

Hotel Markets Face Uncertainty

By Gregory P. Kendall, CRE, MAI ♦ RERC Hospitality ♦ RERC Partner & Vice President

The state of the national economy, including the threat of a recession, the credit crisis, expected increases in unemployment, and record-high fuel costs have hotel investors, as well as hoteliers, wondering what the immediate future holds for the hotel industry.

- Will higher travel costs and waning consumer confidence affect leisure and business travel? If so, for the short or long term?
- Will profitable group and convention customers become more cost-conscious and cancel events, choose venues closer to home, or negotiate more strongly?
- Will new supply continue to come online and create an oversupply that will affect occupancy rates and ultimately rate integrity?
- Will more stringent underwriting result in the delay or cancellation of developments in the planning stage?

The answer to all of these questions is likely “yes,” although the extent to which hotels will be affected will vary widely according to the individual market and even the individual asset.

Hotels are commonly thought of as the most volatile of real estate assets, often reacting to changes in market fundamentals more quickly than other asset types. This is

at least in part attributable to hotels essentially operating on hundreds or thousands of one-day “leases” versus their counterparts (apartment, retail, office, and industrial properties) that may rely on one or several multi-month or multi-year leases, inherently making these properties more stable.

This study summarizes the past performance of the national lodging market and the 15 key hotel markets, in aggregate, with a closer look at six of these key markets, and offers a comparison of the various components that affect hotel market performance. (Please note that we have excluded Las Vegas, the largest hotel market in the U.S., from this discussion due to the unique characteristics of this destination.)

Supply Increases Return in Some Markets

As the trend to convert hotel units to residential condominium units in 2005 and 2006 slowed (or in some cases, died), hotel supply, particularly in major downtown markets and destination resort areas, began to increase. As a result, net gains in the number of hotel rooms are expected to resume.

In 2007, hotel supply grew at a pace of just over 1 percent, similar to the change in demand and resulting in virtually no change in the national occupancy rate. However demand growth has been declining in recent months, suggesting that occupancy rates may be about to decline as well.

Largest U.S. Hotel Markets



Demand Shows Positive but Slower Growth Rates

Smith Travel Research reports that in the last 30 years, lodging demand declined in only 6 of those years. These declines occurred in 1980 through 1983 (recession and energy crisis), 1991 (recession and first Gulf War), and 2001 (September 11 terrorist attacks and significantly reduced travel).

A decrease in the occupancy rate, which has occurred in 16 of the last 30 years, is most typically a direct result of new construction and additional supply outpacing demand growth. For 2008 and beyond, barring a major recession or

other catastrophic event, demand is not expected to decline, although decreases in the occupancy rate are anticipated as additional supply is likely to outpace demand growth in the near term.

Since 2002, demand growth has outpaced additional supply in the U.S. lodging market. However, in this softening

