

Where There Is Smoke...

Liquidity issues will soon impact the viability of assets in all classes. How will the financing game play out?

By Jeff Weinstein, Editor in Chief – Hotels, 3/1/2009

John Arabia, managing director of the investment research firm Green Street Advisors, likens the current and pending debt and lending crises to fighting a 5-alarm fire with just a garden hose when everyone knows it requires the biggest fire hose. Hotel owners are facing serious liquidity issues and still nobody is completely ready to explain how it will play out. However, let's consider the possibilities.



First, functioning capital markets continue to impact visibility into the liquidity and cost of capital for hotel companies. As a result, it is almost impossible to reset the cost of capital and re-price assets. Best estimates have the re-pricing of assets evolving over the next two to three years.

Borrowers that have leveraged themselves with either very high loan-to-cost or loan-to-value, or have superimposed mezzanine loans over their primary mortgages, will experience a financial tsunami due to lower occupancies, diminution of EBITDA and shrinking cash flows resulting in an inability to meet debt service, predicts Homi Vazifdar, managing director of Canyon Equity, Larkspur, California. "So, distress will be based not so much on the types of hotels but more the capital stacks attached to the hotels. A Days Inn could become as susceptible to over-leveraging as a Ritz-Carlton," he says.

"Servicers [in the United States] will, almost by default, be extending many of these loans, almost on a pro forma basis," says Michael Shindler, president of Four Corners Advisors, Chicago. "Ultimately, more, I believe, will be foreclosed as workouts will fail. More critically, I believe that the United States government will need to create a 'RTC 2' to address the assets that are going into default and foreclosure." Some recent results do not bode well, with PricewaterhouseCoopers reporting that last year's 87 insolvencies are just the early casualty report. Among the victims in the UK include Folio Hotels being carved up by administrators and two foreclosures at Niche Hotels.

In the United States, PKF Consulting research shows the number of full-service U.S. hotels lacking the cash flow needed to pay debt will increase by 25% in 2009, and property values will likely decrease another 20.1% (after a 14.1% decline in 2008).

So it should come as no surprise to hear announcements from the likes of Trigild, a San Diego-based distressed property management, loan recovery and real estate receivership specialist, being appointed receiver for six residential and hospitality projects, representing more than US\$80 million in defaulted mortgages.

There will most certainly be many more foreclosures, especially among the highly leveraged deals done in 2006 and 2007, and some refinancing and extensions for the lucky players who still have good cash

flow and are not overly leveraged. While a significant number of loans will mature during 2009 and 2010, the refinancing bubble will occur in 2011-2012 when the US\$55 billion of securitized debt issued in 2006-07 matures.

“People don’t know how it will play out, other than it will be ugly,” says Arabia, whose company has already reduced its estimate of unleveraged asset value for the public hotel owners by 40% to 45% from the peak in the summer of 2007.

Arabia believes a couple of public hotel companies in the United States with too much leverage struggling through this environment will have to give back hotels as soon as the middle of this year. At the same time, he cites companies like Host Hotels & Resorts Inc. and DiamondRock Hospitality Co. as having durable capital structures and the ability to navigate a substantial downturn with 20-30% RevPAR declines in the first quarter.

Even where loans are extended, Arabia expects lenders to “bear hug” borrowers and keep them on a short lease with multiple short-term extensions and cash traps that move any positive cash flow directly to the lender.

Looking ahead to 2010 and 2011, Arabia is even more worried about foreclosures with the maturation of some of the worst-written credit deals with high loan-to-values and weak underwriting. Some industry leaders see potential trouble for a swath of high-priced trades made in late 2007. “We saw a lot of high-priced development deals that came online in 2007 and 2008; that type of trade, if highly leveraged, will have real problems,” one source says.

Others point to a number of limited-service and mid-market hotels where people made deals on personal guarantees, hopes and prayers. In addition, there appears to be potential trouble for some luxury hotels and ego-driven mixed-use properties—unless there are equity partners with deep pockets. That being said, even if the economy is in recovery next year, to get deals refinanced could require the establishment of new conduits or CMBS markets. “Lenders don’t have capacity to refinance the massive amounts of CMBS coming,” Arabia adds.

Even the deals that do get restructured will be painful. One source suggested if LIBOR stands at 150 today, lenders will want to increase the deal to LIBOR plus 450. “Everyone will scream, but it is still relatively cheap. You have to be sympathetic to the banks right now,” the source says.

Financing In Europe, Asia

Across Europe, where CMBS has been in its infancy, workouts shouldn’t be quite as treacherous, according to Jones Lang LaSalle Hotels’ (JLLH) Arthur de Haast, because of generally more conservative lending practices in the UK and on the continent. He adds that the greater transparency of deals in Europe should lead to easier dialogue between lenders. Conversely, that same transparency gives banks more ability to act quickly, if they so desire. Just how bad is the financial crisis impacting hotels in Europe? De Haast says it is hard to quantify, as the market is more fragmented. “We have already seen quite a number of receiverships in the UK, as well as Spain and Ireland, where hotels are closing,” he says. “Leasing is more prevalent here and, as a result, there are more operating issues with high rents not being met. Landlords are taking the assets and putting them into different operating structures.”

