel transaction market's resurgence is set to continue.

Ben Bernanke, U.S. Federal Reserve chairman

U.S. Federal Reserve Chairman Ben Bernanke's comments in June on tapering quantitative easing caused a spike in interest rates and slowed a CMBS market that was heating up. Data from Trepp LLC shows that in the first six months of 2013 lenders originated about US$12 billion worth of hotel CMBS, up from US$7.2 million for all of 2012.

The market reaction prompted Bank of America Corp. to reduce its 2013 forecast sales of commercial-mortgage bonds for 2013 by US$10 billion to US$65 billion. However, that will still be a large increase from 2012, which saw a total of only US$41 billion.

The primary driver behind capital's continued push into hotel investment is the U.S. hotel industry's positive performance outlook for the next few years coupled with a low level of new supply entering operation. By August, investor interest appeared strong enough to withstand the modest increase in interest rates, and fears of larger increases were assuaged after the initial market reaction to Bernanke's statements. In light of this, the 2013 HVS-STR U.S. Hotel Valuation Index projects that U.S. hotel values will surpass their 2006 peak this year and continue to increase through 2016, and also that CMBS will continue to be stronger and the amount of transactions and refinancing will increase.

"I do not think the hotel transaction market will slow down," says David Loeb, an analyst with R.W. Baird & Co., Milwaukee, Wisconsin. "We have a couple years in the underlying fundamentals cycle, and that will correlate closely with the asset cycle. More hotels were brought to market over the past few months, and I think there will be demand for hotel assets as long as the market continues to improve."

Lodging is seeing loosening lending terms, as according to a report from Nomura Securities average underwritten loan-to-values in lodging properties are rising 3.8%.

"It is an interesting environment for investors as there are very few places to go for returns," says Lee Pillsbury, co-chairman and CEO, Thayer Lodging Group, Annapolis, Maryland. "Bond and fixed-income markets look unattractive and appear to have more downside risk than opportunity, and as a result you see investors increasingly looking to private equity and real estate. Never has this happened more than among the public pension funds. The large municipal public funds are being pushed further out on the risk curve and into asset classes such as real estate as they search for higher returns. We will see continued flows of equity capital into real estate markets, which will benefit hotels as they are perceived as good inflation hedges among classes of real estate due to their ability to re-price every day."

Experts also do not expect significant widening in cap rates for the rest of this year, as 10-year U.S. Treasury yields are hovering around 2.6%, up from 1.86% at the beginning of the year. Most of the increase came after Bernanke's quantitative easing comments, but the 10-year yield has since decreased from a 2.73% peak in July. "There is a little bit of room for treasuries to move up before investors demand more return from hotels," Loeb says.

Of course, CMBS market activity remains far below the heady days of 2006 and 2007. Whether it reaches that point again remains to be seen as hotel investors are divided as to the hotel industry's current stage of the cycle.

TO BUY OR NOT TO BUY

Armed with a US$203 million fund, Kimpton Hotels & Restaurants has been steadily expanding its portfolio in North America this year with acquisitions and management deals, and Kimpton CEO Mike Depatie says it is still relatively early in the cycle to purchase assets.

"Some people think we're getting late in the cycle, but it's not late in the cycle. We're either a third or halfway through," Depatie says. "We've had 33 months of RevPAR improvement. The last cycle lasted 64 months. Our pipeline has 11 hotels in it. It's about 60-40, where 40% we're the owner. We still think it is good to buy hotels, but that may change in a couple years."

Other hotel investors argue it was better to buy earlier in the current cycle as pricing in some markets is now being pushed artificially high by capital markets and low interest rates.

"It's getting farther in the cycle for being able to buy and feel really good about the pricing you're getting on assets," says John Kukral, founder, president and CEO of Northwood Investors and former CEO of Blackstone Real Estate Advisors. "Coming out of the downturn, our thinking initially was that people are still going to vacation at drive-to resort markets. That proved true, and we wish we would have bought a lot more resorts in hindsight. We're still a net buyer … but if we feel the market gets too aggressively priced, we will take our capital off the table and sit and wait to reinvest another day."

For the near term, transactions remain concentrated on the major markets — particularly on the coasts — with New York at US$964 million and California at US$463 million boasting the leading U.S. sales volumes during the first half of this year, according to the 2013 HVS-STR U.S. Hotel Valuation Index. Activity in secondary markets has been slower to pick up.

Looking ahead, though, the secondary markets could see a boom in limited-service development. "We will see a lot of select-service and limited-service development, not so much in the major 15 U.S. markets but in the rest of the country," Pillsbury says. "In those segments, new beats old."

– By Nathan Greenhalgh, associate editor