



Manhattan – Top of the Heap

*Manhattan's Luxury and First-Class Hotel Market:
Ten-year Review*

Jonathan B. Sebbane, Vice President

Roland de Milleret, Senior Vice President

Nicolas S. Graf, Ph.D., University of Houston

HVS GLOBAL HOSPITALITY SERVICES – NEW YORK

369 Willis Ave.

Mineola, NY 11501

USA

Tel: +1 516 248-8828

Fax: +1 516 742-3059

March 2009

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Abstract

For most U.S. hotel markets, 2008 represented the first year of the recession; however, the Manhattan lodging market was able to weather the economic recession during the first nine months of the year, closing 2008 with moderate growth and remaining the top-performing market in the U.S. Despite its volatile nature, the Manhattan hotel market experienced growth in demand stronger than the increase in supply during the ten years from year-end 1998 to year-end 2008, allowing the market to aggressively push average rate and occupancy to levels well above those of the other Top U.S. urban hotel markets and offering less downside risk and more upside potential. From a transaction perspective, those characteristics, coupled with the existing barriers to entry in Manhattan – high construction costs, prohibitive land costs, and a lack of available sites – have sustained fairly high prices per room in the luxury and first-class segments. Moreover, financing is extremely difficult to obtain, particularly now that a number of new projects are poised to enter the market. We believe that the lack of capital will be an additional and formidable barrier to entry for new hotel developments in Manhattan, which bodes well for the future of the luxury and first-class hotel markets.

Introduction

Free-trade agreements, repeal of tariffs, terrorism, economic growth, and global recessions are some key terms depicting a dynamic and uncertain decade for the world and for the U.S. hotel industry. This period has also witnessed major structural changes in the industry; hotel chains have geared toward an

asset-light strategy and have concentrated their efforts on brand development and the expansion of their networks of franchised and managed properties.

Despite the tumultuous economic times and two recessions, the demand for accommodation grew steadily from 1998 to 2008, as did the supply of rooms. The number of rooms available in the Top 25 U.S. urban markets – all segments included – expanded at an annual compounded growth rate (ACGR) of 1.48% over the decade, a 17.57% overall growth rate, exceeding 1.4 million rooms by the end of 2008. This growth represents a net addition of more than 200,000 rooms over the period. The supply growth was fueled primarily by the luxury (ACGR of 6.81%), mid-scale without food and beverage (ACGR of 4.51%), and first-class (ACGR of 2.55%) chain-affiliated segments. The economy segment of chain-affiliated properties and the independents (all segments included), experienced much slower supply growth (ACGR of 0.77% and 0.68%, respectively), while the chain-affiliated mid-scale with F&B segment recorded a net decrease (ACGR of 2.98%) in its room count.

On the demand front, the number of rooms sold increased at an ACGR of 1.39% during the decade, all segments included, with the most significant growth coming from the luxury segment (ACGR of 6.53%), followed by the mid-scale without F&B segment (ACGR of 4.38%) and the first-class segment (ACGR of 2.45%). The independent segment experienced slower growth (ACGR of 0.71%) as did the economy segment (ACGR of 0.43%). The mid-scale with F&B segment was the only segment losing demand, with a negative ACGR of 3.49%.



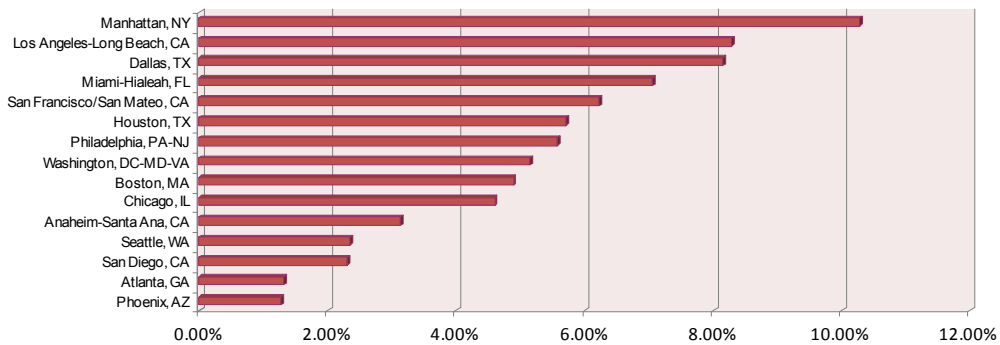
In this context, the fastest-growing luxury and first-class urban markets, in RevPAR terms, were Manhattan (New York), Los Angeles–Long Beach, San Francisco–San Mateo, and Dallas. Figure 1 illustrates the ranking of these markets and highlights the abnormally high performance of the Manhattan market, with a median¹ year-over-year monthly RevPAR growth rate outshining its nearest competitor by more than two percentage points in both the luxury and first-class segments.

¹ The median is a more accurate measure of central tendency due to the skewness (non-normal shape) of the distributions of monthly RevPAR.

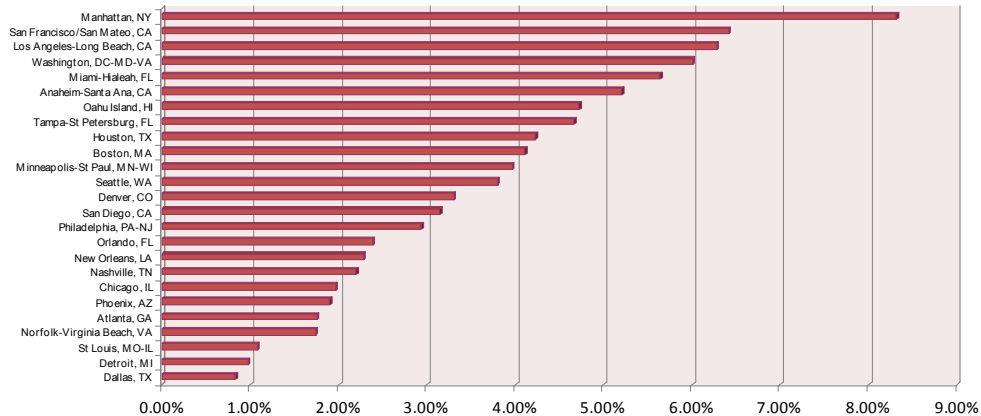


Figure 1 – Market Performance

Median Monthly RevPAR Growth Rate - Urban Luxury Markets - 1998-2008



Median Monthly RevPAR Growth Rate - Urban First-Class Markets - 1998-2008



Source: HVS; University of Houston; STR

Supply and Demand Dynamics

Market-level RevPARs² can be viewed as being driven by the ability of market participants to

