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Hotels packed up and ready to go

Inn owners want out; sales may hit $500M

San Francisco Business Times - by Sarah Duxbury

More and more San Francisco hoteliers hope to hop into bed with a REIT.

With hotels selling quickly, and for prices reminiscent of the real estate boom, others are opting for the sales block.

Jones Lang LaSalle Hotels recently forecast that San Francisco hotel deal volume could reach $500 million in 2011, the second-highest amount recorded.

Closed deals in 2011 are already near the $300 million mark, and two likely REIT targets, the Fairmont and the Hyatt Regency, have just come to market.

While there is no single explanation for why so many hotel owners want out of their inns, one undeniable factor is aggressive purchasing by well-funded REITs.

Real estate investment trusts accounted for 70 percent of purchase activity by volume in 2010, according to JLL. Better still, those REIT transactions have been done at very low capitalization rates — around 3 percent to 4 percent, close to the record lows seen back in 2006. That means that owners who bought during the last peak and whose debt is now coming due are able to exit without losing lots of money.

Because just a few REITs are doing almost all the buying, and there's a scarcity of trophy properties, their own competition is helping to crank up prices and lower cap rates, said Anwar Elgonemy, Director of Acquisitions for Equinox Hospitality Group.

"Without the REITs, we wouldn't be having this conversation" about why so many hotels are for sale, noted Rick Swig of RSBA & Associates. "REITs and their recent purchase activity in San Francisco and around the country are driving the transaction market, so if you have a REIT-qualified or REIT-attractive building, why not? You'd be silly not to test the waters, unless you are making so much money you don't have to."

What the REITs are looking for: large, upscale, prominent hotels.

Most of the properties recently sold or listed for sale fit the bill. But each major hotel being sold has its own backstory.

In the case of the Fairmont Hotel, the Board of Supervisors' rejection of plans to convert part of the property to condominiums killed the owners' interest in holding on to it.

While the Fairmont remains one of San Francisco's greatest trophy properties, Nob Hill has lost its luster as a hospitality stronghold; there's a reason that every single Nob Hill hotel is now up for sale, Swig said, and since the owners couldn't downsize the 591-room Fairmont by turning some of the units into condos, it makes sense to sell.

Many of the other properties coming to market, such as the 802-room Hyatt Regency, and **Larkspur Hotels & Restaurants'** three San Francisco hotels, last traded between 2005 and 2007 and may have looming debt maturities. That certainly is the case with most of the hotels that have sold in the past year.

While REITs have been major players because they can access such cheap capital and target trophy properties in gateway cities to lure prospective investors, the weak dollar means that foreign investors might also start to make moves in San Francisco, where REITs have dominated since the lodging real estate market roared back to life in 2010. San Francisco was the No. 2 market in the U.S. for hotel sales volume in 2010, according to JLL.

While some may raise eyebrows at recent sale prices, and how close they come to the "bubble" prices of 2006 and 2007, there are solid business reasons to buy here.

San Francisco has recovered faster than almost any hotel market in the country: revenue per available room for upscale and luxury hotels is up 18.7 percent in the first four months of the year, according to Smith Travel Research.

Then the economy here is stronger than most other regions, particularly with the growth of tech and biotech; most major hotels (save Hyatt) have signed new contracts with the hotel union; the next few years look strong for conventions; the America's Cup race in 2013 is expected to attract countless visitors; and between the weak dollar and the recent International Pow Wow sales convention that sold San Francisco to thousands of international tour operators, international tourism should be robust in coming years.

Factor in that there will be no new hotel rooms built any time soon and its gateway city status, and San Francisco is one of the most desirable U.S. markets for REITs and other hotel investors.

"Lodging real estate reacts immediately to economic growth due to its nightly nature of leases," said Andrea Grigg, Senior Vice President Jones Lang LaSalle Hotels, arguing that the high prices REITs have been paying for San Francisco hotels are indeed fair market prices. "As such, hotels offer an immediate investment opportunity in recovering markets like San Francisco."

Elgonemy cautioned that while the top line growth story in San Francisco is undeniable, operating here is hard on the bottom line, thanks to the strong hotel union and the high fixed cost structure of hotels.

Too, average daily hotel rates are still lower than they were in 2000, on an inflation-adjusted basis.

As for how much these latest hotels might go for: "There's never an asking price anymore," Swig said. "We're now in the auction world."

Sarah Duxbury *covers retail, restaurants, hospitality and nonprofits for the* ***San Francisco Business Times****.*
Contact her at ***sduxbury@bizjournals.com*** *or (415) 288-4963.*
Read her blog postings at ***Bay Area BizTalk****.*