

## How's the Market?

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Other than “What is your seller’s bottom dollar”, the most often asked question from prospects is “How is the Market”? Of course, the answer is a familiar one. That is, “it depends”. As everyone in the hotel business knows, it depends on a number of factors, including location, age, income, type of property, cash flow, etc., etc., etc.

In our practice, where our primary focus is mid-market properties, (both limited service and full service), our maximum success is found in cash flow deals, which, I am sure, is no revelation to anyone. And, it’s an axiom that will not change. If you have adequate cash flow and the asset is priced correctly, we will get significant sales activity, period.

Currently, our most active product lines are those “mid market” limited service flags such as Hampton Inn, Holiday Inn Express, Comfort Suites and Fairfield Inn. These properties tend to bring a “premium”, although rarely do these transactions exceed replacement costs. For properties 10 years old or less, the revenue multipliers range from 2.8 to 3.2 times room revenue, with the PIP expenses becoming increasingly important after the asset is 4-5 years old. Capitalization rates range between 11-12.5% depending on the calculation of NOI and the PIP expense.

The new upgrade initiatives set forth by the leading franchises have had a tremendous impact on our transactions. Within the deal path, there are often two negotiations, one on price, and then a second negotiation on the PIP. Within the PIP, the franchisor has its chance to upgrade the property to “current standards”. This very fact creates a bit of a problem, in that the seller may not be faced with the same requirements and time lines as a new buyer would be, creating a conflict of who pays for what. On the positive side of the ledger, we have also found that most of the new initiatives have been successful in increasing guest satisfaction, thereby turning a nice hotel into a great property.

As an example, with our sales of Hampton Inns, Holiday Inn Expresses and Fairfield Inns over the last 18 months, the PIP’s have averaged \$200,000 to \$250,000 for properties five years old or less, and higher for those more than 5 years old. Properties 6-10 years old may generate PIP requirements in excess of \$500,000. We inform our prospective buyers to be prepared to spend money on their new acquisition, so that they will be equipped to comply with the PIP provisions. But, no matter how you look at it, everyone “holds his or her breath” with regards to the PIP inspection.

We work very hard to counsel our clients and our prospects that the PIP is a part of every franchised deal and should be approached as a “partnership”. Both parties have the same goal, that is, to create a sale. In a perfect world, the PIP should be available prior to negotiating a contract, which eliminates the unknown and also

alleviates the posturing that occurs if the PIP is delivered 45 days into the deal. We suggest that the seller order the PIP within the first 2 weeks of the listing commencement. On the other hand, if the parties are deep into the deal when the PIP document arrives, collaboration between buyer and seller is the most effective way to deal with its provisions. Each party has the opportunity to cover key items in the document, before approaching the franchisor to negotiate.

A second segment, represents a significant amount of our closed transactions, that is the lower "mid-market" sector. That is to say, these transactions involved older Comfort Inns, Best Westerns, Days Inns and Super 8's, etc. These properties ranged in age from 10 to 25 years old and all produced revenue in excess of \$8,000/key, with most over \$10,000/key. The sales prices ranged from 2.2 to 2.9 x room revenue. The capitalization rates ranged from 13% to 16%. Most of these properties were purchased by owner/operators, therefore, no management fees were deducted. The value of these deals depended on a variety of factors, the most important being cash flow. However, other factors, such as location, property condition, type of footprint and type of corridor all played a role. Newer properties with interior corridor properties always retrieve higher prices than exterior corridor. Larger markets generally achieve higher prices than small towns. As an example, a metropolitan 10 year old interior corridor Super 8 will inevitably retrieve a price in the higher side of the range cited above, while a small town exterior corridor Days Inn or Best Western will be on the lower side of the range.

Among the third tier of properties, we have also marketed and closed a number of under-performing assets. The results of these sales represent a consistent investment trend which has been true throughout our 18 years experience of practice. That is, hotels that demonstrate poor top line revenue and/or no net operating income will be considered distressed by investors. The older properties, especially those in need of renovation, will be treated with increased distress. Placing a value on these types of assets is very difficult because of the varied ways an investor will evaluate them. Value for these hotels depends on location, type of building, local occupancy and the renovation/reposition requirements. In order to be successful, "distressed asset investors" must evaluate a variety of factors, including the overall macro and micro business trends, the acquisition cost, the type of flag and associated business model, the reposition/renovation budget and the estimated stabilization time. All of these factors can carry considerable risk.

With all of the above variables to consider, it is no surprise that opinions of value can vary substantially. Depending on the situation, we have seen distressed assets trade within a wide range of 1x room revenue to 2.5x room revenue, although we have seen a few exceptions. (If a distressed asset brings over 2.5 x room revenue, it would certainly be an exception and probably had special circumstances attached to it, such as great location, newer asset or superior top line revenue).

While sales activity within our practice remains very high, we are cautiously optimistic about the future. Most industry forecasters predict continued increase in

revenue, ADR, occupancy through 2007. While we are certainly seeing these predictions fulfilled in the early stages, our clients tell us that they are concerned about the continued rise in interest rates, world events, the cost of gasoline and a rebirth of new construction based only on optimism for the future. One thing is for sure, the next two years will be quite interesting, and as always, will probably contain a few surprises.