When Will The Bubble Burst?

This past year as I attended many hotel investment conferences around the world, the feelings of hotel owners, lenders and operators were euphoric. Occupancies are up, room rates are growing faster than inflation, hotels are making profits, money is cheap and the industry is having fun again. Even with this upbeat outlook, it is human nature to wonder: When will the bubble burst?

Based on history, the bubble always bursts. In the United States, after a huge building boom during the early 1970s, overbuilding, inflation and high interest rates during the late 1970s burst the hotel industry's bubble. This cycle repeated in the late 1980s when the same factors combined with a major recession in 1991. The last slowdown was precipitated by 9/11 and linked by another recession during the early 2000s that put a damper on hotel profitability. So what is going to transpire to bring the hotel industry to a halt sometime in the future, and when might this occur?

The answer to these two questions can be found in the simple economic principle of supply and demand. When supply increases faster than demand, overbuilding occurs, occupancies fall, room rate growth declines, profits drop and hotel values go down. The same scenario occurs when demand decreases while supply continues to grow or stays constant. Looking back over the past 50 years there have been fewer than 15 years where hotel demand actually declined, and when it did, the period of decline never lasted more than several consecutive years. Most of the declines are related to periods of economic recession rather than major catastrophic events.

It is the excessive supply growth that usually bursts the bubble for the hotel industry. Over the past 10 years, supply growth has been relatively modest. In fact, in markets with condo conversions, supply growth actually has been negative. Developers build hotels when there is money available and when hotels show economic feasibility. But during the past five years most lenders had no interest in financing new hotel development, so developers lacked the funds to start construction. In addition, with the decline in hotel values during the early 2000s, new hotels were not feasible, which meant the replacement cost of a new hotel was more than its value (it cost more to build than it was worth). The combination of no financing and no feasibility slowed new hotel development to a virtual halt.

Today, hotel values are escalating rapidly, and the lack of feasibility is becoming less of a factor. In fact, pretty soon the many buyers and funds out there will see it will be cheaper to build a new hotel than to buy an existing one. When this happens, the building boom will start with a vengeance. I believe the cross-over line—when the economics of building are better than buying—is fast approaching. The great unknown is whether lenders will commence financing new construction. Since lenders historically make bad timing decisions, I foresee they naturally will jump on the opportunity to fund the next building boom that will burst the bubble again.

My prediction: By the end of 2006 most of the hotel funds and investors that are buying up existing hotels at rapidly inflating prices will shift their focus toward new development. It will then take three to five years before excessive overbuilding occurs and we start heading down the cycle again. This doomsday timing either can be extended a year or two if the economy booms and demand increases rapidly, or it might be shortened somewhat if we go into another recession.

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Your Best Scenario

So how do you make the most out of this inevitable scenario? Start before the rush. If you own existing hotels, sell them in the next six to 12 months. In most areas, this should be the peak of the market as the values of existing hotels will significantly exceed their replacement cost. Concurrently, you should then start building new hotels. Try to find markets with high barriers to entry, such as tough zoning and permitting. Pick strong brands, and watch the economics—do not build something that the market will not support. Hold your new hotel until you see either occupancies starting to weaken or room rates rise slower than inflation. When either of these two events occur, sell your hotels immediately, and hold your money for two to four more years to invest in the distressed hotels that will inevitability flood the market. I love picking up the pieces when the bubble bursts. ◆

By Stephen Rushmore, *MAI, CHA, CRE, president and founder of HVS International, a hotel consulting firm with offices in New York, Miami, Denver, San Francisco, Vancouver, Mexico City, London, New Delhi, São Paulo, Singapore, Sydney and Toronto. Rushmore can be contacted at 1.516.248.8828 Ext. 204.*