push average rates upward due to positive supply and demand interactions. In other terms, markets that see their demand grow

² RevPAR is a key industry-metric associated with supply and demand, although it does not include the typical cost structure of a hotel asset and provides no indication of profitability. As such,

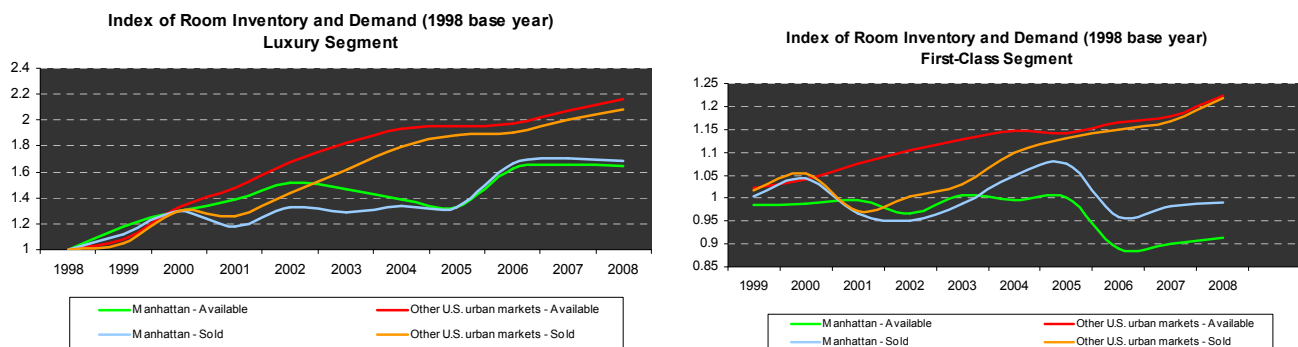
measures based on GOPPAR (gross operating profit per available room) would be more appropriate. For more information, please refer to *GOPPAR, a derivative of RevPAR!* By Elie Younes, Russell Kett, HVS 2003.



faster than their supply tend to exhibit above-average growth in average rate. Figure 2 shows the evolution of supply and demand in the Manhattan market and in the other Top 24 U.S. urban markets (excluding Manhattan) for both segments. While supply and demand in the other urban U.S. markets increased consistently (except in 2001 for the first-class segment), there was a significant slowdown in supply growth in Manhattan starting in 2002 for the luxury market, and more noticeably, a continuous decrease in room count for the first-class segment. A total of 15 hotels closed for full or partial condominium conversions from April 2002 through December 2006 in Manhattan, accounting for a total of approximately 4,000 guestrooms, or roundly 7.0% of the 2007 room inventory. These conversions reflect the strength of the Manhattan condominium market during that period. We note that the condominium conversions were primarily limited to upscale residential neighborhoods, mainly around Central Park, where land and buildings are in short supply and condominium prices are high. These properties were all

upscale or luxury in nature. Given the limited number of upscale/luxury lodging facilities available for condominium conversion, as well as the strong performance of the Manhattan lodging market, no other conversions have occurred since then. In spite of the sluggish growth in demand from 2001 to 2005 in the luxury segment, and from 2001 to 2002 and 2006 to 2008 in the first-class segment, lodging demand in the Manhattan market generally grew at a faster pace than supply. Over the ten-year period reviewed, the demand for the luxury segment in Manhattan increased at an ACGR of 4.85%, superior to the increase in supply (ACGR of 4.63%), whereas the first-class market in Manhattan experienced a stronger increase in demand, roundly 130% higher than the growth in supply. In contrast, the same imbalance was not witnessed in other urban markets; in fact, as Figure 2 suggests, supply growth for the other Top U.S. urban markets exceeded the growth in demand over the decade considered, leaving average room rates under increasing competitive pressure.

Figure 2 – Supply and Demand Indices



Source: HVS; University of Houston; STR



1998 - 2008	Manhattan		U.S. Top 24 Markets*	
	Luxury	First-Class	Luxury	First-Class
ACGR - Supply	4.63%	0.56%	7.25%	2.68%
ACGR - Demand	4.85%	1.28%	6.92%	2.54%
Overall Growth Rate Supply	64.55%	6.36%	116.05%	33.84%
Overall Growth Rate Demand	68.34%	15.07%	108.71%	31.72%