In markets like Germany, France and Italy, performance is sliding, but not as dramatically, and leverage is lower, putting only minimal stress on assets to date. De Haast is more concerned about new and

expensive assets in financially strapped Central and Eastern European markets that now have supply issues and foreign investment leaving the region.

In Asia, with cash flows expected to be down across the markets, it is likely a high number of projects will not be able to cover debt service, especially projects that were completed only recently, according to Robert Hecker, managing director of Horwath Asia Pacific, Singapore.

However, says Hecker, lending in Asia is still primarily based on corporate financing, or at least the corporate relationship between the borrower and the lender. "Non-recourse lending is still rare," he says. "So even though lack of debt coverage is likely to occur in many circumstances, workouts of one kind or another are likely to occur."

Again, Hecker points to recently opened hotels with higher capital investment as the most at-risk. He says markets hit the hardest should include Thailand (compounded by the political traumas) and China (due to oversupply).

Broken Deals, Pipelines

Global hotel transaction volume slowed in 2008 to approximately US\$24 billion and is expected to slow further, according to JLLH, to US\$18 billion-US\$20 billion in 2009. Several factors are at play, including equity not ready to jump back into the pool due to further perceived downside to both hotel revenues and real estate.

However, owners will be reticent to sell into a down market unless absolutely forced to as a result of their weakened financial condition or until a clearly defined floor has been established for market pricing, reports JLLH. Furthermore, lenders are unlikely to force owners to sell high-quality assets into an illiquid market. Once the debt markets reignite, prime assets are in the best position to be refinanced. In Europe, de Haast says values will fall for prime assets in prime cities like Paris and London. But he does not anticipate a huge drop—more likely in the 10% range. However, de Haast does see a large tail of other assets falling in value between 20% and 40%.

At the same time, de Haast sees great disparity in price between buyers and sellers and, with few transactions to measure against, he does not expect a pick-up in transactions until the second half of the year with about €5 billion in Europe assets changing hands for the year.

De Haast also expects most equity to remain on the sidelines throughout the year because investors want quality assets that are probably not about to become available. However, he does see pension funds and REITs moving back into the market for hotels with good leases in place, especially as cap rates bottom out.

As far as the pipeline goes, in the UK, a large part of pipeline is in the limited-service segment (Whitbread's Premier Inn, Dubai Holdings' Travelodge and Accor's Ibis) and should not be significantly impacted, de Haast says. In fact, de Haast believes there may well be an acceleration of the pipeline, with owners using their own money and converting available office space.

In Asia, JLLH reports purchases in 2009 will be opportunistic in nature, with assets in mature markets more likely to transact, as well as developer-driven stressed assets in emerging markets. Investor demand for hotel properties in Asia Pacific has never been a problem, but there has been a constant

shortage of supply, as assets are often tightly held. Hotels will only sell if they are stressed or strategically valuable and offered at a value-for-money price.

JLLH says distressed sellers in China will enter the market by mid-2009, including a number of 5-star hotels, but advises investors to carefully weigh the pricing and location of these assets.

In India, JLLH reports Taj Hotels, Oberoi Hotels and ITC Ltd. are likely long-term holders, while other investors who bought land using debt are most likely to become distressed in 2009, which will create buying opportunities once pricing expectations moderate.

In Hong Kong and Singapore, opportunities to acquire hotels are rare and any assets coming to market, particularly those that offer value for the money, are likely to attract competitive bidding.

Back in the United States, there appears to be significant downside to upscale and luxury hotel real estate. According to Christopher Diffley of RockBridge Capital, Columbus, Ohio, it depends on the investor's tolerance level for real estate and how the capital markets perceive real estate risk going forward from a financing perspective. "With expectations of further declines in cash flow and liquidity challenges, it seems reasonable to expect further downside in real estate values," Diffley says. "At the end of the day, cash flow is key. Strong cash flow will attract buyers and capital."

Arabia says it is fair to assume that if a deal is not already financed or under construction, it is very questionable whether anything can get done unless it is a small, regionally financed deal.

However, Strategic Hotels & Resorts CEO Laurence Geller believes equity will become available later this year. "History tells you private equity will come in for returns and that should happen anytime in the next few months," he says. "They will tell you, 'I will save you for 70% of your hotel.' It will be very expensive because of the big risk, but it is simple commerce."

Diffley also says there is equity capital that will be opportunistic in this market. "The number of players will be fewer and some new opportunistic players will replace others who have been burned in this downturn," he says. "It will be easier to put equity to work once there is stabilization in the industry trends. Despite what may look like a 10% cap rate today, it is impossible to know what type of cap rate that is 12 months from now."

On development deals, Vazifdar predicts it will be two years before debt becomes freely available. On operating hotels, he says there are pockets of equity currently available. "But in most cases, these equity sources come with some pretty onerous golden handcuffs relating to control and preferred returns to the equity investor," he says. "I have found numerous sources of equity—some took the shape of normal equity with controls in place and others took the shape of utterly vulture-like mafia equity shamelessly preying on unfortunate victims of the meltdown."