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Opportunity of a Lifetime

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Hotel REITs like Chatham Lodging Trust are capitalizing on bargain-basement prices.

The hotel sector went nearly dark through much of 2009 in the face of falling revenues and mounting losses, but big deals are starting to make headlines again. Investors are standing in line for the first time in several years, eager to scoop up assets, while cautious sellers who had been waiting for the economy to recover are finally beginning to budge. A new deal-making cycle is kicking into gear.

Publicly traded real estate investment trusts (REITs) are leading the charge. Sunstone Hotel Investors is poised to acquire the Manchester Hyatt in San Diego in a transaction valuing the 1,651-room hotel at \$580 million. Sunstone also bought the foreclosed Royal Palm Resort in Miami Beach on Aug. 16 for \$126.1 million.

The venerable Fairmont Copley Plaza Hotel in Boston sold for \$98.5 million to FelCor Lodging Trust. And in a rapid-fire series of deals, new REIT Pebblebrook Hotel Trust acquired the InterContinental Buckhead Atlanta for \$105 million, and the landmark Sir Francis Drake in San Francisco for \$90 million, among other lodging assets.

With debt still constrained, private-equity firms requiring leverage to consummate transactions have often been outbid this year by REITs willing to make all-cash offers for assets. "We're in an enviable position, and we're doing what we can to take advantage of that," says Jeffrey Fisher, chairman and CEO of Chatham Lodging Trust in Palm Beach, Fla.

Fisher's company raised \$172 million in an initial public offering on April 21 and then promptly bought a portfolio of a half-dozen hotels, with four more acquisitions following soon after.

And yet the private equity companies haven't been shut out entirely. Carl Icahn and an investment group won the 2,100-room Tropicana Casino & Resort in Atlantic City for \$200 million. A partnership of Oaktree Capital Management LP of Los Angeles and Avenue Capital Group of New York agreed to pay \$197.5 million in cash for the Cloister Hotel in Sea Island, Ga., a price that most observers deemed cheap considering that creditors will get shortchanged out of \$340 million in debt in the

aftermath of the troubled resort's sale.

Meanwhile, KSL Capital Partners in Denver got a good deal on the La Costa Resort & Spa in Carlsbad, Calif., paying \$120 million for the golfing mecca.

“We've seen a pretty dramatic increase in the number of properties coming to market in the last 60 days,” noted Jon Bortz, chairman and CEO of Bethesda, Md.-based Pebblebrook, in an early August conference call with Wall Street analysts.

“We expect the industry to be dramatically more active in the second half compared to the first half of this year,” added Bortz. “Sellers, for the most part, are very motivated.”

Bortz is motivated, too. His company raised \$318.3 million in a massive secondary stock offering on July 28 and is eager to keep acquiring. “We think we can get our share” of hotels that come up for sale, the executive said.

Improved vital signs ignite deals

Hotel sales volume in the first half of this year totaled \$3.4 billion, up 143% from the anemic \$1.4 billion total in the first six months of 2009, according to New York-based research firm Real Capital Analytics. The number of properties sold in the first six months of this year rose to 141 from 83 in the year-earlier period, a 70% increase.

Many observers say that the turn to positive fundamentals in both room sales and revenue per available room (RevPAR) has sparked this year's renaissance in transaction activity.

Nationally, approximately 190 million room nights were sold in the first half of this year, up 19% from the 160 million sold in the first half of 2009 and not far off the 200 million total in the first half of 2008, according to Smith Travel Research based in Hendersonville, Tenn.

RevPAR is rising fastest in robust big-city markets — up 15% in New York City and nearly 14% in Boston, for instance, though these markets still trail 2007 peak performance by 10% or more.

Smith Travel Research has revised its forecast for 2010 three times, with each update offering a more bullish forecast on rates and occupancies.

“We've enjoyed a positive demand trajectory each month since December,” says Jan Freitag, vice president of global development at Smith Travel Research. “We're in a recovery here. This time it's the big cities along the East Coast — Boston and New York and Miami and Washington — that are coming back first.”

Some skeptics fear that the hotel recovery could be scuttled if the nation sinks back into a double-dip recession in the coming months, a scenario that economists fear as unemployment remains stuck at high levels and the stock market waffles up and down.

“For leisure travel to come back, we need bigger employment numbers,” says Freitag. Corporate travel has been on the rise but it could quickly get undone, he says, if profits falter.

“Group travel demand in September and October this year will be very important for giving us a

sense of the health of the industry going forward,” he emphasizes.

Most aggressive investors are not willing to wait for more signals. In his former career, Fisher founded the 76-property Innkeepers USA Trust in 1994 and cashed out at the top of the market in 2007 for \$1.7 billion by selling to Apollo Investment Corp.

Palm Beach, Fla.-based Innkeepers went into Chapter 11 bankruptcy protection in mid-August, struggling under a load of more than \$1 billion in debt that it couldn't service.

