First Quarter 2012: Have We Turned the Corner?

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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 issue, we present updates and revisions to our three hotel indices along with commentary and supporting evidence from the real estate market.

Keywords
Cornell, consumer price index, hedonic hotel indices, interest rate spread

Disciplines
Real Estate

Comments
Required Publisher Statement

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EXECUTIVE SUMMARY

The newly created Cornell Hotel Indices portray an industry that has turned the corner to recovery, or is in the process of doing so. However, not all hotels are participating in the price recovery. Prices for large hotel transactions ($10 million or more) began their recovery several quarters ago, indicating a flight to quality. Prices for those properties continue to rise and capitalization rates are declining. However, the strength of large hotel prices has come at the expense of small hotels until recently. If small hotel prices have not turned the corner, at least that corner is now visible for those transactions (under $10 million). However, our repeat sales hotel index (RSHI) provides a more cautionary trend to this euphoria, with the year over year change in the RSHI continuing to trend upwards. This is not necessarily surprising given that a subset of both large hotel and small hotel transactions are included in this index. This is paper number 2 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 issue, we present updates and revisions to our three hotel indices along with commentary and supporting evidence from the real estate market.
**Exhibit 1**

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

![Graph showing median sale price and number of sales for high price hotels](image1)

Sources: CoStar, Real Capital Analytics

**Exhibit 2**

Median sale price and number of sales (hotels with sale prices less than $10 million)

![Graph showing median sale price and number of sales for low price hotels](image2)

Sources: CoStar, Real Capital Analytics
Exhibit 1 and 2 show that sales of both large hotels and smaller hotels have increased over the fourth quarter of 2011 and the first quarter of 2012 relative to the prior four quarters, indicating that hotel market activity has increased. The median sale price for 43 large hotels in 2011Q4 was $32.4 million, and it was $22.1 million for 39 transactions in 2012Q1. For the 114 small hotel transactions in 2011Q4, the median price was $3.2 million, and in 2012Q1, the median rose to $3.3 million for 93 transactions (see Exhibit 3).

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### Analysis of Indices through Q1, 2012

Exhibits 1 and 2 show that sales of both large hotels and smaller hotels have increased over the fourth quarter of 2011 and the first quarter of 2012 relative to the prior four quarters, indicating that hotel market activity has increased. The median sale price for 43 large hotels in 2011Q4 was $32.4 million, and it was $22.1 million for 39 transactions in 2012Q1. For the 114 small hotel transactions in 2011Q4, the median price was $3.2 million, and in 2012Q1, the median rose to $3.3 million for 93 transactions (see Exhibit 3).
In contrast to our last newsletter wherein we noted a divergence between the trends for large and small hotels (with large hotels increasing in price and small hotels declining), the two series have started to once again move in the same direction, as shown in Exhibit 4. This is an encouraging sign that the recovery in smaller hotels has started. We will delve more into this matter in a moment.

To do a more thorough analysis of our three indices, we first graph each index against its three-year and five-year moving average, also known as a rolling average. These moving averages smooth out short-term fluctuations and highlight longer-term trends or cycles. In this way we can eliminate short-term, erratic movements in past prices and thereby reveal more pronounced trends and patterns in the data. The longer the time period in the adjustment process, the more gradual the changes in the moving average. Since most pricing trends eventually revert to the mean, it follows that we can identify whether large or small hotels are moving in an uptrend or a downtrend depending on the direction of the moving average in relation to the index. So, for example, when a moving average is heading upward and the hotel index is above it, hotels are in an uptrend. Conversely, if the hotel index crosses below the moving average a downtrend is signaled. In this paper, we also apply a variation of the moving average system that uses two moving averages. The long moving average, which is the five-year moving average in our analysis, depicts the long-term trend in price or index movements, also known as the trendline. In contrast, the short moving average, which is the three-year moving average in our analysis, represents the smoothed proxy for price or the index. The analysis of the two moving averages is analogous to that of the single moving average system. So, when the three-year moving average moves above the five-year index, this is a signal of an uptrend in hotel prices, and the reverse is true in the case of a downtrend.
Exhibit 5 depicts the movements of the two averages for the large hotel index. The large-hotel index signaled positive momentum when it crossed above both its three-year and five-year moving averages in the third quarter of 2010.

The situation was radically different for smaller hotels, as evidenced in Exhibit 6. The decline in the small hotel index began in the first quarter of 2009, when the index fell below its three-year moving average, and that trend
and issuances have exceeded market expectations and that bodes well for the hotel sector. CMBS conduits are willing to lend in a greater variety of markets and dominated originations in tertiary markets in 2011. CMBS is also proving adept at financing portfolios, where activity has slowed in recent months. The trend in hotel stocks provides another complementary signal in the capital market that the hotel industry is gaining strength. The Baird/STR Hotel Stock Index not only ended first-quarter 2012 with almost a 20-percent increase (2012Q1 Index = 2,424 versus 2011Q4 Index = 2,025) over the previous quarter, but also outperformed both the MSCI REIT Index by 4.7 percent, and the S&P500 Index by 3.1 percent over the same time period. As the capital markets continue to improve, hotel investment sales should also improve. Even though we must caution that the short-term moving average has yet to turn upwards or cross the longer term average for smaller hotels, we see this as not necessarily surprising. It takes a while when using multi-year averages to see a reversal.

