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Fourth Quarter 2012: Price Growth Is Moderating: A Return to Normalcy?

Crocker H. Liu Ph.D.
Cornell University, chl62@cornell.edu

Adam D. Nowak Ph.D.
West Virginia University

Robert M. White Jr.

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Abstract
The Cornell Hotel Indices reveal that the hotel industry is continuing to experience positive price momentum for small hotels, with a moderating of prices for larger hotels. Consistent with this weakening in the price for larger hotels, construction costs for new 5-star hotels are now on par with the price of existing hotels. We also observe a lowering of expected growth in net operating income for full service hotels with anticipated NOI growth also moderating for limited service hotels. Hotel properties also exhibit a widening premium relative to other property types, signaling higher perceived default risk for hotel properties. Our index of business confidence suggests that we should continue to see a moderation in the prices for larger hotels. We expect a moderating of prices for smaller hotels going forward given the flattening of expected growth in NOI for limited service hotels and the worsening of consumer confidence in December. We also anticipate a continuous, slow growth in the hotel repeat sale index based on the NAREIT Lodging/Resort index and the Chemical Activity Barometer. This is paper number 5 of the index series.

Keywords
Cornell, hotel valuation models, interest rate spread, commercial real estate, 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/

This article is available at The Scholarly Commons: http://scholarship.sha.cornell.edu/cremi/5
The Cornell Hotel Indices reveal that the hotel industry is continuing to experience positive price momentum for small hotels, with a moderating of prices for larger hotels. Consistent with this weakening in the price for larger hotels, construction costs for new 5-star hotels are now on par with the price of existing hotels. We also observe a lowering of expected growth in net operating income for full service hotels with anticipated NOI growth also moderating for limited service hotels. Hotel properties also exhibit a widening premium relative to other property types, signaling higher perceived default risk for hotel properties. Our index of business confidence suggests that we should continue to see a moderation in the prices for larger hotels. We expect a moderating of prices for smaller hotels going forward given the flattening of expected growth in NOI for limited service hotels and the worsening of consumer confidence in December. We also anticipate a continuous, slow growth in the hotel repeat sale index based on the NAREIT Lodging/Resort index and the Chemical Activity Barometer. This is paper number 5 of the index series.
Hotel Market Activity Continues to Increase

Hotel market activity continues to increase, as shown in Exhibits 1 and 2 (next page) with the number of recorded transactions of both large hotels and smaller hotels rising in the fourth quarter of 2012 over the fourth quarter of 2011. Large hotel transactions increased 74 percent, with 75 transactions for large hotels in 2012Q4 compared to 43 transactions a year earlier (2011Q4). Similarly, small hotel transactions also increased albeit by a smaller amount (21%) with 138 transactions for small hotels in the third quarter versus 114 transactions in 2011Q4. A slightly different pattern emerges in terms of prices with both the hedonic index for low price hotels (under $10 million) and the repeat sale hotel index rising year over year. The hedonic index for low price hotels increased 10 percent—rising from 120.81 in 2011Q4 to 132.91 in 2012Q4—while the repeat sale hotel index rose slightly (.6%) increasing from 113.35 (2011Q4) to 114 (2012Q4). Both increases were slightly lower than those experienced in the third quarter. In contrast, the hedonic index for high price hotels ($10 million or more) declined 7.2 percent year over year, decreasing from 160.71 in 2011Q4 to 149.01 in 2012Q4 (see Exhibit 3).
Exhibit 1

Median sale price and number of sales for large hotels (sale prices of $10 million or more)

Exhibit 2

Median sale price and number of sales for small hotels (sale prices of less than $10 million)
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There continues to be a divergence in the trends for large and small hotels, with large hotels declining in price and small hotels increasing, as shown in Exhibit 4. This is a continuation of a trend showing that the market for smaller hotels has recovered.