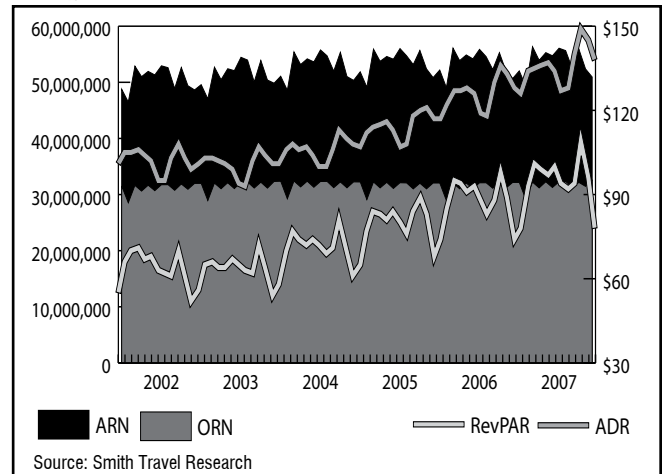
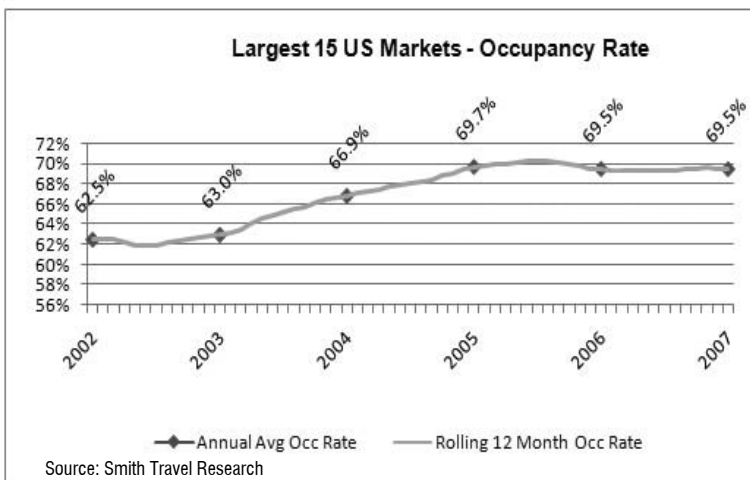
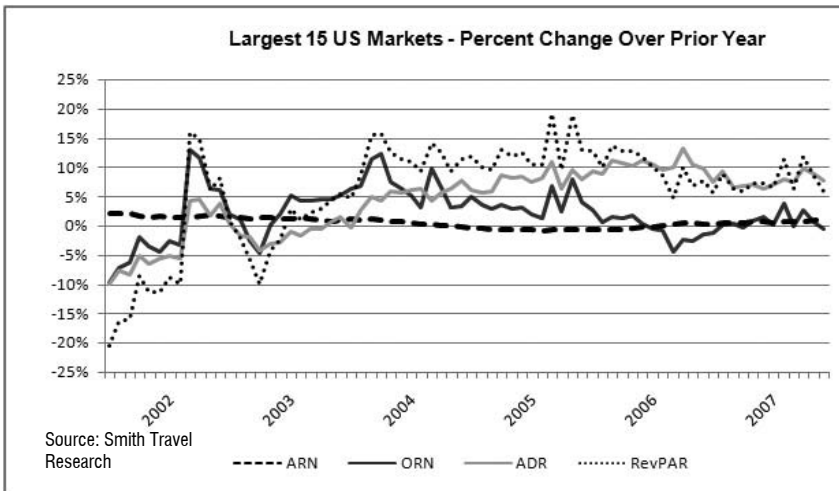
market, the first quarter 2008 occupancy rate declined 2.7 percent from the same period in 2007, while the average daily rate (ADR) increased 4.7 percent, and revenue per available room (RevPAR) increased 1.9 percent. For the month of March 2008 only, the occupancy rate, ADR, and RevPAR changed -4.6 percent, +4.3 percent, and -0.5 percent, respectively.

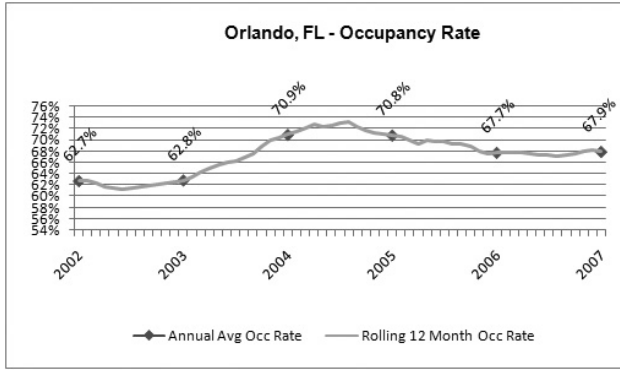
The Key 15 U.S. Markets

- After significant decreases in 2002 (following the terrorist attacks of September 11, 2001), demand as reflected by occupied room nights (ORN) had increased steadily through mid-2006, before leveling off in recent months. Still, demand grew in 4 of the last 6 months of 2007.
- New supply growth as measured by available room nights (ARN) continued at just under 1 percent per year, causing occupancy rates to drop slightly.
- ADR and RevPAR growth has continued at rates well above inflation.