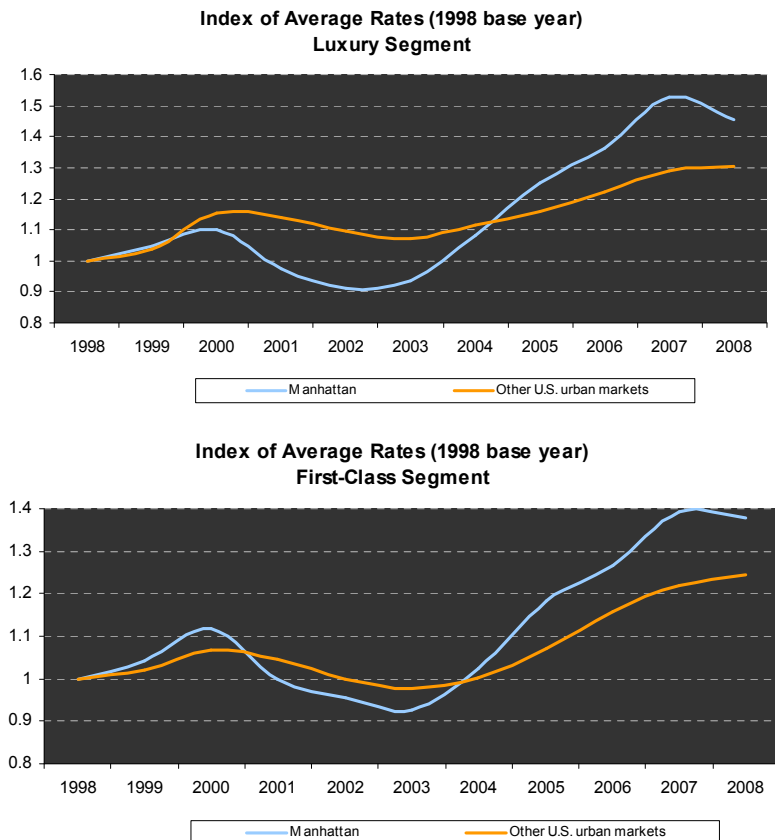
*Excluding Manhattan

Source: HVS; University of Houston; STR

average rate. Average room rates in the Manhattan market – in nominal terms – rose by virtually 50% in the luxury segment and nearly 40% in the first-class segment. In contrast, rates in the other urban markets grew by only about 30% in the luxury segment and about 25% in the first-class segment. The sharp decline in Manhattan from 2001 to 2003 corresponds to the fall in demand caused by the 2001 recession and the September 11th terrorist attacks.

Figure 3 presents the results of these trends on

Figure 3 – Average Rate Indices



Source: HVS; University of Houston; STR



Nevertheless, the average rate performance for Manhattan's luxury and first-class markets rebounded in 2004. An analysis of the monthly trends reveals that average rate for the luxury market registered double-digit increases each month from March 2004 to January 2006 and almost every month in 2007; the first-class market followed a similar trend, albeit at a slower pace. The increase in rates from 2004 to 2007 in Manhattan was due to the changes in supply in both segments as illustrated in Figure 2, and what appears to be a shift in demand from the first-class segment to the luxury segment, where first-class hotel customers traded up to luxury accommodations. This move appears to be driven in part by the actual shift in supply that started in 2006.

RevPAR Cyclicity – The Upside Potential of Manhattan

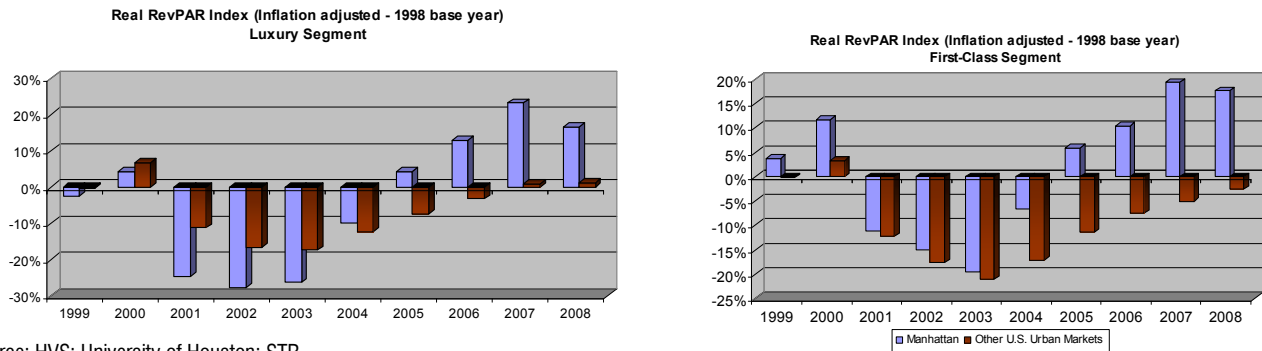
The positive supply and demand imbalance in Manhattan made the market the Top U.S. urban market performer in terms of RevPAR growth over the decade. The overall evolution of RevPAR has been highly cyclical and strongly associated with overall economic conditions. During the past decade, real RevPAR³ in the luxury and first-class segments of the other Top U.S. urban markets peaked in 2000 and has never fully recovered from the 2001-2003 recession (see Figure 4). In 2007 and early 2008, usually viewed as the climax of the last expansion phase, real RevPAR barely exceeded its 1998 level in the luxury segment, and for

first-class properties remained 5% to 10% below the 1998 level. In contrast, and despite a sharper tumble for the luxury segment in 2001-2003, the Manhattan market exhibited more resilience and offered far greater upside potential during the 2004-2008 growth phase; real RevPAR for the luxury and first-class markets exceeded the respective 1998 levels during the period, peaking in 2007 at levels about 20% higher than those of the base year. The first-class segment also exhibited less downside risk and more upside potential than other urban markets throughout the last decade.

³ Real RevPAR is adjusted for inflation; the revenues used in the RevPAR calculation are based on the 1998 price levels instead of using nominal revenue figures. This adjustment results in RevPAR growth rates that better capture the ability of market participants to grow (or decrease) their revenues beyond inflation.