Large Hotels Have Moderated in Price

As shown in Exhibit 5, which depicts the movements of the two averages for the large hotel index, this index has started to lose momentum. In particular, the index has crossed below its three-year moving average as of 2012Q4 (although it is still above its five-year moving average). This crossing signals a lateral to downward movement in the price trend for large hotels. Exhibit 6 offers confirmatory evidence that the large-hotel index continues to decline on a year over year basis. The index has experienced a -7.3-percent decrease in value from 2012Q4 to 2012Q4. On a quarter to quarter basis, the decline was much less, at -.11 percent (2012Q3 to 2012Q4).

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

About the Cornell Hotel Indices

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 Real Capital Analytics (RCA) commercial real estate databases. For the repeat-sale index, we compare the sales and resales of the same hotel over time. All three measures provide a more accurate representation of the current hotel real estate market conditions than does reporting 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 Indicators,” which is available at no charge from the Cornell Center for Real Estate and Finance (CREF). In this and subsequent issues, we present updates and revisions to our three hotel indices along with commentary and supporting evidence from the real estate market.
Exhibit 5

Large-hotel index, three-year moving average, and five-year moving average

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 trendline

Sources: Cornell Center for Real Estate and Finance, CoStar, Real Capital Analytics
We have identified two sources of the moderating momentum for large hotels. Rising construction costs appear to be one factor that accounts for the dampening of investor enthusiasm for higher end hotels. Exhibit 7 shows the relationship between the hard costs (direct building cost excluding land) for constructing a 5-star hotel per square foot of gross floor area relative to the sold price per square foot of gross floor area. The spread between construction costs to

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1 We use Rider Levett Bucknall (http://rlb.com/rlb.com/pdf/research/) to obtain the current building costs of a 5 star hotel. RLB reports hard construction costs (building cost excluding land) based on U.S. dollars per square foot of gross floor area (GFA). Markets include Boston, Denver, Honolulu, Las Vegas, Los Angeles, New York, Phoenix, Portland, San Francisco, Seattle, and Washington, DC. We take an equally weighted average of the high and low building costs across all of these markets. To obtain the sold price per square foot of gross floor area, we use CoStar and collect all hotels sold in 2008Q1 that sold for at least $10 million dollars and take the average price per square foot of GFA. Using this beginning value in 2008Q1, we increase or decrease this value in each subsequent time period using the hedonic index for large hotels.

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2 To calculate the expected growth in net operating income (NOI) for full service hotels, we used quarterly survey data on IRRs and cap rates for full service and limited service hotels from Realtyrates.com. We subtract the cap rate from the IRR to obtain the expected NOI growth rate.
**Exhibit 8**

Large-hotel index and expected NOI growth in full-service hotels

Sources: Cornell Center for Real Estate and Finance, Realtyrates.com

**Exhibit 9**

Small-hotel index, three-year moving average, five-year moving average

Sources: Cornell Center for Real Estate and Finance, CoStar, Real Capital Analytics
Smaller Hotels Continue to Increase

In contrast to larger hotels, the price of smaller hotels continues to exhibit positive momentum, as shown in Exhibit 9. Currently, the performance of smaller hotels is at their five-year moving average. The year over year evidence in Exhibit 10 is consistent with our moving average analysis. The small-hotel index increased 10 percent over the 2011Q4 to 2012Q4 period and experienced a 1-percent increase on
a quarterly basis. In terms of NOI growth expectations for limited service hotels however, we expect the price growth in smaller hotels to slow and start to normalize based on the evidence in Exhibit 11.

**Hotels Continue to Normalize in terms of Repeat Sales**

The repeat sale of hotels in Exhibit 12 based on the full sample echoes a similar albeit weaker story to that for smaller hotels.\(^3\) Currently the repeat sale index (full sample) stands at 114 (2012Q4), which is approximately where it was as of the first quarter of 2010. The repeat hotel sale index rose 0.6 percent on a year over year basis (2011Q4 to 2012Q4) and 1.5 percent on a quarterly basis (2012Q3 to 2012Q4).