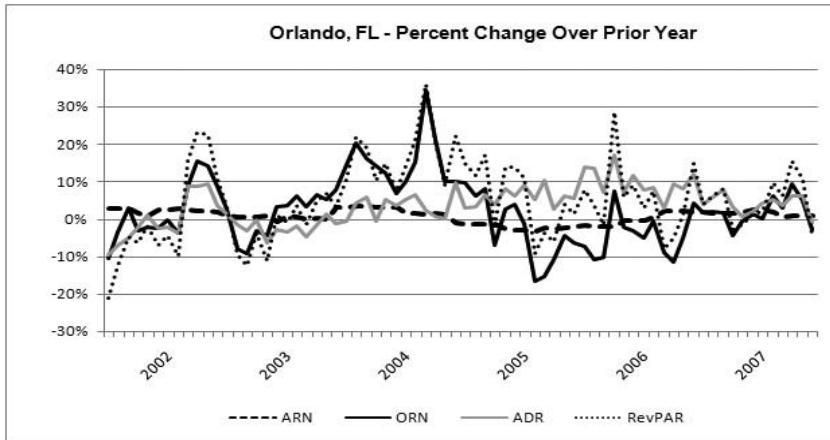
Largest Hotel Markets - U.S. ¹	
Annual Available Room Nights - 2007 ²	
Orlando, FL	40,621,975
Chicago, IL	36,906,535
Los Angeles-Long Beach, CA	33,688,786
Washington, D.C.-MD-VA	33,668,466
Atlanta, GA	33,067,353
New York, NY	29,688,739
Dallas, TX	26,077,826
Houston, TX	22,371,343
San Diego, CA	19,717,119
Phoenix, AZ	19,202,716
Anaheim-Santa Ana, CA	19,169,424
San Francisco/San Mateo, CA	18,343,587
Boston, MA	17,710,834
Miami-Hialeah, FL	15,405,990
Tampa-St Petersburg, FL	15,001,523

Source: Smith Travel Research
¹Minus Las Vegas market
²Annual available room nights = number of guest rooms x 365 days.

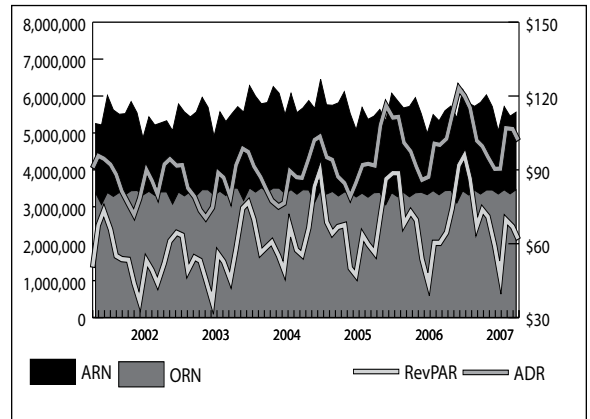




Source: Smith Travel Research



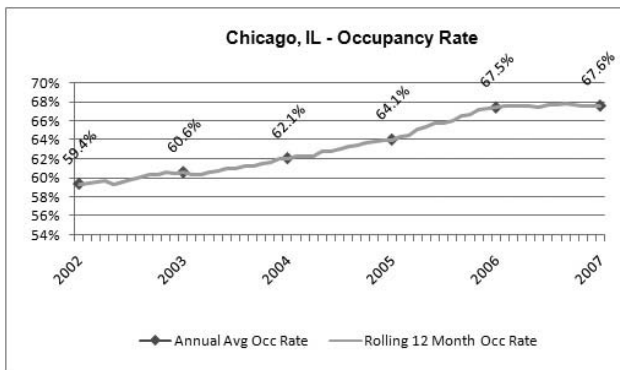
Source: Smith Travel Research



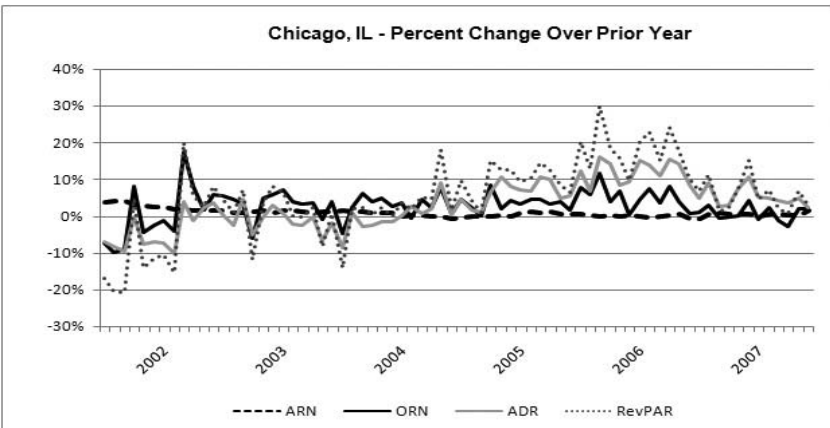
Source: Smith Travel Research

Orlando

- After ORN dropped sharply in 2005 through mid-2006, demand growth returned in 2007.
- Only December 2007 showed a decline in demand.
- With additions to supply restrained, occupancy rates ticked up slightly for 2007.
- Likewise, December 2007 showed the market's first decline in ADR and RevPAR since early 2007.



