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Buying High and Selling Low Revisited: The "Quiet Industry"

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Abstract
In summary, while there may be some potential for extraordinary profits from investing in hotels, we believe that the ability to simply buy low and sell high as a result of lodging market cycles or capital market cycles will be greatly diminished in the future. Opportunities to take advantage of noise traders (that is, those whose motivations are based on factors other than the economics of the deal) are gone, and there is no evidence of distressed selling in the current environment, even though the challenges to the industry have been great. Disciplined equity and debt capital, smart underwriting, and broad capital markets will continue to weaken the ability for noise trading to exist in the market for hotels as investment property. Paraphrasing John Houseman’s words in the old Smith Barney advertisement, in today’s lodging market, you have to make money the old fashioned way, you have to earn it.

Keywords
hotel real-estate market, lodging industry, property values, transactional analysis, buyers

Disciplines
Hospitality Administration and Management

Comments

Buying High and Selling Low Revisited:

The "Quiet Industry"

It is quieter now that the "noise traders" are absent from the hotel real-estate market!

BY JOHN B. CORGEL AND JAN A. DEROOS

In the December 1994 issue of *Cornell Hotel and Restaurant Administration Quarterly,* we published an article with the ironic title, "Buying High and Selling Low in the Lodging-property Market." The purpose of that article was to test the so-called "law of one price" in the special case of the hotel real-estate market. This well-known economics principle states that goods or services that are either of equal quality or are perfect substitutes (for each other) will sell at the same price. This principle is founded on the assumptions that the market is perfectly competitive, and that the buyers and sellers who are involved in transactions, being equally informed and totally free to deal, have no effect on settlement prices. Stated differently in the context of hotel transactions, a hotel located in city X at the corner of Y Street and Z Street will command the same price per room regardless of whether the seller is either a large REIT or a small limited-liability corporation, and whether the buyer is a hotel-operating company or an individual investor. All that really matters with respect to property pricing are the fundamentals of the property, such as the number of rooms and location, that underlie the hotel's ability to generate stable net operating income.

In addition to the two assumptions above, the law of one price comes with a set of restrictive assumptions about

 This report is a commentary on an article that was previously published in *Cornell Quarterly* and which is reprinted herein (see pages 69–75).

the character of the market. The most important of those restrictions are that information costs are not prohibitively high so as to provide unfair advantages for large-scale participants and that the parties in transactions are not under duress.

Because of the location monopoly of a real-estate parcel, it is commonly held that only imperfect substitutes exist in real-estate markets and that information costs are naturally high. In addition, real-estate market participants frequently find themselves under pressure to sell too cheaply or to buy too dearly. Given these endemic conditions in the hotel real-estate market, we fully expected going into the 1994 study that the law of one price would be rejected in the case of hotel real-estate markets. We expected to find that some investors were buying high and some owners were selling low. Indeed, that is exactly what we found! Beyond testing the law of one price, our specific interests were to identify the "renegade" traders and estimate the magnitude of their errors (clearly not for our gain—we're researchers!).

Hypothesis testing in our study involved the development of a hedonic (i.e., regression) pricing model incorporating important fundamental variables. With the fundamentals held constant, we introduced a series of indicator variables representing various types of hotel buyers and sellers. The significance and size of the coefficients on these buyer and seller variables allowed us to determine who overpaid and who undersold their property, and by how much. A large data base of hotel transactions completed during the period 1985 through 1992 that we maintained then at Cornell was used to derive parameter estimates. The following two points summarize our key findings (remembering that this is a picture of the industry in the late 1980s and early 1990s).

- Foreign buyers (institutions and individuals), especially Japanese buyers, substantially overpaid for hotels. These buyers were new to the U.S. real-estate markets and really did not understand asset pricing and the market distortions that occurred during the 1980s.
- Federally regulated institutions, especially the RTC, substantially undersold hotel property because of pressure by Congress to quickly rid their portfolios of commercial real-estate exposure.

The Hotel Real-estate Market Since '92

The hotel real-estate market has not undergone structural changes during the past ten years. From 1992 through 1997 hotel property prices rose steadily as a number of influences played out. These are:

> The lodging industry today is much closer to the "law of one price" than it was in 1992.

