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**Third Quarter 2012: And the Beat Goes On**

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Third Quarter 2012: And the Beat Goes On

Abstract
In our inaugural issue of the Cornell Hotel Index series, we introduced three new quarterly metrics to monitor real estate activity in the hotel market. These are a large hotel index (hotel transactions of $10 million or more), a small hotel index (hotels under $10 million), and a repeat sales index (RSI) that tracks actual hotel transactions. These indices are constructed using the CoStar and RCA commercial real estate databases. The large and small hotel indices are similar in nature and construction to the consumer price index (CPI), while the repeat sale hotel index is analogous to the retail concept of same store sales. Using a similar logic process for hotels, we compare the sales and resales of the same hotel over time for that index. All three measures provide a more accurate representation of the current hotel real estate market conditions than does reporting the average transaction prices, because the average-price index doesn’t account for differences in the quality of the hotels, which also is averaged. A more detailed description of these indices is found in the first edition of this series, “Cornell Real Estate Market Indices,” which is available at no charge from the Cornell Center for Real Estate and Finance. In this fourth issue, we present updates and revisions to our three hotel indices along with commentary and supporting evidence from the real estate market.

Keywords
Cornell, hotel valuation models, commercial real estate, NAREIT, HOTVal

Disciplines
Real Estate

Comments
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Supplemental File:
Hotel Valuation Model (HOTVAL) We provide this user friendly hotel valuation model in an excel spreadsheet entitled HOTVAL Toolkit as a complement to this report which is available for download from http://scholarship.sha.cornell.edu/creftools/1/
EXECUTIVE SUMMARY

The Cornell Hotel Indices reveal that the hotel industry is continuing to experience positive price momentum for both large and small hotels. Consistent with this upward momentum, hotel cap rates have declined below their five year moving average. However, mortgage financing costs are rising due to increased default risk. This is paper number 4 of the index series.
In our inaugural issue of the Cornell Hotel Index series, we introduced three new quarterly metrics to monitor real estate activity in the hotel market. These are a large hotel index (hotel transactions of $10 million or more), a small hotel index (hotels under $10 million), and a repeat sales index (RSI) that tracks actual hotel transactions. These indices are constructed using the CoStar and RCA commercial real estate databases. The large and small hotel indices are similar in nature and construction to the consumer price index (CPI), while the repeat sale hotel index is analogous to the retail concept of same store sales. Using a similar logic process for hotels, we compare the sales and resales of the same hotel over time for that index. All three measures provide a more accurate representation of the current hotel real estate market conditions than does reporting the average transaction prices, because the average-price index doesn’t account for differences in the quality of the hotels, which also is averaged. A more detailed description of these indices is found in the first edition of this series, “Cornell Real Estate Market Indices,” which is available at no charge from the Cornell Center for Real Estate and Finance. In this fourth issue, we present updates and revisions to our three hotel indices along with commentary and supporting evidence from the real estate market.

Analysis of Indices through Q3, 2012

Increase in hotel market activity. Exhibits 1 and 2 (overleaf) show hotel market activity has continued to increase with the number of transactions of both large hotels and smaller hotels rising in the third quarter of 2012 over the third quarter of 2011.¹ Large hotel transactions more than tripled, with 62 transactions for large hotels in the third quarter of 2012 (2012Q3) compared to 19 transactions a year earlier (2011Q3). Similarly, small hotel transactions approximately doubled, with 108 transactions for small hotels in the third quarter versus 55 transactions in 2011Q3. A slightly different pattern emerges in terms of prices. Both the hedonic index for low price hotels (under $10 million) and the repeat sale hotel index rose year over year. The hedonic index for low price hotels increased 13 percent, rising from 116.45 in 2011Q3 to 131.64 in 2012Q3.
Exhibit 1

Median sale price and number of sales (hotels with sale prices of $10 million or more, 2012Q3)

Exhibit 2

Median sale price and number of sales 2012Q3 (hotels with sale prices less than $10 million, 2012Q3)
### Hotel indices through 2012, quarter 3

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while the repeat sale hotel index rose 20 percent, increasing from 106.72 (2011Q3) to 127.84 (2012Q3). In contrast, the hedonic index for high price hotels ($10 million or more) declined 5 percent year over year, decreasing from 160.67 in 2011Q3 to 152.11 in 2012Q3 (see Exhibit 3, previous page).

Thus, we see a continuing divergence between the trends for large and small hotels, as shown in Exhibit 4. This is a continuation of the recovery trend for small hotels that we identified in previous editions of this index.