**Cap Rates Have Compressed**

For the third quarter of 2012, the latest quarter for which ACLI reports data on hotel cap rates, cap rates have declined

\(^3\) We report two repeat sale indices. The repeat sale full sample index uses all repeat sale pairs, whereas the repeat sale index with a base of 100 at 2000Q1 uses only those sales that occurred on or after the first quarter of 2000, and thus doesn’t use information on sales prior to the first quarter of 2000. As such, if a hotel sold in 1995 and then sold again in 2012, it would be included only in the repeat sale full sample index but it would not be included in the repeat sale index for 2000 and beyond.
**Exhibit 13**

**ACLI hotel capitalization rates**

![ACLI hotel capitalization rates graph]

*Sources: ACLI, Cornell Center for Real Estate and Finance*

**Exhibit 14**

**Interest rate spreads of hotels versus 10-year U.S. Treasury bonds**

![Interest rate spreads graph]

*Source: Cushman Wakefield Sonnenblick Goldman*
from 7.6 percent in 2012Q2 to 6.01 percent in 2012Q3 (see Exhibit 13).

**Mortgage Financing Costs Are Rising due to Increased Default Risk**

Exhibit 14 and Exhibit 15 depict interest rate spreads relative to different benchmarks. Exhibit 14 shows the spread between Class A and also Class B&C hotel interest rates over the ten-year Treasury bond. Exhibit 15 similarly shows the spread between the Class A and also Class B&C hotel interest rates over the interest rate corresponding to non-hotel commercial real estate which we hereafter call the hotel real estate premium.4 Although the spread associated with Class A hotels (3.35%) and Class B&C (3.10%) continues to narrow (Exhibit 14), Exhibit 15 shows that the hotel real estate premiums for both higher quality (.57%) and lower quality (.71%) hotels have increased over the previous quarter (high quality, .51%; lower quality, .65%). The hotel real estate premium for higher quality hotels is now larger than its historical median of .47 percent, while it is slightly lower than its historical median of .75 percent for Class B&C hotels. The increased premium in Exhibit 15 signal that the perceived default risk for hotel properties have increased relative to the four major commercial real estate property types.

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4 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.
Exhibit 16
Repeat sales index versus NAREIT lodging/resort price index

Sources: Cornell Center for Real Estate and Finance, NAREIT

Exhibit 17
Repeat sales index versus chemical activity barometer

Sources: American Chemistry Council, Cornell Center for Real Estate and Finance
A Look Ahead: Reading the Tea Leaves

Exhibit 16 compares the performance of the 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 academic 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 predicted a flattening of prices in the next quarter for our Cornell Repeat Sale Hotel Index (full sample). The repeat sale index’s slight, .6-percent rise approximates this case. Another forward looking measure is the chemical activity barometer (CAB).\(^5\) The CAB anticipates peaks and troughs in the economy. According to material posted on their website, “the CAB is a leading index of overall U.S. industrial production, and comprises many indicators including everything from chlorine production to railcar loadings. It is constructed using a five-step procedure similar to the one used by the Conference Board to calculate composite indexes.” Exhibit 17 offers a confirmatory view of a moderation in prices. Based on both the NAREIT and CAB indicators, we thus expect to see a continuous, slow growth in sale price of hotels. An additional forward looking measure is the ISM PMI (Purchasing Managers’ Index) Diffusion SA (six months ahead). The ISM PMI (formerly known as the National Association of Purchasing Managers or NAPM index) is based on a survey of over 250 companies within twenty-one industries covering all 50 states. It not only measures the health of the manufacturing sector but is a proxy for the overall economy. It is calculated by surveying

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\(^5\) [http://www.americanchemistry.com/cab](http://www.americanchemistry.com/cab)
purchasing managers for data about new orders, production, employment, deliveries, and inventory, in descending order of importance. A reading over 50 percent indicates that manufacturing is growing, while a reading below 50 percent means it is shrinking. We use the ISM index in this study as a measure of business traveler demand and anticipated business confidence. Exhibit 18 shows that the ISM PMI is a leading indicator of the hedonic index for high priced hotels (≥$10 million). The exhibit provides a confirmatory signal that we expect a continuing flattening in the transaction price of hotels equal to or greater than $10 million.

