



Cap Rates Continue Their Trend Downward in Q2 Summary

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As the next installment to my March 2009 article published in Hotel News Now, I thought it best to literally pick up where I left off on that date. In the last paragraph of that article I concluded that because Strategic Hotel Capital (BEE on NYSE) has a cap rate below 10%, over 200 basis points below the next lowest, its share price may still have potential for further declines. At that time, cap rates ranged from 9.6% (for BEE) to 15.4% (for Host) and averaged 12.8% for all seven REITS based on their March 2, 2009 share prices and 2008 year-end statistics. My final sentence read, "So whether you are lowering your income on a TTM basis or forecasting 2009, you can safely anticipate most of those cap rates to trend downward through 2010."

So here we find ourselves three months later, and indeed cap rates have declined from those highs as indicated in the following table. As I did on March 2, 2009, I have calculated the current (as of June 2nd, 2009) capitalization rate for each of seven publicly traded lodging REITS and on average they have declined by 300 basis points during that time. With trailing twelve-month (TTM) through Q-1 2009 revenue and EBITDA as well as equity and debt information for each company, I have calculated the total enterprise value of each REIT to be used as the denominator for each respective capitalization rate. The first set of rates labeled Net Income to Enterprise Value indicates the cap rates based on the current share price of the respective company. To the right of those rates, I have posted the resulting cap rate from a similar methodology applied to previous points over the past two years.

Cap Rate Trends - Lodging REITs

	Based on Current Value (6/02/09)		Cap Rate As of March 2, 2009	Cap Rate As of September 9, 2008	Cap Rate As of May 9, 2007	9-Month Cap Rate Change	9-Month % Per Room Enterprise Value Change
	Net Debt as a % of Enterprise Value	Net Inc./ Enterprise Value (Current Cap Rate)					
Lodging REITs							
HOST HOTELS & RESORTS	57%	10.3%	15.4%	8.7%	5.2%	1.6%	-30.0%
HOSPITALITY PROPERTIES	60%	11.2%	13.7%	10.4%	6.0%	0.8%	-5.0%
SUNSTONE HOTEL INVESTORS	87%	10.3%	11.9%	9.6%	5.1%	0.7%	-32.7%
LASALLE HOTEL PROPS	57%	9.5%	13.4%	8.8%	4.8%	0.7%	-17.7%
STRATEGIC H & R	83%	7.9%	9.6%	8.0%	4.0%	-0.1%	-23.0%
FELCOR LODGING TRUST	71%	11.4%	13.2%	10.4%	5.7%	1.0%	-4.4%
DIAMONDROCK HOSPITALITY	54%	8.3%	12.8%	9.5%	3.9%	-1.2%	-7.5%
AVERAGES	67%	9.8%	12.8%	9.3%	5.0%	0.5%	-21.9%

Cap rates declined largely due to the weakening operating performance of the lodging REITS as forecasted. However, the decline in cap rate was also the result of substantial increases in the share prices of most of the lodging REITS. As we know, the overall stock market enjoyed a significant gain from a low of roughly 6,500 on the Dow to over 8,500 today. Undoubtedly lodging REIT stocks rode that wave upward just as they rode it down since September 2008. While cap rates based on TTM performance will assuredly continue to decline in Q-3, share prices will likely continue to follow the overall market trend and as you know, there is great debate regarding which way the overall market will go.

What is clear is that the current individual cap rates of the lodging REITS are somewhat mismatched with the stocks themselves. Although Strategic Hotel Capital did not experience the decline in share price that I cautioned of in March; among the lodging REITS, BEE did achieve the lowest increase in share price over the past three months. This minimal increase likely reflects both the more excessive declines in the performance of luxury hotels and the risk associated with the high debt load of BEE. HPT and LaSalle experienced the least decline in EBITDA from Q-1 2008 to Q-1 2009 (13%) while BEE experienced the greatest decline (60%).

