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"IRRATIONAL EXUBERANCE" OR GOLDEN AGE: IS THIS THE BEST OF TIMES FOR NEW YORK CITY HOTELS?

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(Updated January 2016 with a new introduction)

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Nearly two years ago, I wrote an article that asked the question: “Irrational Exuberance or Golden Age: Is This the Best of Times for New York City Hotels?”

My answer at the time was “Yes … But!” In spite of a building boom and a resulting dramatic increase in capacity, I argued that fundamental factors – the scarcity of New York City real estate and the city’s sustained drawing power as both a tourist destination and an economic engine – provide New York with long-term protection from the boom-and-bust cycle that had halted growth in such other markets as Orlando.

But there were cautions as well. The critical idea for investors to keep in mind, I wrote, was “long term.” While over time, New York City hotels produce healthy growth, and both average daily rates and valuations come back after downturns, there are indeed downturns, and their impact can be significant for investors who can’t or won’t stay in the game long enough to wait them out and benefit from the overall upward trend. Historically, New York has grown its way out of recession and come out better, but it is not immune.

Two years later, what has changed? Nothing … but everything. New York continues to be the hottest market in the hotel industry. And with that heat come the same concerns about whether we are in a bubble or can look forward to sustained growth.

The upsurge in capacity has been dramatic. Over 100 new hotels have opened in the past six years, effectively doubling the supply of New York City hotel rooms. Another 50 or so are expected to open in 2016 and 2017, adding another 40 percent in room supply.

All of that new supply is having an impact. While numbers are not yet final, even the most optimistic estimates show that revenue per available room was flat in 2015. Some estimates show RevPAR off by 2-3 percent. Despite these alarm bells, transactions have not slowed – at the high end, they have heated up. Big names on the block in 2015 included the New York Palace and The Waldorf Astoria – the latter reported fetching an astounding $1.4 million per key.

With those numbers in play – surging inventory, flat or negative RevPAR (revenue per available room), soaring valuations – it’s understandable that there would be fresh concern about an overheated market coming to a bad end. And for short-term investors, the data may in fact be worrisome and the day of reckoning may, in fact, be near.

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But for long-term investors looking for assets to hold perhaps for family generations, and who invest with prudent leverage, I believe the future can still be bright – just as it was two years ago. And with that in mind, it may be timely for you to reread my original article, take note of the cautions, plan carefully, and look forward to a New York City hotel market that over the long term will grow from strength to strength.

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By now, we all know what a bubble looks like. When Alan Greenspan made his “irrational exuberance” speech in 1996, to some the idea of a bubble seemed exotic, maybe even outdated. Seventeen years later, after multiple run-ups and collapses that led the world into financial crisis, we know better. There are, in fact, bubbles, and bubbles are dangerous.

Is the New York City hotel industry generating a bubble right now?

That’s the central question, and the answer has real consequences for hotel investors, owners, developers and management companies. New York hotel valuations are at an all-time high. Is this a bubble caused by irrational exuberance? Or have fundamental factors changed the landscape and created a “golden age” of New York City hotels?

New York City hotel valuations are at an all-time high

Let’s look at the numbers.

Ten years ago, it was not uncommon for New York City hotel transactions to trade between $150,000 and $250,000 per key. Only top-of-the-line premium properties would trade substantially beyond that.

A decade later, with little national inflation during that time, the same types of properties are trading between $300,000 and $400,000 per key, sometimes even more. Premium properties are trading well above that. Even properties in dire need of substantial renovation are trading well above the $150,000 per key seen ten years ago.

Are the valuations sound? What do the underlying fundamentals say?

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Bubble or not?

To answer the question, we need to define what we mean by “bubble”. The classic definition of a bubble is a run-up in valuations that greatly exceeds the value of an underlying asset. In the case of current New York City hotel valuations, for the transaction values not to be a bubble, the fundamentals of the industry must have changed. Have they?

According to the 2013 Hotel Market Overview developed by HVS Global Hospitality Services, New York City occupancy has grown from less than 70 percent twenty years ago to 86.7 percent in 2013. The rise in actual rooms booked is even larger than those figures suggest – it occurred during a time that overall capacity actually increased.