Figure 4 – Real RevPAR Indices



Source: HVS; University of Houston; STR

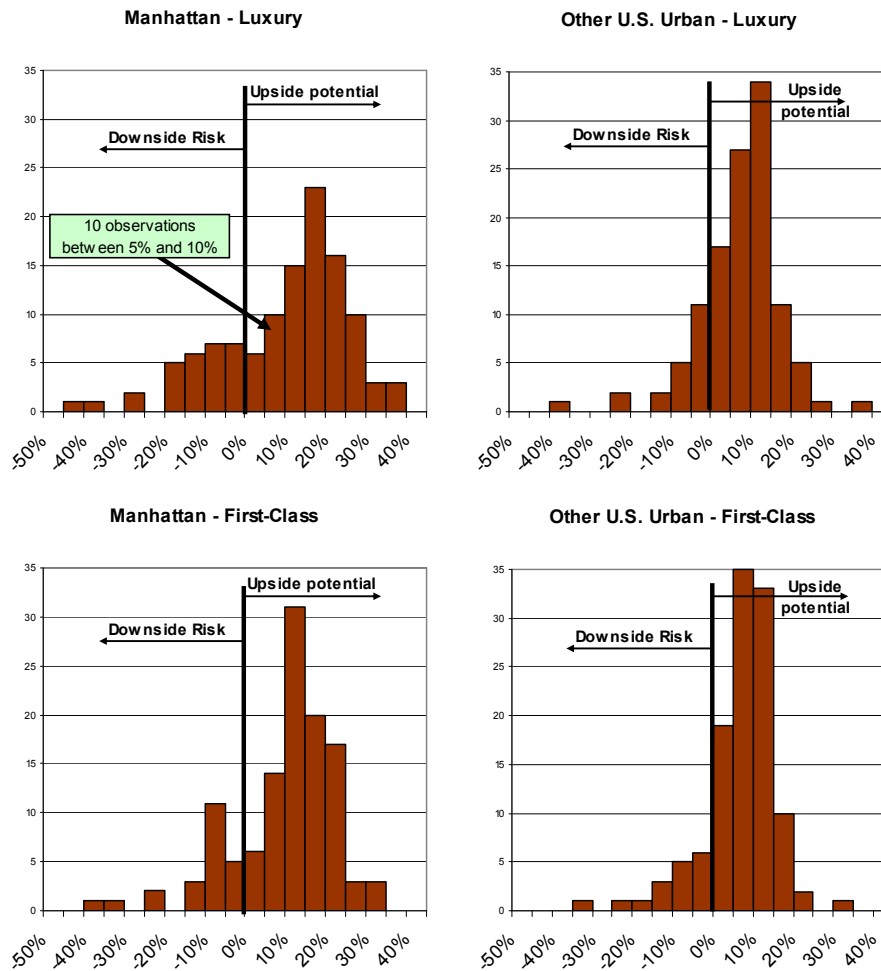
The distribution of monthly RevPAR changes for these segments and markets over the past decade further illustrates the strength of the Manhattan market relative to other urban markets. Figure 5 shows the frequency of year-over-year monthly RevPAR changes. The horizontal axis represents year-over-year monthly percentage changes sorted by intervals of 5% (i.e., $0\% < X \leq 5\%$, $5\% < X \leq 10\%$ and so on, where “X” is the actual percentage change). The vertical axis shows the frequency of percentage changes observed for each interval. For instance, in the Manhattan luxury segment, ten year-over-year monthly RevPAR changes have been observed in the interval of 5% to 10% (see colored box in the chart). These charts reveal the higher proportion of positive year-over-year monthly RevPAR changes in the

Manhattan market than in the other urban markets, and especially illustrate the greater proportion of double-digit increases in monthly RevPAR for Manhattan.

An analysis of these distributions shows that the mean and median monthly RevPARs for both the luxury and first-class segments were more than twice as great for Manhattan as for the other urban markets. The lower downside risk of the Manhattan market is also substantiated by the relatively low negative monthly RevPAR growth rates: 29.1% vs. 29.9% for other luxury urban markets and 23.1% vs. 30.8% in the first-class segment. These percentages of downside risk are represented in Figure 5 by the orange bars in the left half of each distribution.



Figure 5 – Distribution of Monthly RevPAR Changes



Source: HVS; University of Houston; STR

Similarly, the upside of the distribution is evidenced by the relatively lower percentage of monthly RevPAR growth rates below the annual compounded inflation rate during the

covered period in the Manhattan market – 33.3% vs. 38.5% in the luxury segment and 28.2% vs. 41.0% in the first-class segment (see Table 1).


Table 1 – Descriptive Statistics of Monthly RevPAR Changes

	Luxury Segment		First-Class Segment	
	Manhattan	Other U.S. Markets	Manhattan	Other U.S. Urban Markets
Mean	6.42%	2.79%	5.68%	2.42%
Median	10.28%	4.49%	8.31%	4.04%
% of months with a negative growth rate	29.1%	29.9%	23.1%	30.8%
% of months with growth rate below compound annual inflation rate (1998-2008: 2.43%)	33.3%	38.5%	28.2%	41.0%

Sources: HVS; University of Houston; STR

The Decoupling of the Manhattan Hotel Market

Besides the upward potential, low downside risk and abnormal RevPAR growth of the Manhattan market, another outcome of the distinctive evolution of the market's supply and

demand is the significant decoupling of its RevPAR from the general evolution of other U.S. urban markets. Table 2 shows the overall correlation coefficients of the Manhattan market segments with the other urban markets over the past decade.