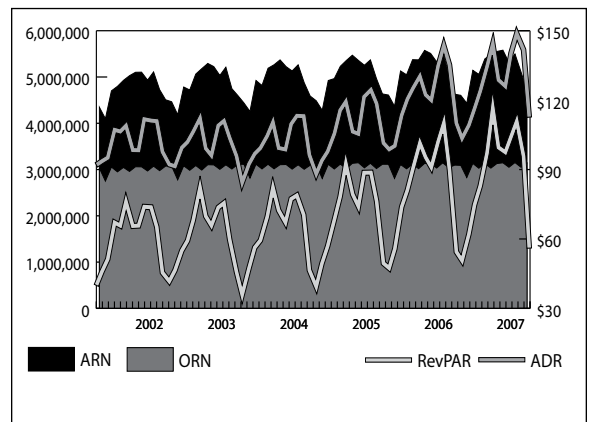
Source: Smith Travel Research



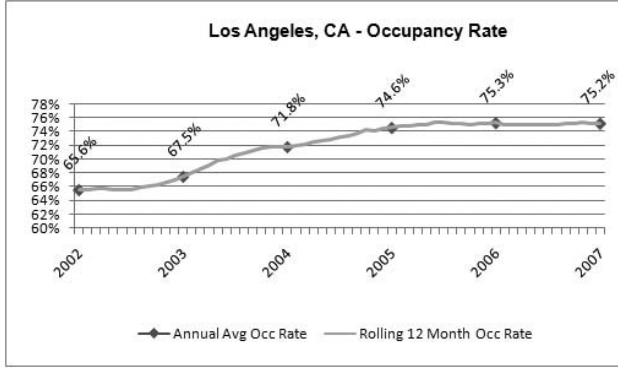
Source: Smith Travel Research

Chicago

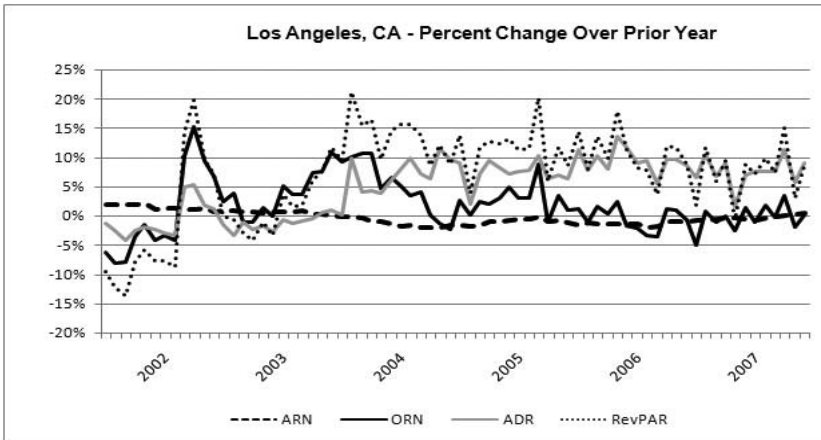
- Demand growth has generally outpaced supply growth recently.
- Although there were declines in ORNs in July, September, and October 2007, we saw increases in November and December.
- Occupancy increased strongly through 2006, before leveling off recently.
- ADR growth and RevPAR growth have declined to levels at or just below inflation.