Does the misfortune of Innkeepers give Fisher pause? Hardly. On top of the \$172 million that Chatham Lodging Trust raised in its IPO this spring, the CEO invested \$10 million of his own money in the REIT. Then in mid-summer the REIT received an \$85 million secured-credit facility from a group of lenders led by Barclays Bank PLC.

Seizing the moment

Chatham Lodging Trust has been wasting no time. On April 23, the company landed a portfolio of six Homewood Suites hotels totaling 800 rooms for \$73.5 million. Then it bought a 120-room Hampton Inn & Suites in Houston for \$16.5 million and a 124-suite Residence Inn by Marriott on Long Island for \$21.3 million.

At press time, four more hotel acquisitions were pending, including deals for two Residence Inns in Westchester County, in New York's suburbs.

“This is the best buying opportunity in my lifetime,” declares the 54-year-old Fisher, a select-service hotel specialist who also owns a hotel management firm called Island Hospitality.

“We've never had the backdrop of financial distress that we've got today,” explains Fisher. “People overpaid and over-levered for assets in the debt bubble that rose up between 2005 and early 2008, and then the bubble burst. That's set up the opportunities we're seeing today.”

The early returns suggest that the timing of Chatham Lodging Trust is good. Through June 30, RevPAR in the initial half-dozen hotels the REIT acquired was running 10% ahead of the same period a year ago, driven by a 15.5% rise in the occupancy rate.

The company had expected RevPAR to be merely flat this year for its newly acquired hotels. The woes of some of its rivals helped boost the returns of Chatham Lodging Trust. Its hotels in suburban Nashville, for instance, benefitted when the nearby Gaylord Opryland Hotel closed its doors.

Chatham Lodging Trust is buying the majority of its assets at respectable 7.5% to 8% capitalization rates, not that far off the sub-7% cap rates that were common in the select-service segment back in 2007.

Fisher estimates that his acquisitions so far have come at an attractive average 20% to 30% discount to replacement cost. Does the possibility of a double-dip recession give him pause? Not really. He figures that the current economic recovery will experience some bumps in the next year or two.

Even if RevPAR growth drops to mid- or low-single digits late this year, Fisher's preference for cash

acquisitions rather than relying on debt will help him thrive in today's thorny market.

"Even if the hotel market goes flat this year, I'm still giving my investors 7% and 8% returns," he says. And he plans to expand. How big can Chatham Lodging Trust get? "I fully expect to have 50 hotels worth more than \$1 billion within three or four years," he says.

Flippers out, holders in

The hotel transaction market was populated a few years ago with what the industry calls "flippers." Their strategy was to use heavy leverage to buy and quickly renovate a hotel, upgrade the brand name and install savvy management, all in two or three years. The goal was to boost cash flow 20% or more and exit with a handsome profit.

Alas, in the current environment the flippers have been largely absent. Brokers and investors agree that a different class of dealmaker, the "patient holder," now dominates the market. Patient holders use little debt, shun risk and often have investment time horizons ranging from five to 10 years.

Many peg their returns to cash flow analyses that presume a return to peak 2007 net operating incomes at properties they acquire by 2013 or 2014. "The REITs are the guys doing deals now because they have the patient money," says Michael Cahill, CEO of Hospitality Real Estate Counselors in Denver, which represents sellers of some 60 hotel properties.

There is a lot of activity under the REITs' radar, observes Cahill. In July alone, he sold 10 hotels each priced under \$10 million and sporting flags like Comfort Inn and Holiday Inn Express. The buyers weren't operating with Wall Street money like Chatham Lodging Trust does.

"The buyers are small guys who own two or three hotels — guys like the rich car dealer who dabbles in hotel investing on the side," says Cahill, who co-chairs an industry group called the Lodging Industry Investment Council. "They can still get loans from their local community bank or even from the SBA (Small Business Administration)."

The market for smaller properties has held up fairly well, adds Cahill. "Valuations haven't fallen nearly as far as they fell for the big institutional properties."

Improvements are costly

Still, small-asset deals can get complicated. The Hotel Group, based in Seattle, is conducting due diligence on a Sheraton that it hopes to sell for \$12 million, worth \$50,000 a key. But the property's improvement plan calls for up to \$7 million in additional investment.

That infusion would push the cost to almost \$75,000 a key, says Douglas Dreher, president and CEO of Hotel Group, who did not identify the buyer. It's a high price tag for an establishment with occupancies at 50%. The first-year cap rate, Dreher reveals, is pegged at 5%.

Dreher, who owns 20 hotels and controls an investment fund with \$75 million available, is an eager buyer as well as seller. Still, the thin crop of available assets frustrates him. Some brands are less desirable, or a hotel's condition has deteriorated, while others are in receivership and even new capital may not stabilize them, explains Dreher.

On the other hand, some fine trophy properties are selling at prices near the peak of a few years ago.

