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Investor interest in California stays strong March 14 2014

High levels of demand and generally little new supply are fueling continued interest in hotel acquisitions in California.

In late January, Ensemble Hotel Partners purchased the 57-room Bernardus Lodge in Carmel Valley, California. (Photo: Bernardus Lodge)

By Ed Watkins Editor-at-Large

REPORT FROM CALIFORNIA—California was a market of choice in 2013 for hotel investors, and interest continues this year, sources said.

Last year, 332 hotels were sold in the state, up from 308 transactions in 2012, according to the “California hotel sales survey year-end 2013,” published by Atlas Hospitality Group. The strong demand for hotel real estate pushed dollar volume up nearly 35% to \$4.7 billion, while the median price per room rose 17.7% to \$68,648.

“For the most part, we expected these results,” said Alan X. Reay, president of the Irvine, California-based hotel brokerage. “One surprise was how high prices were pushed for properties in ‘A’ locations.”

According to Reay, the largest transaction in the state on a per-room sales price basis was the London West Hollywood, which sold for \$975,000 per room. The largest single transaction in the state was the \$365.8-million sale of the 474-room La Costa Resort and Spa in Carlsbad.

Highlights

- The sale of the London West Hollywood was the largest hotel transaction in the state during 2013 on a per-room price scale.
- RevPAR rose 13% in the San Francisco/San Mateo market last year.
- Transactions volume in the state is forecast to top \$5 billion this year.

“We’re seeing this trend continue into 2014, and the London held the record for only about a month, when the Calistoga Ranch (in Napa Valley) transaction closed at \$1.2 million per key,” he said. “Back in 2007, there was a lot of publicity surrounding the sale of the Hotel Del Coronado because it was the first time the million-dollar per-room barrier was broken. This time, we blasted through the million-dollar price point without a lot of fanfare."

Driving the market

Several key factors are fueling investor interest in the state, sources said.

"There's a very strong demand story, particularly in San Francisco, where (revenue per available room) is up significantly," said Lukas Hartwich, analyst with Green Street Advisors. "This should continue given that there is no new supply and demand seems like it is only getting better."

In the San Francisco/San Mateo market, RevPAR increased 13% in 2013 on a 9.3% rise in average daily rate and a 3.4% increase in occupancy to 83%, according to data from STR, parent company of Hotel News Now. RevPAR rose in the market by 12.7% in 2012 and 19.6% in 2011.

Renewed interest from the lending community is also driving transactions in California and elsewhere, said Hartwich.

"As debt markets open up, private equity is getting more and more involved," he said. "Debt for stabilized assets is very attractive these days, and terms are getting looser by the day. Also, the (real estate investment trusts) have been quite active, especially in San Francisco."

In the past year, hotel REITs purchasing hotels in San Francisco included Pebblebrook Hotel Trust, Sunstone Hotel Investors and LaSalle Hotel Properties, which bought three properties in the city. Last week, Summit Hotel Properties announced a $39-million acquisition of a 210-room DoubleTree by Hilton in San Francisco.

Offshore investment

Additional capital for purchases in the state is coming from offshore sources, particularly China, Reay said.

"Chinese investment generally falls into two categories," he said. "One is the acquisition of existing products. That's not necessarily driving up the price per room as, for the most part, these investors are purchasing well-established, but not trophy properties. The other side of it is the financing of new development projects. Downtown Los Angeles, for example, is a very active market for Chinese investment."

In many California markets, especially center-city locations, it's hard for developers to find suitable and affordable sites to build new hotels. In San Francisco/San Mateo, two hotels are under construction and 10 others are in planning or final planning stages, according to STR. If they all are built and open, these properties would add 1,767 rooms to the market, which currently has 51,220 rooms.

"We don't worry too much about new supply in the full-service hotel arena," said Jay Litt, executive VP of asset management for Waramaug Hospitality. In January, the company, in a joint venture with Interstate Hotels & Resorts, purchased the 329-room Hilton Concord. "There will be new supply in limited service (segments) but to build this kind of hotel again would be fairly prohibitive in today's market," Litt said.

The unliklihood of new supply in the market was one of the reasons Ensemble Hotel Partners purchased the 57-room Bernardus Lodge in Carmel Valley, said Brian Ehrlich, chief investment officer.

“The attraction for us is this is a very high-barrier-to-entry market,” Ehrlich said. “It’s a market where you’re not going to have any more supply because of water restrictions in Monterey County. There’s no more water so there is no ability to build and zero chance of additional supply coming on board.”

Ehrlich said the previous owner relocated an on-premise laundry to another county in exchange for water credits that will enable Ensemble to add 16 additional rooms to the hotel.

“These will probably be the last 16 hotel rooms built in Monterey County for the next decade,” he said.

The health of the market is also attracting first-time investors to the California hotel industry.

Pathfinder Partners, a San Diego-based real estate investment company, made its first hotel acquisition last month with the purchase of the 129-room Homewood Suites by Hilton in La Quinta, California. Pathfinder bought the hotel in partnership with management company Vesta Hospitality.

“We consider ourselves to be opportunistic investors so we made this deal even though (hotels aren’t) our preferred product type,” said Lorne Polger, co-founder and senior managing director of Pathfinder. “We feel this is the best hotel in its (competitive) set location-wise and best in its comp set propertywise. We bought it at almost 50% below replacement cost so even if someone else comes into the market with a competitive property they would have to charge significantly higher rates to achieve their investment objectives.”

A look ahead

While most sources are bullish on California for hotel investment opportunities, they agree new supply additions might be the primary threat to continued interest in acquisitions.

“The concern I have is supply,” Ehrlich said. “Even in 2014 and 2015 you will begin to see some impact from new supply. Some markets have no reason to have three or four hotels being developed in them.”

According to Reay, most of the new development in the state is of higher-end, limited-service hotels in suburban and secondary markets. However, that could change if the market continues to heat up, he said.

“Unlike most of the rest of the country, California is somewhat insulated, at least in the ‘A’ markets, from overbuilding,” Reay said. “Look at Manhattan. That’s a scarce market, but when you get prices per room approaching $1 million or more you’ll find developers are very creative in bringing in new supply.”

This year, Reay forecasts between 300 and 350 hotel transactions in California, with the median price per room increasing between 5% and 10%. Total dollar volume will be $5 billion-plus, he said.

“This year, we’ll see a lot more transactions in the secondary and tertiary markets, like the Inland Empire and in central California cities like Bakersfield, Fresno and Stockton,” Reay said. “There is very little product left for sale in the ‘A’ markets, and it is extremely high-priced.”