Table 2 – Correlation Matrix of Monthly RevPAR (January 1998 to November 2008)

	Manhattan Luxury	Manhattan First-Class	Other Markets Luxury	Other Markets First-Class
Manhattan Luxury	-			
Manhattan First-Class	0.980	-		
Other Markets Luxury	0.554	0.552	-	
Other Markets First-Class	0.484	0.489	0.959	-

Sources: HVS; University of Houston; STR

While these coefficients are all practically significant (and most statistically significant), a closer look at their evolution on a year-by-year basis reveals the previously mentioned decoupling effect. Figure 6 shows that the RevPAR for the Manhattan market varied quite similarly to the RevPAR in the other urban markets until 2001, but not beyond that year. In reality, the Manhattan market's RevPAR

appears to be unrelated or slightly negatively related to other markets over the 2002-2008 time frame. The bars on Figure 6 show the strength of association in monthly RevPAR movements between Manhattan and the other urban markets; the continuous decrease in the heights of the bars (as well as the decrease in the coefficients) is evidence of a loss of commonality in RevPAR evolution. What this

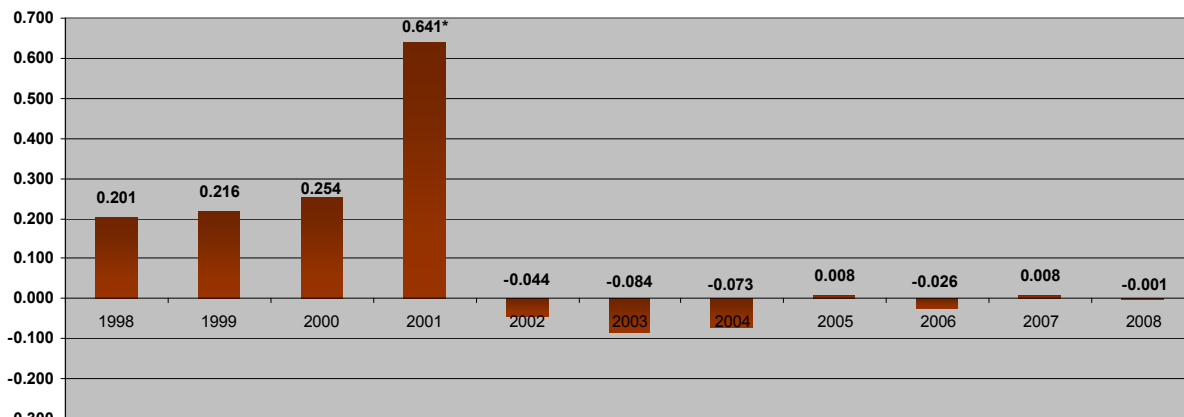


suggests is that the occupancy and room rate levels in these markets were influenced by increasingly different drivers, such as the conversion of hotels to condominiums between

2002-2006, limited supply growth, and a weak U.S. dollar attracting a growing number of international visitors mainly from Western Europe and Canada.

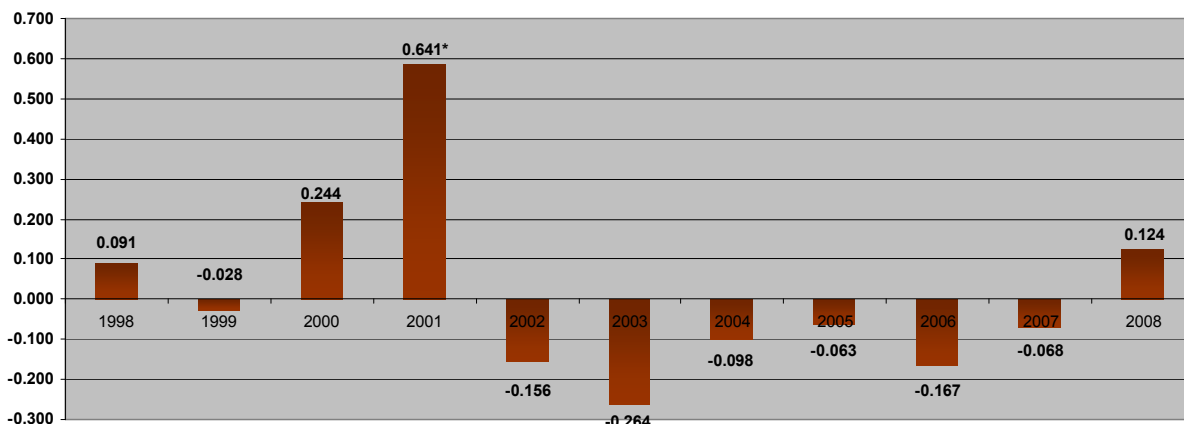
Figure 6 – Year-by-Year Monthly RevPAR Correlation Coefficients

**Evolution of Monthly RevPAR Correlation Coefficient
Luxury Market - Manhattan vs. Other U.S. Urban Markets**



* denotes statistical significance at 0.05

**Evolution of Monthly RevPAR Correlation Coefficient
First-Class Market - Manhattan vs. Other U.S. Urban Markets**



* denotes statistical significance at 0.05



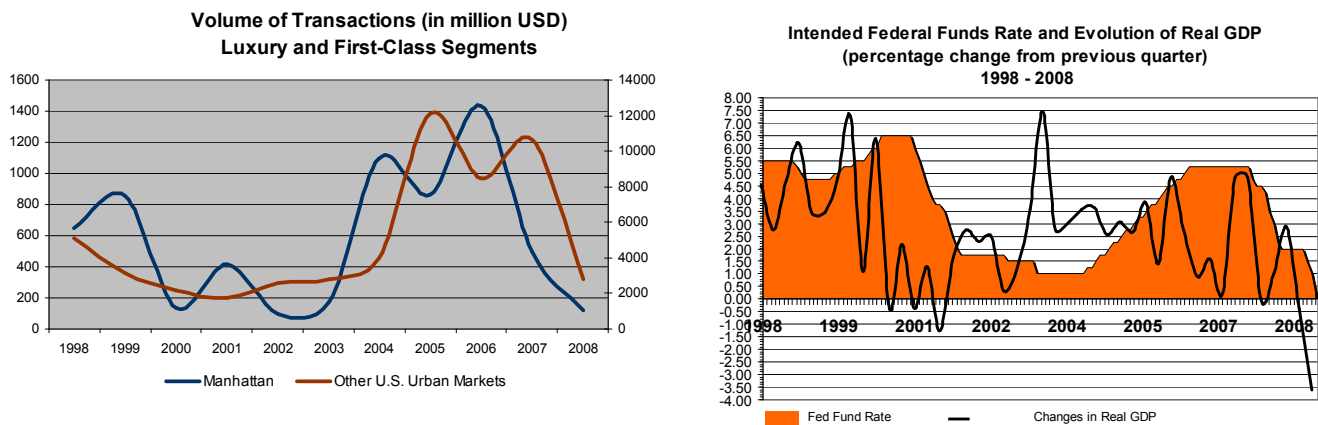
Transaction Volume and Per-room Prices – Competition for Space

Has the stronger performance of the Manhattan market translated into higher and more resilient asset values and transactions? The short answer is “yes.”