The increase in occupancy translates directly into financial returns. The study shows that in a period starting in 1989 and encompassing the last three major recessions, Average Daily Rates (ADRs) increased from $125 to $279.62 in 2013. While the last figure represents a decline from the all-time high of $313.78 in August 2008, it also reflects a sharp increase from the post-recession low. In fact, while ADRs dipped after the recessions of 1990-1991, 2001 and 2008-2009, it came back in the recoveries stronger than before – each recovery is much higher than the previous one, and the overall trend is up.

The numbers indicate that the New York City hotel industry is in robust economic health. The fact that supply increases have not hurt pricing indicates that over a sustained period, demand continues to outstrip supply. So, in terms of this most basic of fundamentals, the industry seems to be sound. In other words, perhaps this really is a golden age.

Significant new supply is in the pipeline – but will demand outpace it?

A question remains, though. Significant supply increases are still in the pipeline. What will be their impact? The golden age can only continue if underlying fundamentals remain as healthy as they are today.

There is reason to believe that the industry’s fundamentals will remain sound well into the foreseeable future. Market dynamics are in place that justify – and sustain – the demand. New Yorkers like to trumpet the idea that the city is unlike any other. There’s some truth to the hype. New York doesn’t resemble most US markets. The city – and Manhattan in particular – is the economic center of the world. That’s true even in down economic times. New York’s appeal serves to shield it to some extent from economic turbulence and

dampen the worst effects of downturns. Prosperity elsewhere helps New York – a continued increase in tourism and in the number of foreign residents bodes well for New York City hotels.

All of that seems like a strong argument for sustainability. But are the industry’s operating numbers sustainable? As we’ve seen, the industry tends to emerge from downturns stronger than before. But what if there are changes in business patterns? What if the city doesn’t hold its place as a global economic capital, or if patterns of residency and tourism change? Any of those developments, or several of them in combination, would seem to be the strongest threat to the golden age.

Oversupply is a threat to growth and can burst a bubble – as Orlando’s experience illustrates

The biggest single threat is oversupply. An oversaturated market is one where the economic fundamentals aren’t sound or sustainable – one that’s ripe for downturn. The experience of Orlando comes to mind. Could New York City become another Orlando?

Orlando was a great market over a period of 20-30 years – momentum that seemed unstoppable until it ended abruptly 10 or so years ago. During Orlando’s boom years, orange groves were replaced by the theme parks that clustered around Disney’s original development. Businesses relocated to the area. A new and thriving destination was created. Old, traditional motels with outside hallways – the classic down-market Florida hotel property – were replaced by new and thriving brand franchises. Destination resorts were created. Time-share developments sold well. Still more hotels were built near business areas. It was a gold rush with theme parks! The rising tide lifted all boats!

But, alas, the game came to a sudden, screeching halt. The economy softened; occupancy rates fell; ADRs collapsed, and many properties were left to deteriorate into disrepair. Some were foreclosed; others went at bargain prices to vulture investors.

What happened? Very simply, oversupply that vastly exceeded demand.

But New York City is unlike Orlando - restricted space and many sources of demand make oversupply less likely

Can the same thing happen in New York?

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It seems much less likely – improbable, at least in the long haul. It’s highly instructive to compare the two markets and note the differences. Orlando is characterized by wide-open spaces with extremely affordable land. The market was ripe for over-expansion because there were few if any natural constraints on development. In New York, by contrast, land availability is famously limited. Manhattan is a three mile-wide island with no place to go. Scarcity is its hallmark. The only way to develop is vertically – toward the sky! Manhattan commands steadily rising prices and generates sustained intense competition for its use.

Concerning land use and demand – Orlando was and is limited to its major source of traffic – leisure travel. New York features both domestic and international leisure travel, but both are complimented by robust business travel, as befits a city that is the business and financial center of the world. Each moment when rates soften is met by a new wave of foreign tourists and business travelers.

Sky-high New York hotel valuations do pose a risk – especially to short-term investors

So New York is fundamentally unlike Orlando. Still, the question lingers: Do recent sky-high deal valuations raise the question of whether New York might be in transition from a golden age to a bubble for hotel investors?