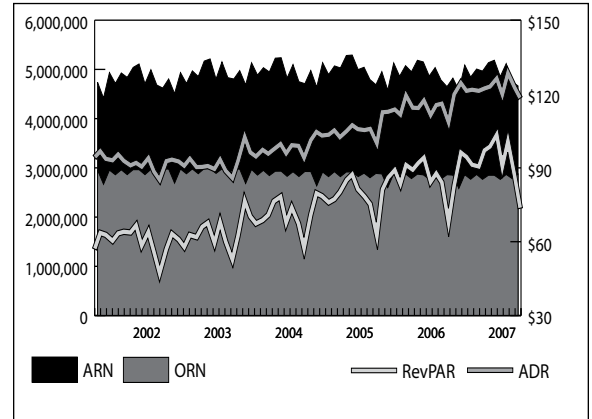
Source: Smith Travel Research



Source: Smith Travel Research



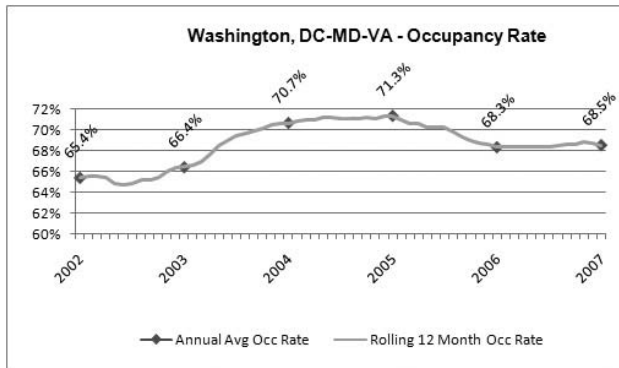
Source: Smith Travel Research



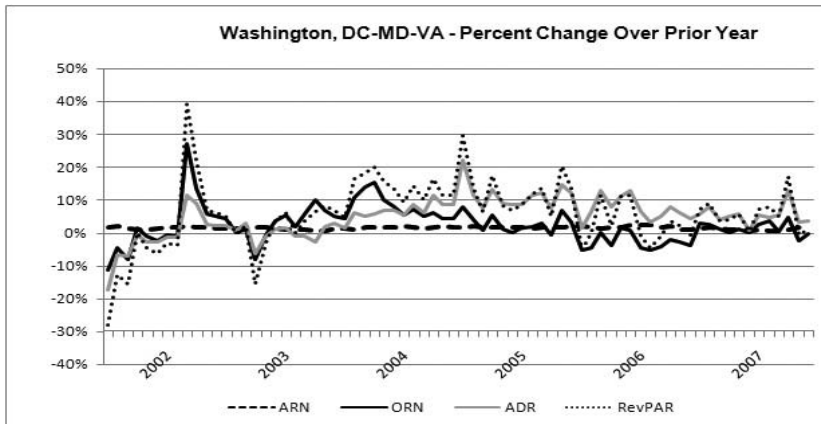
Source: Smith Travel Research

Los Angeles

- Supply decreases accompanied by continued increased demand resulted in strong occupancy through 2006.
- Demand has decreased in 3 of the last 6 months.
- With additions to supply restrained, occupancy rates declined slightly for 2007.
- With occupancy rates above 75 percent, properties were able to push up rates and both ADR and RevPAR increased.



