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In an Uncertain Market, Hotels May Be Ripe Buys

By J. ALEX TARQUINIO

A \$200 million resort hotel does not exactly resemble a suburban home. But scratch the surface of the sales market for each property category, and they look remarkably similar today.

The number of hotel deals in the United States during the first quarter plummeted by more than 40 percent, to 127. There is a gaping spread between what sellers are asking for hotels and what buyers are willing to pay. And lenders are writing much smaller mortgages at higher interest rates than they were a year ago.

And yet several private equity firms have quietly managed to raise cash to buy hotels in recent months, said Warren Marr, a hotel consultant at PricewaterhouseCoopers. "It may take a bit longer than it did two years ago, but the money is there," he said.

Some hotel industry experts contend that this is an excellent time to raise cash, because they see fire sales on the horizon. Mr. Marr said that some investors who bought hotels a year ago, at the peak of the market, and used financing to cover as much as 85 percent or 90 percent of the purchase price, might be forced to sell soon. "You could call these distressed assets — not physically distressed, but financially distressed," he said.

HEI Hotels and Resorts, based in Norwalk, Conn., is the latest company to raise cash for a new private equity fund. This is the third fund raised by the company, which also manages the hotels in its portfolio. The new fund has more than \$500 million to invest in hotel properties.

Gary Mendell, chief executive of HEI Hotels and Resorts, said that across the industry, it is harder to raise capital now than it was a year or two ago. But he attributed his ability to raise \$500 million now to the number of repeat investors. The company focuses exclusively on raising money from university endowments, and six of the 16 investors in the new fund also invested in both of HEI's earlier funds, which closed in 2004 and 2006.

There is little doubt that hotel sales have plummeted since the credit squeeze took hold late last summer. For example, buyers spent \$4.1 billion on hotels in this year's first quarter, less than half of the \$8.6 billion spent in the first quarter of 2007, according to Real Capital Analytics.

There are also far fewer big spenders. Only eight investors bought more than \$100 million worth of hotels in the United States in the first quarter, down from 27 buyers who did so a year earlier, the firm reported.

Buyers are also starting to demand a little better return on their investment. Capitalization rates — or the initial rate of return on a property, expressed as a ratio of the current income relative to the purchase price — are rising for all types of commercial real estate.

But Dan Fasulo, the director of market analysis at Real Capital Analytics, wrote in a report about hotel sales last week that the “large gap between asking prices and current bids indicates that buyers think cap rates should be even higher.” Mr. Fasulo said the average cap rate for all United States hotel deals in the first quarter was around 8 percent.

Mr. Mendell said the HEI fund would probably buy fewer hotels than it might have two years ago, simply because lenders are demanding more equity.

Experts say that until last year, a fund like this could have financed 75 percent or more of the cost of the hotels in its portfolio, while today it is more likely to finance 60 percent to 65 percent. In this new credit environment, a \$500 million fund might acquire around \$1.5 billion of real estate, rather than the \$2 billion it might have bought a year ago.

Mr. Mendell, who started the company with his brother, Steve, in 2002, said this would not alter the type of properties that HEI invests in, which tend to be upscale full-service hotels. Instead, he said the new fund would probably purchase fewer hotels. While a year ago the fund might have bought 28 full-service hotels, he said this fund was more likely to buy 20 or 21 hotels.

Noble Investment Group, which is based in Atlanta and owns and operates hotels through similar private equity funds, raised its latest fund in early 2007. Mit Shah, the chief executive, said the company had invested about 40 percent of this \$310 million fund so far and was focused on investing the rest, rather than on raising capital for a new fund.

Mr. Shah said he thought the main reason so few hotels were on the market today was that most sellers were unwilling to part with their properties at current prices. “If you don't have to sell, you won't sell in this market,” he said.

But he added that the pool of buyers was much shallower than it was a year ago, so he hoped to pick up some good deals soon. "There is a significant amount of capital on the sidelines," he said.

David Loeb, a hotel analyst at Robert W. Baird & Company, an investment bank in Milwaukee, predicted that the fundamentals of the hotel business would worsen over the next two years.

He said this was only partly because of the lagging economy. He said a significant amount of new hotel construction was in the works, which had been financed before the credit markets soured. He estimated that the number of hotel rooms in the United States would increase 2.5 percent this year, and possibly another 2 percent to 2.5 percent next year.

Mr. Loeb said he thought this was a smart time to be raising money to buy hotels. "There will be owners who can't afford to keep their hotels anymore," he said, because they bought them in highly leveraged deals a year or so ago.

He added that some trophy properties might even change hands. "Luxury properties do not come on the market often," he said. "But in this market, you will absolutely see some of them sell."

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