Bad Debt Looms Over Hotel Sector

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Executive Summary

- The entire commercial real estate market was overleveraged in the frothy 2006-2007 period, but it may be more difficult for hotels to recover, in part because hotel loans have (on average) worse credit characteristics than those of other property types. Plus, many lenders are reluctant to return to the sector and will be conservative when they do.
- The weak average debt-service coverage (DSCR) and loan-to-value (LTV) ratios of hotel loans in CMBS pools will make refinancing problematic without some combination of new equity and/or write-down by a lender. The need for recapitalizations of hotel loans will produce a significant number of opportunities for investors in coming years.
- Coming off two strong years of income growth, with supply looking to be low for the foreseeable future, hotels performance should continue improving. Any boost in profits will help ease the degree of mortgage distress.
- However, growth in hotel revenue is dependent on the strength of the economy. Hotel demand is sensitive to swings in the economy due to its short-term leases, so the trends can change quickly. Some analysts have downgraded future performance based on forecasts of slow GDP growth.
- The location and type of hotel property make a difference in performance. Luxury and high-end properties have outperformed less pricey segments so far in the recovery, and top-tier markets with high barriers to entry are outperforming the country as a whole.

Storm Clouds on the Horizon for Hotel Loans

The hotel sector is likely in the beginning stages of a major shake-up that emanates from the peak of the last cycle in 2006 and 2007, when large portions of the commercial real estate market were traded or refinanced with highly leveraged CMBS debt. The frothiness extended into the hotel sector, where lenders have traditionally been more cautious owing to its higher volatility. Tens of billions of dollars of hotel loans were originated – many for mergers and portfolio sales – in late 2006 and early 2007 at levels of proceeds that will be impossible to match when those loans mature due to the significant decline in asset values and tighter underwriting standards. Some of the loans were securitized, but many of them never made it into CMBS pools before the market collapsed in mid-2007, so they remain on the balance sheets of banks. The larger loans featured complicated structures that involved multiple tranches of junior debt that was sold to mezzanine lenders.

The result is a brewing storm for hotel owners. Many properties are overleveraged, although banks have been too overwhelmed to take action on problem loans. Mezzanine lenders are jockeying to protect their positions or take over properties if they can. Refinancing is impossible without injecting additional capital, in part because lenders have become more conservative than they were during the boom period.

Some of the overleveraged debt has already been restructured, but most has yet to mature or has had the maturity date extended into the next few years. When banks stop extending and pretending, many hotel loans will have to be recapitalized through an injection of additional debt or equity provided by opportunistic investors. While this is true to some extent for all commercial real estate, hotel loans may be deeper underwater than other segments as a result of lower valuations and more-conservative lending standards.
Hotel Loans Have Relatively Poor Credit Characteristics

Hotel loans represent 8% of the $584 billion CMBS universe as of November 2011, yet they constitute 10.3% of the $73.6 billion of CMBS loans in special servicing, according to Trepp. Some 11.1% of hotel loans were 60 days delinquent as of November 2011, compared to 6.5% of all outstanding CMBS (Trepp, Chart 1). What’s more, the likelihood is that the proportion of troubled hotel loans will increase, since loans in CBS pools backed by hotels have extremely poor credit characteristics.

The most predictive measures of defaults are DSCR and LTV ratio. Debt-service represents the ratio of a property’s net income versus the amount of its loan payments. When the two amounts are equal, the DSCR is 1. A property owner is obviously much more likely to default when net income is less than the amount of the monthly loan payment. The income of a healthy loan typically is 1.4 times or more than the loan payment.

As of November 2011, the average weighted DSCR of CMBS loans backed by hotels was 1.22, well below the 1.43 average for the entire CMBS universe, according to Trepp (the data covers loans for which information is available, about 75% of the CMBS universe). Hotel DSCRs were on average the lowest of all property types (Chart 2). Multifamily loans, which along with hotels have the worst delinquency rates, have the second lowest DSCRs at 1.3, followed by mixed-use (1.39), retail (1.41), industrial (1.5), office (1.51), other (1.56) and co-op housing (1.77), according to Trepp.