Large Hotels Exhibit an Upward Trend

Exhibit 5 depicts the movements of the two averages for the large hotel index. As we said, on a year over year basis the large-hotel index declined on a year over year basis experiencing a -5.3% decrease in value from 2011Q3 to 2012Q3 (see Exhibit 6). However, the recent trend has been positive. Not only has the large-hotel index continued to exhibit positive momentum (it is still above both its three-year and five-year moving averages in 2012Q2) with respect to the two moving average system, but also the three year moving average has risen above the five year moving average. This development signals an upward movement in the price trend for large hotels. Indeed, the quarter to quarter decline in 2012 was much less than the year-over-year change, at -7%
Exhibit 5

Large-hotel index, three-year moving average, and five-year moving average (2012Q3)

Sources: Cornell Center for Real Estate and Finance, CoStar, Real Capital Analytics

Exhibit 6

Year over year change in large-hotel index, with a moving average trend line (2012Q3)

Sources: Cornell Center for Real Estate and Finance, CoStar, Real Capital Analytics
Exhibit 7

Small-hotel index, three-year moving average, and five-year moving average (2012Q3)

Sources: Cornell Center for Real Estate and Finance, CoStar, Real Capital Analytics

Exhibit 8

Year over year change in small-hotel index, with a moving average trend line (2012Q3)

Sources: Cornell Center for Real Estate and Finance, CoStar, Real Capital Analytics
The repeat sale of hotels in Exhibit 9 tells an even stronger story than does small hotel index. Currently the repeat hotel sale index stands at 127.84 (2012Q3), as compared to 101.76 in 2009Q3. The repeat hotel sale index rose 19 percent on a year over year basis (2011Q3 to 2012Q3), and 81 percent on a quarterly basis (2012Q1 to 2012Q2). Smaller hotels and the repeat sale of hotels have thus both continued to exhibit positive momentum.

(2012Q2 to 2012Q3). In summary, the market for large hotels is experiencing a positive price momentum, albeit we must note the negative year over year perspective.

Smaller Hotels Continue to Strengthen
The positive price momentum is even stronger for smaller hotels, as evidenced in Exhibit 7. Although the performance of smaller hotels has still not yet crossed their five year moving average, they are poised to do so, and the year over year evidence in Exhibit 8 is consistent with our moving average analysis. The small-hotel index increased 13 percent from 2011Q3 to 2012Q3 and experienced a 4.8 percent increase from Q2 to Q3 this year.

The repeat sale of hotels in Exhibit 9 tells an even stronger story than does small hotel index. Currently the repeat sale index stands at 127.84 (2012Q3), as compared to 101.76 in 2009Q3. The repeat hotel sale index rose 19 percent on a year over year basis (2011Q3 to 2012Q3), and 81 percent on a quarterly basis (2012Q1 to 2012Q2). Smaller hotels and the repeat sale of hotels have thus both continued to exhibit positive momentum.
Cap Rates Remain Stable

For the second quarter of 2012, the latest quarter for which ACLI reports data on hotel cap rates, cap rates have continued to remained relatively stable although they have increased slightly from 7.5 percent in 2012Q1 to 7.6 percent in 2012Q2. Exhibit 10 shows the hotel cap rate relative to the three year and five year moving averages. Note that the three year moving average has declined below the five year moving average signaling cap rate compression. This is consistent with an upward momentum in hotel prices.
Mortgage Financing Costs Are Rising Due to Increased Default Risk

At the time of this writing we are still awaiting the third quarter statistics for hotel mortgage originations from the Mortgage Bankers Association’s Quarterly Survey of Commercial/Multifamily Mortgage Bankers Originations. Exhibit 11 and Exhibit 12 depict interest rate spreads relative to different benchmarks. Exhibit 11 shows the spread between interest rates for Class A hotels and for B&C hotels over the ten-year Treasury bond. Although the risk premium for both sets of hotels is still smaller than their five-year historical medians (Class A hotels, 3.35% versus a 3.45% median; Class B&C, 3.60% compared with 3.85%). Third quarter risk premiums have risen 137 basis points (1.37%) above the June 2012 risk premium. Exhibit 12 shows the spread between the Class A (B&C) hotel interest rate over the interest rate corresponding to non-hotel commercial real estate, which we will call the hotel real estate premium. The hotel real estate premiums for both higher quality hotels (.53%) and lower quality hotels (.67%) have increased over the previous quarter (high quality, .37%; lower quality, .51%). The hotel real estate premium for higher quality hotels is now larger than its historical median of .47 percent, while it is equal to its historical median of .67 percent for Class B&C hotels. Both these exhibits show that mortgage financing costs have increased due to increased perceived default risk for hotel properties.

2 The interest rate on hotel properties is generally higher than that for apartment, industrial, office, and retail properties, in part because hotels' cash flow is commonly more volatile than that of other commercial properties.
Hotel Index Is Related to NAREIT Index
Exhibit 13 compares the performance of the Cornell repeat sales index relative to the NAREIT Lodging/Resort Price Index. The repeat sales index tends to lag the NAREIT index by several quarters. This is consistent with studies which find that securitized real estate is leading indicator of underlying real estate performance since the stock market is forward looking or efficient. Based on the NAREIT Lodging Price Index, we should expect a flattening of prices in the next quarter for our Cornell index.

Hotel Valuation Model (HOTVAL)
We have updated our hotel valuation regression model to include the transaction data used to generate this report. We provide this user friendly hotel valuation model in an excel spreadsheet entitled HOTVAL Toolkit as a complement to this report which is available for download from our CREF website.
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