During the past decade, transaction volume in the U.S. urban markets evolved similarly to that of most residential and commercial real estate,

growing at an unprecedented pace from 2003 to 2006 to finally burst in 2007 and 2008 following the crises in the housing and credit markets. Figure 7 shows this evolution, which is partially related to the general evolution of interest rates and real GDP; transactions appear to generally lead changes in federal fund rates by about a year to two years. As is apparent on the first chart, the Manhattan market is leading other U.S. urban markets by one year.

Figure 7 – Transaction Volume, Interest Rates and Real GDP



Source: HVS; University of Houston; STR; Federal Reserve Bank, Bureau of Economic Analysis

The remarkable increase in volume transaction between 2004 and mid 2007 appears to be driven in part by the rather slow reaction of the Federal Reserve Bank to the astonishing rebound in real GDP growth that started in the second half of 2003. This hyperactive period for real estate transactions can be, to a large extent, attributed to sustained economic growth coupled with an environment of low financing costs (and loose financing terms).

The lead time in transaction volume between Manhattan and the other urban markets can likely be explained by a number of factors. However, asset conversion, which tends to favor short-term holds, appears to be a reasonable justification. Indeed, conversions require months of construction and design work that promote a more aggressive acquisition timing (i.e., activities taking place earlier in the cycle), and a value orientation toward asset improvement rather than an



income approach. As a matter of fact, a number of asset improvements in the Manhattan market, involving the conversion of first-class properties into mixed-used luxury products, have occurred in the recent past. Table 3 lists a few transactions involving the conversion of

first-class hotels into smaller luxury hotels, frequently with condos (“smaller” here means fewer rooms). The indicated cap rates suggest strategies aimed at making value happen through short holds and returns on improvements rather than on historical income.

Table 3 – Selected Manhattan Transactions

Property	Date of Sale	No. of Rooms	Price	Price per Room	Indicated Cap. Rate
The Mark Hotel (leasehold) <i>Sold for Condo Conversion</i>	Jan-06	176	150,000,000	852,000	2.0% - 3.0%
Westin Essex House <i>Adjusted price for Capital Infusion</i>	Sep-05	605	400,000,000	661,000	3.0% - 4.0%
			450,000,000	744,000	2.0% - 3.0%
Algonquin <i>Adjusted price for Capital Infusion</i>	Sep-05	174	74,100,000	426,000	3.0% - 4.0%
			77,600,000	446,000	3.0% - 4.0%
Sheraton Russell <i>Sold for Condo Conversion</i>	Dec-04	146	40,250,000	276,000	2.0% - 3.0%
The Plaza <i>Sold for Condo Conversion (except for 150 rooms)</i>	Oct-04	805	675,000,000	839,000	2.0% - 3.0%

Sources: HVS; University of Houston; STR

Although mixed-use properties have been a prominent development strategy in the past few years, it appears that the case of Manhattan is singular in that these mixed-use developments have taken away a fair amount of existing upscale lodging supply and have driven the market toward more luxury products. Other markets witnessing mixed-use conversions have conversely not experienced such supply slowdown (or drop in the case of the first-class segment) nor such repositioning of the market in the upper segments. This evolution of the Manhattan lodging market is essentially due to its high entry barriers where the limited availability of suitable land has fostered competition for space among all residential and commercial real estate asset

classes. As a matter of fact, the indicated cap rates listed in Table 3, ranging from 2.0% to 4.0%, provide evidence of values derived from highest and best use analyses rather than from the capitalization of historical stabilized operating income. Indeed, highest and best use analyses are only relevant when projects are mutually exclusive due to land or financing availability – financing was not an issue until late 2007 early 2008, making land availability the most plausible reason for conducting such analyses and accepting such gloomy cap rates.

The limited lodging and space capacity in the Manhattan market thus pushed RevPAR up over the decade, and sustained fairly high prices per room. Figure 8 shows the ten-year