Dreher aims for investment at 60% of replacement cost. "We've competed for a few like that, but we've been outbid so far."

Indeed, bidding has become particularly intense for marquee properties. The Sir Francis Drake in San Francisco, offered for sale by San Francisco-based Chartres Lodging Group LLC, reportedly attracted more than 100 interested parties. The winning bidder, Pebblebrook, paid \$216,000 a key, equating to just a 2% cap rate.

Jim Butler, founding partner at Los Angeles law firm Jeffer Mangels Butler & Mitchell LLP and head of the firm's global hospitality group, figures the Drake may require as much as \$50 million in remodeling. That would significantly reduce the financial return.

"Values for great hotels like the Drake are a lot higher than they were a year or two ago," Butler observes. "Unless the flow of new product to the market speeds up soon, we'll continue to see a line around the block waiting to bid on any decent property that comes up for sale."

Maybe so, but there is still considerable discipline in the marketplace. Donald Trump's Trump Hotel Collection has put on hold plans to build new hotels it had announced for New Orleans, the Dominican Republic and Dubai. A Trump hotel in Toronto is still on track to open in February 2011.

Instead of building new hotels from the ground up, as it has in the past, Trump is now looking for older properties it can remake into five-star hotels. That's a fresh turn for The Donald.

"The world of hotels is much tougher today," says Jim Petrus, chief operating officer of Trump Hotel Collection. "We're expanding our horizons, broadening our scope. But the industry is so cyclical that you have to be very careful about where and how you invest."

H. Lee Murphy is a Chicago-based writer.

MAJOR U.S. HOTEL SALES IN 2010 AT MID-YEAR

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Property	Rooms	Sales price (\$millions)	Buyer	Seller
Tropicana Casino and Resort, Atlantic City, N.J.	2,129	\$200	Carl Icahn Investment Group	Tropicana Entertainment Inc.
Hilton Minneapolis	821	\$155	Diamond Rock Hospitality Co.	Marquette LLC*
Hyatt Regency Boston	498	\$112	Chesapeake Lodging Trust	Hyatt Hotels Corp.
InerContinental Buckhead, Atlanta	433	\$105	Pebblebrook Hotel Trust	InterContinental Hotels Group PLC
Sofitel Washington, D.C. Lafayette Square	237	\$95	LaSalle Hotel Properties	Gem Realty Capital Inc.

Sir Francis Drake Hotel, San Francisco	416	\$90	Pebblebrook Hotel Trust	Chartres Lodging Group
W The Court & W The Tuscany, New York	320	\$78	St. Giles Hotels LLC	Starwood Hotels & Resorts Worldwide Inc.

*including Starwood Capital Group

Source: CB Richard Ellis

A tale of two Californias begins to emerge

In once-hot hospitality destinations like California, a great divide has cropped up between the most desirable and most troubled markets.

Through the first half of 2010, transactions in Northern California were up almost 62% from a year ago, according to Atlas Hospitality Group in Irvine. Dollar volume was up 186%. In Southern California, transactions rose 56% and dollar volume was up 158%.

Leading transactions in the first half included the sales of the Four Seasons in San Francisco for \$109.1 million and the Courtyard Mission Valley in San Diego for \$43 million.

But not every market shared in the hotel sales gains. While Los Angeles County hotel transactions soared 350% in the first half and rose 68% in San Diego County, deals were actually down 50% in Riverside County, part of the Inland Empire.

Deals were down 99% in Sacramento County, where the most expensive sale this year has been the 22-room Hotel del Rio in Isleton at \$336,000.

According to Atlas, 478 California hotels are currently in default or in foreclosure, up 132% over the total at mid-year in 2009. Big properties like the Heritage Hotel in Mendocino and the elite Quail Lodge in Carmel have gone completely dark. So has the Borrego Springs Ranch Resort in Borrego Springs, owned by GH Capital and closed since January.

Small towns, small pockets

◆ We're in a situation in California where demand for transactions in Class-A markets like Los Angeles and San Francisco is very high, ◆ says Alan Reay, president of Atlas Hospitality. ◆ In Class-B and Class-C markets there isn't much demand for hotel assets at all. Deals are very tough to finance in smaller towns now. ◆

John Stueber, president and owner of Summit Capital in Carlsbad, a finance brokerage, believes that investors may be poised to discover smaller towns soon. His firm recently arranged financing for a \$9.6 million Marriott TownePlace Suites in the little village of Elko, Nev.

◆ That deal would have been pretty tough six months ago. But the lending situation is getting marginally better every day, ◆ says Stueber. As he looks around at the damaged assets in small

towns in California, he predicts a flood of fresh investment in hotel assets before long.

◆ This is probably one of the biggest buying opportunities of my career, possibly of my lifetime, ◆ says Stueber. ◆ Everybody agrees we've passed the bottom. Now is the time to be putting sales contracts together. ◆

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