Lending picks up. One reason for these favorable developments is lenders’ greater willingness to lend on hotel properties. According to the February 2012 hotel report by Real Capital Analytics, “so far in 2012, CMBS originations and issuances have exceeded market expectations and that bodes well for the hotel sector. CMBS conduits are willing to lend in a greater variety of markets and dominated originations in tertiary markets in 2011. CMBS is also proving adept at financing portfolios, where activity has slowed in recent months.” The trend in hotel stocks provides another complementary signal in the capital market that the hotel industry is gaining strength. The Baird/STR Hotel Stock Index not only ended first-quarter 2012 with almost a 20-percent increase (2012Q1 Index = 2,424 versus 2011Q4 Index = 2,025) over the previous quarter, but also outperformed both the MSCI REIT Index by 4.7 percent, and the S&P500 Index by 3.1 percent over the same time period. As the capital markets continue to improve, hotel investment sales should also improve. Even though we must caution that the short-term moving average has yet to turn upwards or cross the longer term average for smaller hotels, we see this as not necessarily surprising. It takes a while when using multi-year averages to see a reversal.

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1 Commercial mortgage-backed securities (CMBS) are a common funding mechanism for hotel purchases.

2 http://www.hospitalitynet.org/news/154000320/4055644.html
Improving cap rates. One of the reasons why large hotels have experienced price growth is capitalization rate compression (declining cap rates) for large hotels. Exhibit 8 shows the historical trend in large hotels using data from the American Council of Life Insurers (ACLI). The cap rate on large hotels has declined below both the short-term and long-term moving averages, which in turn suggests that prices of large hotels increased as a result. However, the short-term moving average for the cap rate has exceed that of the longer term moving average since the third quarter of 2009, which indicates that price performance is still not back to the level of the mid-2003 period.

The last two exhibits, Exhibits 9 and 10, on the next page, depict interest rate spreads. Exhibit 9 shows the spread between Class A (B&C) hotel interest rates over the ten-year Treasury bond, while Exhibit 10 shows the spread between the Class A (B&C) hotel interest rate over the interest rate corresponding to non-hotel commercial real estate. As the expected risk of delinquencies and defaults decreases, the spread between the hotel interest rate and the risk free ten-year Treasury bond falls. Recently, loan spreads for hotel

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Estate boom, although it has neither crossed its short-term or longer term moving averages.

Operating results strengthen. Supporting the case for recovery, the positive momentum for hotels is also buoyed from an operational perspective. According to TravelClick’s December 2011 North American Hospitality Review (NAHR) based on actual hotel bookings from Q4 2011 through Q3 2012, "hotels will continue to see strong growth in 2012, primarily driven by rate increases and strong, steady demand for hotel rooms. Over the next twelve months, committed occupancy is up 3 percent year-over-year; average daily rate (ADR) is up 3.6 percent; and revenue per available room (RevPAR), the top-line indicator, is tracking ahead by 5.3 percent." In summary, TravelClick’s prognostication is for “slow and steady” increase in hotel performance through 2012Q3 based on actual hotel bookings.

A different perspective exists when we examine the repeat sale of hotels in Exhibit 7. The repeat hotel sale index (RHSI) exhibits a similar hotel price growth pattern to that of smaller hotels. However, the positive trend is more gradual in nature. It appears that the RHSI has almost recovered to its Q1, 2005 level, the period at the start of the hotel real estate boom, although it has neither crossed its short-term or longer term moving averages.

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Exhibit 9

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

Source: Cushman Wakefield Sonnenblick Goldman

Exhibit 10

Interest rate spreads of hotels versus non-hotel commercial real estate

Source: Cushman Wakefield Sonnenblick Goldman
properties have started to narrow again. Exhibit 9 shows that the interest rate spread on Class A hotels is now approximately at its historical median (same level as 2008), while that for lower quality hotels (Class B&C) is still lower than its historical median. Another way to view hotel interest rates is relative to interest rates on non-hotel commercial real estate. 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 10 shows that the interest rate for high quality hotels are within their historical median measured over the 2007 to 2012 period. However, the interest rate for lower quality hotels is still below its historical average.

Pop Quiz

Let’s now return to the question that we posed in the title of this report. Have we turned the corner yet with respect to the performance of hotel properties? If this were a multiple choice question, what would the best answer be? Is it (a) Yes, (b) Maybe or Perhaps, or (c) No? Or is it actually (d) All of the above?

The answer depends on what type of hotel property one is focusing on. If it is large hotel properties, then the answer is (a) yes. In contrast, the most probable answer for small hotel properties at this writing is (b) perhaps. But the answer is currently (c) no, if hotel transactions that make up the repeat sale hotel index is our primary focus. Thus, we see a divergence in the hotel market, and the final answer is, (d) all of the above.
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**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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