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Opinions

Prospects for hospitality investments through 2018

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There’s several important dynamics taking place that are affecting the lodging sector, and hotel owners may want to further investigate.

By Lou Plasencia

Hotel performance across virtually all United States markets has been solid in the first quarter of 2018, which have been favorably affecting hotel investment dynamics. Looking ahead to the remainder of 2018, we expect hospitality investment activity to be similar to or slightly better than what we experienced in 2017, although values may not fare as well.

The potential effects of the Tax Cuts and Jobs Act of 2017, the emergence of an important new class of investor for hotel properties and the continued allure of higher-end properties are just three factors that many owners of hotels and resorts may want to further investigate. Here’s a look at each.

Tax reform affects investment activity
The tax act is the most significant change to U.S. tax law in several decades. While time will tell how things fully play out, recently enacted changes are expected to be advantageous to most real estate investors. The act’s favorable provisions include preservation of Section 1031 tax exchanges for real estate, a new 20% deduction for pass-through entities through which many real estate investments are organized, and the ability to opt out of certain business interest deduction limitations. According to an analysis by multinational law firm Shearman & Sterling, this last provision may lower the after-tax cost of capital for U.S. real estate companies while creating new investment incentives to foreign capital sources.

Changing investor mix
The changes in the tax law will have significant appeal for two increasingly important groups of hospitality investors: high-net-worth private investors and investors from Latin America.

The growing participation of high-net-worth individuals and family offices in hospitality investment is a trend we saw take hold strongly last year. This group is finding operating cash flows and overall cash-on-cash returns on hotel investments very attractive. Many of these investors appreciate and understand operating businesses like hotels. Our own research indicates that high-net-worth investors in Florida, where we are headquartered, may be responsible for as much as two-thirds of hotel transactions over the last year or so.

In comparison, involvement by larger, well-capitalized private equity firms has cooled off as they seek higher-leveraged internal rates of returns than hospitality properties currently generate. Publicly-traded real estate investment trusts also generally remain on the sidelines due to their inability to raise significant capital.

In addition to high-net-worth individuals and family offices, we have witnessed an increase in foreign capital investing in hotel properties over the last four to five years. Recently, the profile of that investor has changed, particularly in Florida and Texas, with more “flight capital” coming in from Latin American investors, especially those from Argentina, Venezuela and Mexico. These Latin American investors are partnering with domestic asset and property managers who have established performance records and know well the operating dynamics of U.S. markets.

Notwithstanding the availability of private and foreign capital, the low interest rate environment and strong industry performance, many owners are still choosing to hold their hotels. Rather than selling, some are refinancing or recapitalizing their hotel properties. These supply and demand dynamics have resulted in stronger valuations and sale prices for those properties that do transact. Simply put, there are lots of buyers but not enough product available for them to acquire.

While Chinese investors were the talk of the industry as recently as three years ago, it’s worth noting that the Chinese government has reeled in some free-wheeling investors who were over-leveraging their properties. This is reminiscent of what the industry witnessed with some Japanese investors in the late 1980s and early 1990s. More recently, Chinese investments were primarily made in prestige hotels in gateway markets. Some of these properties are now trading at discounts to their last sale prices, yet those “markdowns” are not as great as many investors had hoped.

While there may be limited downward pressure on valuations in a few select markets, we believe the broader impact of Chinese retrenchments will be modest and temporary. In fact, we look for Chinese investors to return to the U.S. hospitality space in the next four to five years, albeit at a more moderate pace.

Foreign investment is also being spurred by the extension of the EB-5 visa program. While the amount of base EB-5 investment by foreign nationals needed to qualify for the visa (i.e., Green Card) may increase, an extension of the program will sustain a continued source of foreign investment for private hospitality assets.

A matter of class

All hospitality subclasses, from economy and select service to full service, luxury and boutique, remain strong, with excellent operating fundamentals and impressive asset valuations. However, luxury hotels, in particular, have become an even more highly sought-after asset class by investors. This is due to their superior rate elasticity under a strong demand environment, wedded to recession-resistant qualities when hospitality markets are weaker. Further, very little new luxury inventory is entering the market, making supply and demand dynamics even more favorable for this segment of the lodging industry.

Interestingly, select-service and extended-stay properties are also very attractive to investors right now, especially mid-range investors such as the aforementioned high-net-worth individuals and family offices. Positive factors here include an attractive price of entry into hospitality investment, the ability to more easily generate occupancy on weekends (as compared to full-service properties), and the generally higher profit margins generated by these types of hotels.

Final thoughts

While the hospitality sector continues on solid footing, and investment activity is not predicted to decline, we do expect that hotel and resort property values will be flat and, potentially even drop slightly in the near term. Should interest rates rise, as we expect they will, there will be a corresponding increase in cap rates, and owners may experience a decline in property valuations.

While many properties are reporting strong occupancy levels, it is evident that average-daily-rate growth at most properties will not be able to keep up with increases in operating expenses. Many operators are under siege in select high-cost markets with respect to labor costs, insurance costs and property tax assessments. These are areas that will receive greater scrutiny from property and asset managers in the year ahead, especially as they work diligently to rein in costs should revenue per available room flatten.

Realistically, after eight years of month-over-month RevPAR gains, many industry pundits expect the market is nearing its peak. Then again, many have been calling the "end of the cycle" for over two years now. We don't see anything meaningful on the horizon at the moment that will cause a derailment. Regardless, hospitality properties remain an attractive class of commercial real estate investment where, in virtually any phase of a cycle, astute, opportunistic investors will be rewarded.

Lou Plasencia is the Chairman and Chief Executive Officer of The Plasencia Group, which he founded in 1993. He is responsible for the firm's business development activities and the oversight of all of its investment advisory and consulting engagements. Throughout his career in hospitality and commercial real estate, Mr. Plasencia has been involved in a number of high-profile assignments, including individual and portfolio engagements with institutional and private owners of hotel, resort and golf real estate assets.