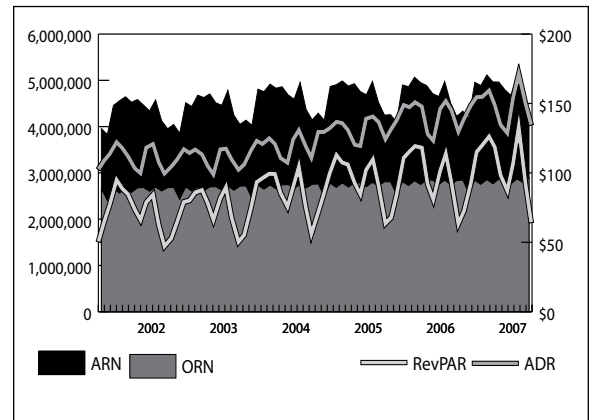
Source: Smith Travel Research



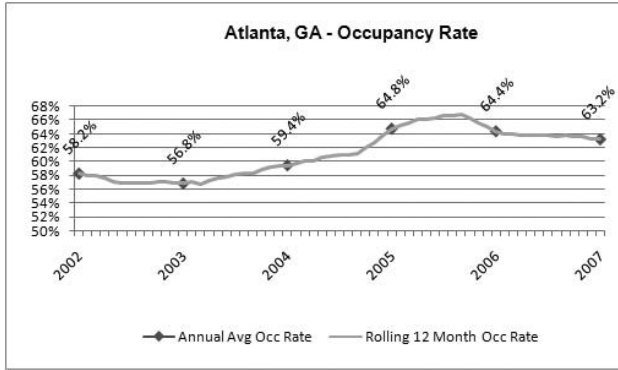
Source: Smith Travel Research

Washington D.C., Maryland, and Virginia

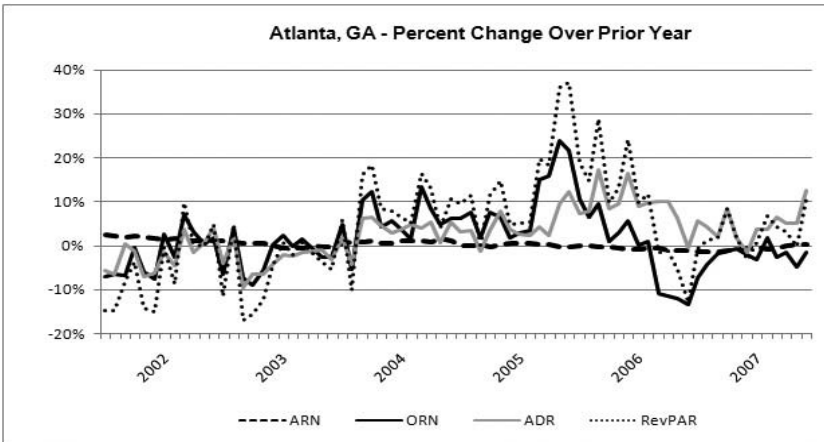
- After ORN dropped sharply in 2006, demand growth returned in 2007, except in November and December.
- With sustained supply growth in 2006 and 2007, occupancy rates declined.
- The declines in demand in November and December 2007 were accompanied by ADR growth slowing to just above inflation during those months.



Source: Smith Travel Research



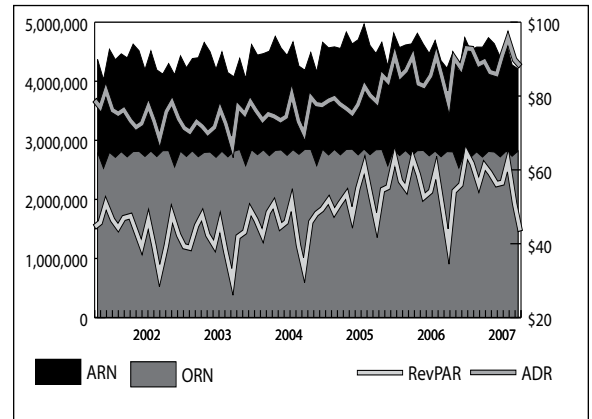
Source: Smith Travel Research



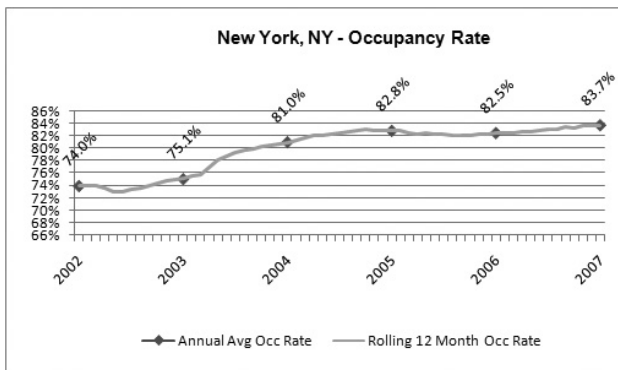
Source: Smith Travel Research

Atlanta

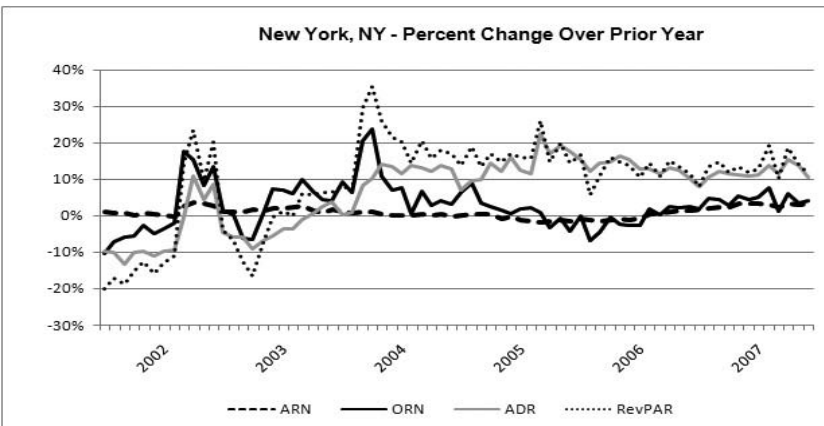
- Demand began to decline in 2006 and continued to decline through 2007.
- Demand declined in 5 of the last 6 months.
- Reductions to supply in 2006 through mid-2007 offset the demand loss somewhat, resulting in a slightly lower occupancy rates for 2007.
- Growth in ADR and RevPAR has continued at rates well above inflation.



