Select-Service Lodging Becomes an Attractive Investment

Madden Real Estate Ventures is both developing and buying in the segment

Mitchell Hochberg is very bullish on select-service lodging. The principal of Madden Real Estate Ventures sees a niche in the segment other institutional buyers may have missed. His New York City-based firm is both building new select-service hotels and buying and investing in existing properties.

"There are a lot of opportunities, particularly in secondary markets, to buy select-service properties at below replacement cost," says Hochberg in explaining part of his firm's strategy. "A lot of institutional money is focusing on primary markets so there is an interesting spread in cap rates as to what you can buy in the secondary market—anywhere from a 9 to 11 cap—versus similar assets in primary markets that are trading at 7 to 8 caps."

He says many of these properties have strong cash flows but can benefit from more aggressive management to improve performance and value. "They're typically distressed sellers, not distressed assets," he says. "Some [of the properties] have been built in the past five years and aren't worth what it cost to build them. We can buy these assets at below replacement cost and below peak performance, bring in a better management system and sometimes a better flag. It gives us substantial upside in the asset."

Of course, if it were easy, everyone would be doing it, and Hochberg admits sourcing these kinds of deals is difficult and time consuming. Madden uses a shotgun approach: dealing with brokers but also mining existing relationships with banks looking to unload hotel assets on their books. Another technique is to look at larger portfolios that might contain select-service assets in secondary markets that aren't key to the entities controlling the portfolios. The goal, he says, is finding deals before they enter the competitive marketplace. "Once a deal gets into a broker's pretty book, we're probably not going to be a buyer because those assets get bid up very quickly," he says.

Of course, financing is another challenge, although Hochberg says money is more available for select-service deals than other kinds of lodging assets. One source of debt has been regional banks, but the loan-to-value requirements are typically 50% to 60%. Madden provides equity on some smaller deals, but relies on institutional partners for larger opportunities.

Madden also has an appetite for development, with Aloft projects underway in Hollywood, CA and Florida's South Beach. Hochberg has a long track record in development, although mostly in the housing sector. He owned Spectrum Communities for nearly 30 years before selling to WCI Communities in 2005. Since then, he's been in the hotel business, a short time as president of Ian Schrager Co. and currently as a director of Orient-Express Hotels and head of Madden.

Judging by the location of Madden's Aloft projects, Hochberg believes select-service development opportunities are better in primary markets. In both of those cases, Madden was considering full-service or boutique-type new builds, but Hochberg says the economics are difficult to justify today. He says development costs for each of the two Alofts are between 50% and 75% of what full-service hotels would cost to build. He's a fan of Aloft, particularly in those two locations, because of the demographics of the brand and the proximity of the two hotels to W Hotels.

"It's an interesting opportunity to play off the Starwood reservations system with a product that is competitively price for a guest who may be looking to stay at a W but otherwise can't afford it," says Hochberg.

He believes the predicted tsunami of CMBS debt coming due in the next year or so will create more opportunities, but it comes with a caveat. As he notes, in the past 12 to 18 months many distressed lodging assets showed such improved performance that banks were willing the restructure the properties' financing.

"If the market continues to stay strong, particularly in gateway cities and other primary markets, banks will continue to restructure a lot of assets," says Hochberg. "However, there may be opportunities with some of the big pooled loans in secondary markets that haven't recovered as fast. That's what we've got our eyes on."