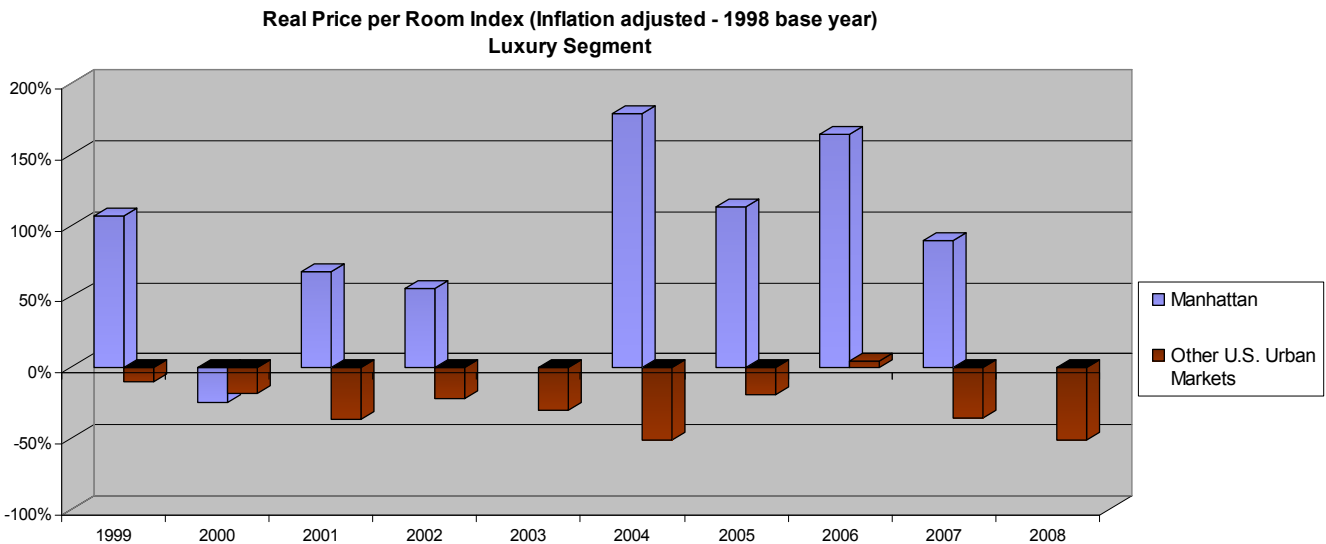


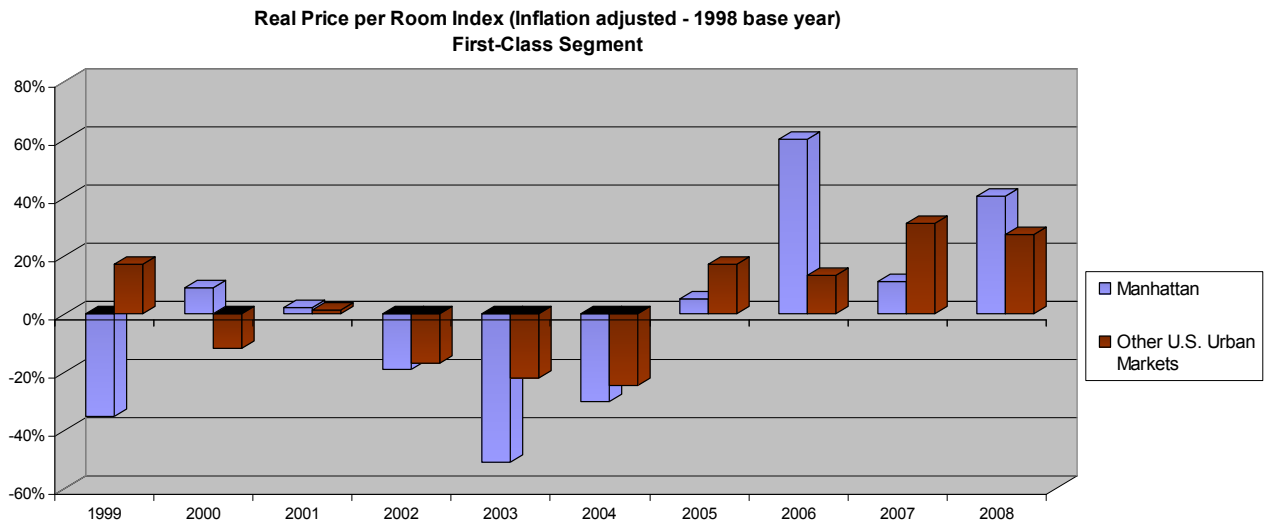
evolution of the yearly average real prices per room in the Manhattan market and in the other U.S. urban markets. These indices show that, in real terms (i.e., adjusted for inflation), prices per room in the Manhattan markets were mostly superior to their 1998 levels, especially for the luxury segment. In contrast, these prices were regularly well below their 1998 levels in the other U.S. urban markets. This trend is consistent with the higher RevPAR growth in Manhattan and attests to the strength and

attractiveness of the market. The following shows the average real prices per room over the period covered in these respective markets and segments:

- Manhattan luxury segment – \$475,531
- Other U.S. urban markets luxury segment – \$196,374
- Manhattan first-class segment – \$280,852
- Other U.S. urban markets first-class segment – \$103,573

Figure 8 – Indices of Real Prices per Room: 1998-2008





Source: HVS; University of Houston; STR

Looking Ahead

As Nils Bohr, a Nobel laureate in physics, once said: “Prediction is very difficult, especially if it's about the future.” In today’s environment, we will certainly not contradict him; however, there are a few lessons that can be learned from the historical analysis of the Manhattan lodging market that can help us envision potential directions the future may take.

First, the evolution of room supply in Manhattan over the past few years resulted in a historically low vacancy rate (i.e., the inverse of occupancy rates), which has permitted an increase in average room rates well above inflation. The current depressing trends in global lodging demand, resulting in close to double-digit declines in RevPAR across urban markets and segments, are likely to create a shorter-term impact on Manhattan than on

other markets. Comparatively, Manhattan’s RevPAR has been well above that of any other urban market and has significantly increased in real terms (i.e., adjusted for inflation). Thus, even if Manhattan’s 2009 RevPAR level decreases by more than 10% relative to the 2008 RevPAR, such level will still settle higher on a real term basis compared to that of a decade ago. A similar situation is not expected for any other urban market in the U.S.

Second, the low vacancy rates experienced over the past four years place the Manhattan market in a better position to maintain room rates at an acceptable level throughout the current downturn, which is likely to result in more pricing power when the economy rebounds. In addition, the current pipeline of confirmed new hotel rooms in the luxury and first-class segments in Manhattan remains in the lower range of the long-term supply growth of the



market. Despite the wealth of proposed hotels, current credit market conditions have put a majority of these on hold. Of the potential new addition to supply, only a few projects can thus be considered as confirmed. Consequently, the expected growth in supply in the Manhattan luxury segment is roundly 17.0% over the next three years, an annual compounded growth rate (ACGR) of 5.37%, and an 11.06% three-year increase for the first-class segment, or an ACGR of 3.56% (representing a net addition of about 1,500 rooms for the luxury segment and about 2,200 rooms for the first-class segment). By historical standards, these increases are rather low and shouldn't dramatically alter the supply and demand equilibrium that has been observed over the past four years. In reality, such pipeline will not create the oversupply condition that existed in the market after September 11th, even if the current recession is by many counts deeper than that of 2001-2003. One needs to bear in mind that the September 11th terrorist attacks primarily affected Manhattan, and that these events placed tremendous downward pressure on demand, which was already suffering from general economic conditions.