Source: Smith Travel Research



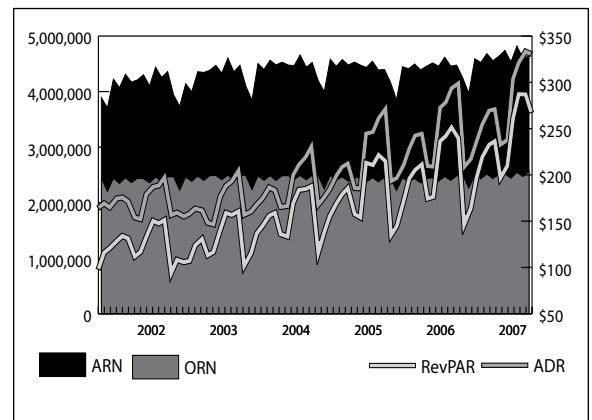
Source: Smith Travel Research



Source: Smith Travel Research

New York City

- Strong demand growth has consistently outpaced continued supply growth.
- No decline in demand was evidenced in 2007.
- With occupancy rates above 80 percent for the last 4 years, both ADR and RevPAR continued to grow at rates well above inflation.



Source: Smith Travel Research

First Quarter 2008 Update

Occupancy rates continued to decline slightly, but ADR increases have resulted in RevPARs that are increasing at roughly inflationary rates. Smith Travel Research's first quarter 2008 statistics for North America show changes in occupancy rate, ADR, and RevPAR of -2.6 percent, 5.4 percent, and 2.7 percent, respectively. Starwood's first quarter 2008 North America performance shows RevPAR growth of 2.9 percent, and they project growth in RevPAR of 4 percent to 6 percent for year-end. Choice Hotel's first quarter 2008 figures indicate that domestic RevPAR was up 2.7 percent, and they project growth of 1.5 percent in the second quarter and 2.0 percent for the year.

Recession Fears and the Credit Crunch

According to a recent report, Donald Trump stated that "the market in Chicago is dead as a doornail right now, as is the rest of the country, other than Manhattan or Palm Beach, Florida," explaining why sales in his Trump Tower mixed-use development had slowed to a trickle. As of year-end 2007, he had reportedly sold some 65 percent of the project's 339 condo-hotel units and 75 percent of the 486 residential units since sales began robustly 3 years ago. While this pronouncement about the Chicago market may have been premature, overstated, or just simply wrong, it does express the nervousness of many regarding the near-term future of commercial real estate, especially as it relates to residential condominium and hotel development.

As RERC institutional survey responses indicate, required returns are moving a little, but generally remain at near-historic lows. Overall, this would suggest some underlying confidence in the prospects for their performance. Any negative near-term impact in the industry likely will be felt first and strongest by those properties with secondary and tertiary locations or product.

Some pundits suggest that the economy is headed for a true recession (two or more successive quarters of negative GDP growth). Fourth quarter 2007 GDP displayed a 0.6 percent increase over the previous quarter, while first quarter 2008 GDP growth also was estimated at 0.6. In this time of market uncertainty, many will take a "wait and see" stance, with underwriters of commercial loans tightening their guidelines after what many believe to be an extended period of poor underwriting practice.

Most experts expect the Federal Reserve to continue to attempt to stimulate the economy by making borrowing cheaper through additional rate cuts. The danger of the further weakening dollar relative to other currencies makes international travel to the U.S. attractive, but will not help domestic travel. While high gasoline prices affect most industries, the effect on travel and the hotel industry is even more direct.

What's next?

So is there any consensus regarding the near-term future of the hotel industry? In general, we expect flat to slight declines in occupancy rates in most markets, although at this time, we believe the declines should be short term, with recovery in as little as 4 quarters.

In addition, tight credit has helped keep the construction of new supply in check. The market may have shown just enough restraint in new construction in recent years to counter the anticipated reduction in demand growth.

If occupancies soften significantly, the lodging market will see downward pressure on room rates. Markets and individual properties that are unique in some way, or at the top of their respective markets, will generally fare well. In many markets that are at or near capacity constraints, the effects will be less pronounced. However, more marginal markets or properties, considered so because of their secondary or tertiary location or product, likely will be hit the quickest and hardest in the event of a significant economic downturn.

