

## Scarce debt raises red flags for luxury hotels.

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Nearly 75 percent of lenders said they reduced underwriting hospitality loans for the hotel sector, according to a report by Hotel Brokers International (HBI), Kansas City, Missouri.

HBI's report, *TransActions Recap 2009*, said sales dropped nearly 25 percent during the second half of 2008 compared with a 44 percent decline in upscale and luxury hotel sales.

Jeff Westgor, president of Westgor & Associates, Minneapolis, said the credit crunch's biggest impact came last year for larger-dollar transactions--\$10 million or more. Upscale and luxury hotel sales at more than \$10 million dropped 57 percent while economy and mid-market properties fell 11.2 percent, he said.

With debt scarce and hotels' growth cycle ending, upscale hotel sales dropped nearly 70 percent.

"The one-two punch of a severe economic recession and a dysfunctional credit market, suffering from the disappearance of CMBS debt, has had a major impact on our industry, which previously had experienced five years of significant increases fueled by easy access to capital and the growth of RevPAR [revenue per available room] and earnings," Westgor said.

"Because sales in many markets have fallen so dramatically, operating profit becomes negative and making payroll--the nuclear bomb problem in hotel operations--will require a capital infusion," said Steve Van, president and chief executive officer of Prism Hotels and Resorts, Dallas, and author of *Hotel Default Blog*.

Real Capital Analytics (RCA), New York, said 710 hotels in the United States, primarily in the southeast, Midwest, west and southwest regions, will likely go into foreclosure for reasons that include owner bankruptcies. "Lenders can no longer count on borrowers to pay up," Van said. "Most owners know they have no equity left. Payroll will become a lender problem, and a nasty one with little warning. Get ready."

HBI's report said Small Business Administration and U.S. Department of Agriculture (USDA) loans with government guarantees limited exposure for regional banks and lenders financing select-service hotel transactions.

By December 2008, industry cap rates increased from 9.21 percent to 9.49 percent; HBI brokers said cap rates will continue to increase as underwriting criteria becomes more stringent and performance values and fundamentals decline.

RCA reported 262 U.S. hotels already in pre-foreclosure or real estate-owned (REO) properties, primarily in the southeast, west and Midwest regions. "If you are a lender, asset manager or CMBS special servicer with a loan originated since 2006, get ready for a default," Van said. "Not only were the [2006 and 2007] loans underwritten with increasingly lax standards--about 75 percent of the loans were interest-only or partial interest-only, and coverages came down to 1.0 of future revenues--but most markets today are producing less income than they were in 2006."

Van said half of the top 25 hotel markets year-to-date have less income than they did in 2004, and many are down more than 30 percent.

"Maybe this explains why brokers aren't able to sell any hotels these days--they are not representing the true owners," Van said.

Westgor expects the economic downtrend to hit bottom in 2010, and lag economic recovery. However, he said industry analysts expect RevPAR improvement in 2010.

"Financing will continue to be difficult to obtain, but the corollary is that there will be opportunities for savvy investors to buy assets at significant discounts," Westgor said. "On the sell side, we see the maturity of billions of dollars in CMBS debt creating significant increase in assets for sale over the next three years."