Again, the trends of the past 25 years are highly encouraging. Each recession produces a dip, but each dip leads to a recovery that leaves the market stronger than before. Those figures speak of solid fundamentals and the likelihood of strong long-term growth, even in the face of sharp downturns in the global economy.

But this is not an argument in favor of throwing caution to the winds. A market that steadily increases in value over the long term is nevertheless not a risk-free market. And many of the risks come directly from the high valuations themselves.

Remember that market fundamentals work both ways. High prices mean that initial investments are costly. The higher the cost, the harder it is to generate a positive return. Adding costs on top of the purchase price – for example, by taking on costly renovations – can serve to increase the risk. A buyer should be careful to consider the increase in risk caused by necessary improvements in a property that was already costly due to the high valuation.

Risk can also come as a result of trends in the fiscal markets. Today, interest rates continue at historic lows. But that may not continue. Current high valuations are supported by low interest rates and a ready supply of

capital. An increase in interest rates could pose a serious threat to property values. A rise to interest rate levels from only a few years ago would seriously affect all property values - including hotels in New York City.

The key to success in New York City hotel investment is a long-term horizon

The economic fundamentals indicate that the answer to our initial question is a strong yes – this is, in fact, a golden age for the New York City hotel industry and for current and prospective New York hotel investors. But a golden age is not a green light to proceed recklessly. True, New York is not Orlando – it’s the center of the world economy, an international destination with limited land and a history of always growing and always coming back. But does that mean that an investor should move immediately to park money in New York City hotels?

It depends. As in so much of the investment landscape, the most important consideration is the time horizon. New York City hotel valuations grow dramatically over time – but there are those dips to consider. At current price levels, a fund with a three- to five-year investment horizon would be taking great risks – it could very well be caught short if it has to sell in the middle of a dip. There could be – there have been – near-term dips in ADRs and bouts of overbuilding. The higher the purchase price, the harder it is to recover the valuation in a sale. You might succeed if you manage the property skillfully and control capital expenditures – but you might not, especially if you have to sell by 2018. In a worst case, an investor with a short-term horizon has to rely on greater-fool theory – the notion that there will always be someone out there, no matter what the conditions, willing to pay an even higher price for the property. Any student of economic history – especially recent economic history – knows that this is a recipe for disaster.

But a patient investor with a long-term outlook can – and should - do very well with a New York City hotel in its portfolio. With a longer term horizon for a sale, or a long-term plan to hand the property over to the next generation, there is huge upside. A long-term investor can hang in and find out why the key to hotel investing, like real estate in general, is location, location, location – and there’s no location quite like New York. While the risk for a fund-type investor is great, for a long-term player in the New York City hotel market, today might very well be just the start of the Golden Age!

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About Lawrence Cohen

Lawrence Cohen is the Hospitality Group Leader at Marks Paneth LLP. He rejoined the firm after having served for many years as the President and Chief Executive Officer of The Griffin Group, the investment and management company of the late Merv Griffin.

Mr. Cohen has strong roots in the hospitality industry. The Griffin Group and its affiliates owned and managed properties that ranged from high-end resorts to limited service properties. Mr. Cohen spearheaded all aspects of the business including acquisition, development and redevelopment, financing, management team hiring, supervision of operations and eventual sale.

At Marks Paneth, Mr. Cohen draws on his deep experience and serves his clients as a business ‘‘coach.’’ For mature companies, he will advise entrepreneurs, CEOs and CFOs on strategies to reposition their companies in the current business environment. For start-up companies, he will delve into the business plans and advise on the growth of their infrastructure. While Mr. Cohen will usually directly assist in the business plan preparation process and support the money-raising process, he will also often ‘‘roll-up his sleeves’’ and assist with the execution of his advice including negotiating the business points of lender agreements, leases, distribution agreements, etc. as well as hiring and/or terminating employees.

In addition, Mr. Cohen has had business interests in the Los Angeles area for more than 25 years and shares responsibility for the firm’s operations on the West Coast.

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