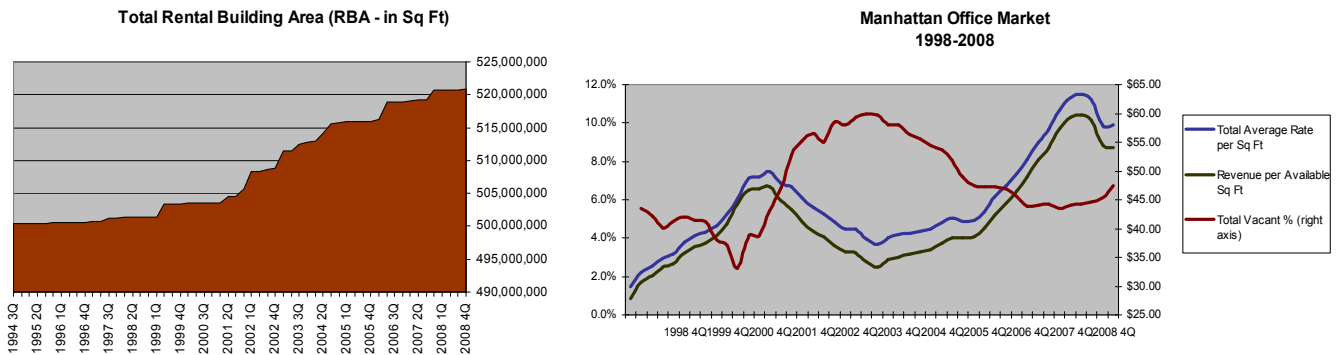
Third, the high entry barriers to the Manhattan market, driven by the lack of available land, are not expected to change in the coming years. The competition for space consequent to these entry barriers has been healthy for the Manhattan real estate market in general. The lodging sector has not been the only performing real estate asset class. For instance, the office

market has performed just as well as lodging, and similar patterns have emerged on various other performance indicators. Figure 9 shows four key indicators for the office market. The supply of office space, in square footage, increased steadily over the last decade, with the addition of more than 120,000,000 square feet, or more than 20% over the period covered. Similar to the lodging market, the office vacancy rate rose quickly (i.e., the occupancy rate decreased) during the 2001-2003 recession, but then continuously decreased through late 2008. As a result, average rental rates per square foot increased through the second half of 2008, followed by a slight drop as a result of the current recession. Revenue per available square foot has essentially followed the trend of average rental rates.

The increases in performance for the lodging and office sectors are evidence of the health of the Manhattan real estate market. While data suggest that, from a real estate perspective, lodging and other real estate asset classes are substitutes for each other, the lack of available land forces real estate developers to make rational decisions, thus preventing oversupply and maintaining supply and demand equilibria that push average rates up in each asset class. Such observations suggest that operating performances are likely to rebound strongly once the recession ends, in a manner similar to the growth observed in the post 2001-2003 period.



Figure 9 – Overview of the Manhattan Office Market: 1998-2008



Source: HVS; University of Houston; STR; MVS

Where is the Manhattan lodging market really headed you may wonder. Well, we must add some “ifs” to our thoughts. If the buildup of boutique hotel rooms in Manhattan does not significantly dilute the demand for luxury and first-class products, if the current recession does not fundamentally change how corporate and transient customers behave over the long term, and if no other real estate asset class suffers more than it did in the aftermath of the previous recessions, then we believe:

1. Year-over-year monthly RevPAR will grow at a 6% to 9% median rate over the next decade in the Manhattan luxury and first-class segments.
2. Annual RevPAR will start growing again in 2011 and will reach a level higher than the 2008 level by 2012-2013.
3. Transaction volume will increase again in the second half of 2009 and will reach the 1998 level by 2010. We do not expect the volume to reach the 2006 peak anytime soon unless 2007 leverage levels and more flexible debt covenants return, which is unlikely.

4. Real price per room will remain above the 1998 level throughout the recession and grow at an annual rate above inflation.
5. New projects over the next decade will continue to be driven by asset conversions and improvements, yet will involve fewer conversions into condos.

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About the Authors



Jonathan B. Sebbane serves as Vice President at HVS' New York office. Since joining the firm in January 2007, he has consulted and appraised over \$10 billion in existing and proposed hospitality real estate. Jonathan specializes in luxury and boutique hotels in the Manhattan and Miami markets.

He graduated from the Ecole hôtelière de Lausanne in Switzerland, where he majored in hotel real estate and corporate finance.



Roland de Milleret is Senior Vice President of HVS' New York office. Since joining HVS in January 1999, he has provided consulting and appraisal services to over 1,000 hotels throughout the U.S and the Caribbean. His industry expertise includes market studies, feasibility

analyses, appraisals, development consulting, and negotiation of management agreements. Roland is an adjunct professor at NYU School of Continuing and Professional Education and is finalizing his MAI designation.



Nicolas S. Graf is Assistant Professor of Hotel Finance and Strategy at the C. N. Hilton College of the University of Houston and Adjunct Professor at ESSEC Business School and Reims Management School in France. His research focus and expertise

are in valuation, supply and demand analysis, and competitive strategy. Nicolas has delivered training and consultancy on these topics in over 20 countries. He is a graduate of the Ecole hôtelière de Lausanne in Switzerland and received his Ph.D. from Virginia Polytechnic Institute and State University.

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