Our final forward looking measure is the Consumer Confidence Index from the Conference Board which we use as a proxy for anticipated consumer demand for leisure travel. Exhibit 19 shows that the consumer confidence index is a leading indicator of the hedonic index for low priced hotels (<$10 million). Given the trendline, we anticipate a continuation of an upward trend in the transaction price for low priced hotels. However, a countervailing force is the impact of the new tax law which should act as a moderating factor.

**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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CREF Industry Fellows

Arthur Adler
Managing Director and CEO-Americas
Jones Lang LaSalle Hotels

Richard Baker
President and CEO
National Realty & Development Corp

Michael Barnello
President & COO
LaSalle Hotel Properties

Scott Berman
Principal, Industry Leader
PricewaterhouseCoopers

Vernon Chi
Senior Vice President
Wells Fargo

Howard Cohen
President & Chief Executive Officer
Atlantic Pacific Companies

Jeff Dallas
Senior Vice President, Development
Wyndham Hotel Group

Joel Eisemann
SVP & CEO
InterContinental Hotels Group

Kevin Fitzpatrick
Managing Director
Spring Bay Property Company

Russell Galbut
Managing Principal
Crescent Heights

Kate Henrikson
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RLJ Lodging Trust

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President & Co-Founder
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Chairman & Managing Partner
Watermark Capital Partners

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Steve Rushmore
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HVS Global Hospitality Services

Jay Shah
Chief Executive Officer
Hersha Hospitality Trust

J. Allen Smith
Chief Executive Officer
Prudential Real Estate Investors

Robert Springer
Senior Vice President—Acquisitions
Sunstone Hotel Investors

Susheel Torgalkar
Chief Operating Officer
Westbrook Partners

Robert White
President
Real Capital Analytics

Conley Wolfsinkel
Strategic Management Consultant
W Holdings

Dexter Wood
SVP Global Head—Business & Investment Analytics
Hilton Worldwide

Daniel Yih
Chief Operating Officer
Starwood Capital Group

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Jan A. deRoos, Executive Director
Jennifer Macera, Associate Director
Glenn Withiam, Director of Publications

Center for Real Estate and Finance
Cornell University
School of Hotel Administration
389 Statler Hall
Ithaca, NY 14853

Phone: 607-255-6025
Fax: 607-254-2922
www.cref.cornell.edu

CREF Advisory Board
ABOUT THE AUTHORS


Adam D. Nowak, Ph.D., is an assistant professor of economics at West Virginia University. He earned degrees in mathematics and economics at Indiana University–Bloomington in 2006 and a degree in near-east languages and cultures that same year. His thesis title was “Eigenvector Methods and Cointegrated Series.” Nowak taught an introduction to macroeconomics course and a survey of international economics at Arizona State. He was the research analyst in charge of constructing residential and commercial real estate indices for the Center for Real Estate Theory and Practice at Arizona State University.

Robert M. White, Jr., CRE, FRICS, is the founder and president of Real Capital Analytics, Inc., an international research firm that publishes the Capital Trends Monthly. Real Capital Analytics provides real time data concerning the capital markets for commercial real estate and the values of commercial properties. A noted authority on the real estate capital markets with credits in the Wall Street Journal, Barron's, The Economist, Forbes, New York Times, and Financial Times, he was named one of National Real Estate Investor's “Ten to Watch” in 2005, Institutional Investor's “20 Rising Stars of Real Estate” in 2006, and Real Estate Forum's “10 CEOs to Watch” in 2007. He spent 14 years in the real estate investment banking and brokerage industry and has orchestrated billions of commercial sales, acquisitions and recapitalizations. He was formerly a managing director and principal of Granite Partners LLC and spent nine years with Eastdil Realty in New York and London. White is a Counselor of Real Estate, a Fellow of the Royal Institution of Chartered Surveyors, and a Fellow of the Homer Hoyt Institute. A graduate of the McIntire School of Commerce at the University of Virginia, he is also a member of numerous industry organizations and a supporter of academic studies.

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