(1) The mid-1990s was a period characterized by rising personal incomes and employment and, consequently, increasing RevPARs throughout the United States. Property prices followed the resulting upward movement of hotel income.

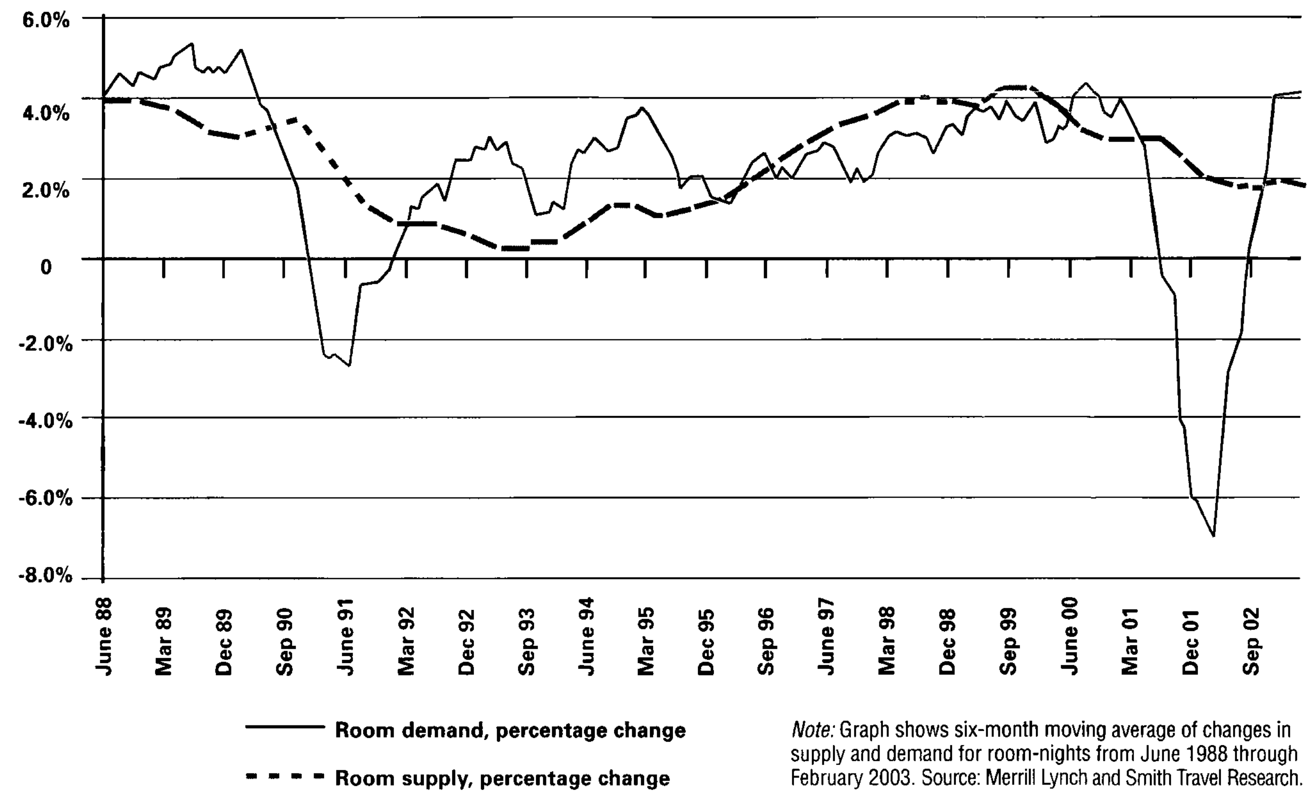
(2) As the ugliness of the early 1990s' real-estate crisis became an increasingly distant memory, capital availability became less of an issue for hotel investors and developers.

(3) The demand for REIT shares experienced an unprecedented rise as institutional investors sought liquidity. Along with growth, hotel REITs became increasingly aggressive bidders, creating an arbitrage opportunity for private market sellers. So, by 1995, both price-per-room and transaction volume were accelerating.