Because it was only one quarter, that decrease only accounts for a 14% decline in BEE's annual income and only 3% for HPT and La Salle. However, once Q-2 and likely Q-3 earnings are reported, I expect these trends to continue to the point where annual EBITDA may have declined year over year by 25% to 30% on average. This would result in another 200-basis-point decline in cap rates from June 2nd to December 2nd, even if lodging stock prices stay the same over the remainder of the year.

If lodging REIT share prices maintain their current level without significantly reducing debt, the market would have to get comfortable with cap rates averaging around 8% on a TTM basis. This seems plausible given the (hopefully) atypically poor performance of hotel assets in 2009. However in order for all seven lodging REITS examined here to average an 8% cap rate, certain stocks will need to be priced below an 8% cap rate (and some above).

This is a point at which I do not believe too many investors will feel particularly comfortable and therefore would likely induce a repricing of lodging REIT stocks relative to one another. Furthermore, if share prices increase, the TTM cap rate at the end of Q-2 and/or Q-3 will be below 8%, and again likely lead to some discomfort for shareholders. Therefore, I anticipate that most lodging REIT share prices with significant luxury and

convention-oriented hotel holdings will experience a backward slide over the remaining two quarters as they struggle with debt payments on their significantly leveraged assets. The exception to this will be Hospitality Properties Trust (HPT) because their entire portfolio is comprised of limited-service, extended-stay and focused-service lodging properties.

A strong indicator that share prices of public REITS are currently being valued by stock analysts and not hotel operators is the fact that HPT is typically "labeled" with the highest cap rates among lodging REITS. Despite the ubiquitous knowledge among all lodging operators that limited-service hotels are far more efficient and profitable than luxury or full-service properties, the investment community typically perceives that luxury hotels and resorts offer less risk because of their underlying land or high replacement cost. This is a reasonable assumption when you compare one luxury full service hotel to one limited service or focused service property because the barriers to entry are generally low that the lower-end property will gain a competitor or competitors. However, for a Lodging REIT or a hotel portfolio owner, the geographic diversity of the portfolio can usually mitigate this potential issue. Therefore, I have tried to dispel this notion for over twenty years with articles published regarding extended-stay hotels in the 1980s and limited-service portfolios in the 1990s but again I will state that limited/focused service and extended stay portfolios are far more risk adverse during economic downturns than luxury hotel portfolios. This is born out again in 2009 where STR Global reports Year-to-date RevPAR declines in the Economy and Mid-Rate tiers have declined 15% to 20% compared to 20% to 30% for upscale and luxury hotels.

Hotels are bought and sold almost entirely based on their ability to generate income. So other than brief periods when the market is so hot that buyers ignore or inflate the operating performance of luxury hotels, the fact that the underlying land or physical asset is somehow a safety net for the degradation of value is not generally applicable. I suppose there are instances wherein luxury hotels during downturns experience either low levels or even no positive EBITDA and still trade for \$100,000 a key or more. This is one way in which the luxury-oriented property (and its physical attributes) offers a hedge against an erosion of the economics behind the hotel operation. But I would hardly consider the comfort that such a hedge provides as a sound investment strategy. Rather, investing in (limited/focused-service) hotel portfolios that, in a worst case, will decline in operating performance but still produce positive cash flow is what I propose to be a better investment strategy. We shall see if this is taken to heart when I examine cap rates for the Lodging REITS again in September of 2009.

Gregory Hartmann is Managing Director of HVS, the largest hotel consulting firm in the world. Greg and his staff, based in Boulder, Colorado, have appraised and evaluated over 10,000 hotels from single assets to portfolios containing hundreds of properties. In addition to HVS, Greg owns a number of small businesses in and around the Boulder area, was an adjunct professor at CU and has authored numerous articles and spoken at industry conferences for nearly two decades. Contact Greg at 303-301-1121 or ghartmann@hvs.com