The hotel property market began cooling down well before the recession of 2001, as all of the positive influences mentioned above exhibited signs of fatigue. Investors in existing assets, capital suppliers, and developers simultaneously and instinctively began slowing down the pace of the market in 1999. A graph from a recent Merrill Lynch industry report shows the slowdown in supply growth start-

EXHIBIT 1

Changes in supply and demand for U.S. lodging industry, 1988–2003



Note: Graph shows six-month moving average of changes in supply and demand for room-nights from June 1988 through February 2003. Source: Merrill Lynch and Smith Travel Research.

ing at the end of 1999 (see Exhibit 1). The situation in that time period is different from that of the early 1990s, when it took almost two years for supply to adjust to the downturn in demand. These reactions provide the first real-world evidence of the market discipline that analysts and academics had been expecting for some time.

Disciplined Markets Begin with Sophisticated Participants

The cliché that "experience is the best teacher" became a reality in real-estate markets during the late 1990s. Everyone learned a great deal about how these markets operate from the experiences dating back to the late 1980s. Substantial learning occurred because this period represents the first time in the history of real-estate trading that reliable data were available to study market behavior through a complete cycle. With availability came accessibility to even the smallest hotel investors. For example, Hotel Brokers International (then Hotel Brokers Association of America) in the mid-1990s began producing the *Transactions* report that provides details of all hotel transactions closed through its membership. These reports continue to be available to the public for a modest charge. Other innovations in the hotel industry that promoted market discipline since the early 1990s include:

(1) *Occupancy, ADR, demand, and supply data.* Smith Travel Research continues to increase market coverage and reporting frequency.

(2) *Construction activity.* Lodging Econometrics, and recently Smith Travel Research with the F.W. Dodge Company and Property and Portfolio Research, began to offer detailed reports on hotel-construction pipeline activity by brand and local market.

(3) *Econometric forecasts.* PricewaterhouseCoopers and (recently) the Hospitality Research Group with Torto-Wheaton Research, produce forecasts of hotel financial performance using sophisticated statistical models.

(4) *Operating-expense data.* The Hospitality Research Group of PKF Consulting extended its efforts to supply timely and accurate benchmarking data, and Smith Travel Research initiated a service to benchmark hotel financial performance to the NOI line.

What We Think Now

In light of the ongoing changes to the investment climate, the transparency that comes from enhanced data availability, and the continuing evolution of the capital markets' understanding of lodging, we believe that the lodging real-estate market will continue to become more efficient—and thus, based less on "noise." The following are among the most important changes.

- Availability of an ever-broader range of capital sources will continue to ensure that hospitality real estate does not face a liquidity crisis and ensure that hotels are fairly priced. As an example, over the past two years, the principals of many opportunistic funds thought they could repeat their success of the early 1990s, when they took advantage of the combined effects of an industry downturn and a liquidity crisis by buying low and selling high. The majority of these funds have sat on the sidelines this time around as investors with lower required rates of return, such as the REITs, both public and private, and the large institutional investors purchased properties that met their investment criteria.
- Debt capital will continue to provide market discipline. The current environment is dominated by first-mortgage providers who will underwrite a loan with a 60-percent loan-to-value ratio, meaning that equity providers (i.e., owners) must have a substantial stake in their investments. Those investors who use the so-called mezzanine debt market might be able to achieve debt leverage of 80 percent, but only by pledging the majority of excess cash flow to the mezzanine lender; this creates incentives for investors to consider only deals that are economically viable.
- Financial innovations are changing the nature of lodging income. Globally, the use of leases with hotel operators or the

> The wide availability of transaction information combined with more knowledgeable financing sources has promoted discipline in the market for lodging real estate.

willingness of operators to guarantee a minimum return on investment (or at least to subordinate their fees to achieve a minimum return on investment) have the effect of transforming what was a risky flow of net operating income to a much less risky flow. This risk reduction allows for lower required rates of return and higher pricing for hotels.

Just earn it. In summary, while there may be some potential for extraordinary profits from investing in hotels, we believe that the ability to simply buy low and sell high as a result of lodging market cycles or capital market cycles will be greatly diminished in the future. Opportunities to take advantage of noise traders (that is, those whose motivations are based on factors other than the economics of the deal) are gone, and there is no evidence of distressed selling in the current environment, even though the challenges to the industry have been great. Disciplined equity and debt capital, smart underwriting, and broad capital markets will continue to weaken the ability for noise trading to exist in the market for hotels as investment property. Paraphrasing John Houseman's words in the old Smith Barney advertisement, in today's lodging market, you have to make money the old fashioned way, you have to earn it. ■

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