Digging deeper, the picture looks even worse for hotels. The probability of default rises exponentially as DSCRs drop. For example, a study by J.P. Morgan Chase found that compared with loans with 1.3 DSCR ratios, loans with a DSCR of 1 were four times as likely to default and loans with a 0.5 DSCR were 10 times as likely to default. Yet 35% of hotel loans in CMBS pools have DSCRs of less than 1, a level at which the probability of default is relatively high (although not certain), and another 30% have DSCRs of between 1 and 1.4. Only about one-third of hotel loans have DSCRs of 1.4 or above, a range that is less prone to default both during the life of the loan and at maturity (Trepp, Chart 3).

Sources: Trepp, PREI® Research
Similarly, loan defaults rise as LTVs rise. J.P. Morgan’s default study found that compared to a loan with an 80% LTV, loans with a 100% LTV were four times as likely to default while with a 120% LTV were nine times as likely and loans with 140% LTV were more than 20 times as likely to default. The weighted average LTV of lodging loans in CMBS pools at issuance was 82%. Considering that as of November 2011, hotel property values remain 27% less than they were in April 2007, according to Green Street Advisors, a significant number of hotel loans are more than 100% of current value.

Nearly 20% of hotel loans in CMBS pools have been transferred to special servicing (source: Trepp). Of those loans, 37.4% have an LTV greater than 150%, and nearly two-thirds (65.1%) have LTVs greater than 120%. It should be said that not every loan with a high LTV will default. Some property owners can use reserve accounts to make payments, while others absorb losses while trying to turn a property around and/or collect management fees. That enables some underwater borrowers to muddle through as long as lenders are willing to amend or extend loans.

However, at some point the “lend-and-pretend” mode will end for each loan and borrowers and lenders will have to resolve the fact that they will be unable to refinance at the same level of proceeds as the maturing debt. The process of restructuring hotel debt will probably take several years, but eventually each loan will have to be paid off or recapitalized.

Market Conditions Will Impact the Size of the Problem

The depth of the default problem and the amount of capital needed to repair underwater loans will depend on a variety of factors:

**Lending conditions.** The more conservative lenders are, the more capital will be needed to cover the “funding gap” to retire maturing loans. One simple example can be drawn using LTVs. At the height of the market peak, a hotel valued at $100 million might have qualified for an $80 million loan (80% LTV). In today’s market, the value of the hotel may have dropped by 30%, to $70 million, and lenders might only be willing to provide proceeds of 60% of the market value, or $42 million. That would leave a $28 million funding gap. However, if a lender is willing to write a 75% loan, the new loan proceeds would climb to $52.5 million, which would reduce the funding gap by $10.5 million. The example demonstrates one way in which lending conditions play a role in the depth of the funding gap. The same principle applies to other loan metrics, such as reserve amounts, debt yields and debt-service ratio.

The bottom line is that the funding gap increases as lenders grow more restrictive. The likelihood of sustained
volatility in the capital markets through most of 2012 makes it likely that lenders will maintain tight loan standards into 2012 and possibly longer, particularly for assets that are considered more risky. With leases that expire daily, hotels are deemed more risky than property types with longer leases, making it almost certain that lending on hotels will remain cautious as long as financial markets are volatile and economic growth is weak.

During the 2006-07 peak market, many loans were underwritten with the assumption that net operating income would rise, not based on in-place revenues. This was particularly egregious in the case of hotels, whose income is harder to project than other property types because leases change daily. If lenders do nothing more than underwrite loans with in-place income, levels of proceeds will grow more conservative. In fact, the average weighted LTV of hotel loans securitized 2009 or later is roughly 51%, far below the levels prior to the peak years (Trepp).

The location and quality of properties are factors for lenders of all stripes, who are more willing to book loans on top-quality assets and prime locations. For example, loans on assets in New York represent 9% of outstanding CMBS backed by hotels, and the Top 3 metros (New York, Washington and Los Angeles) represent nearly one-quarter (23.3%) and the Top 10 metros account for 45% of all hotel CMBS, according to Trepp (Chart 4). Hotels outside those metro areas will have a more difficult time finding financing and will be offered more conservative terms than those in top-tier locations.

**Property values.** Hotels will qualify for larger mortgages as property values rise, and the average prices of hotels did improve in 2011. Hotels have sold for a record $169,000 per room through October 2011, topping the previous peak of $160,000 in 2006 and up from $119,000 per room in 2009, according to Real Capital Analytics (RCA). Meanwhile, the average initial yield, or capitalization rate, of hotels sold in 2011 has dropped to 7.6%, according to RCA, down from 9.9% in 2010 and even lower than 8.4% cap rate in 2007 (Chart 5).

However, the numbers are based on a small number of actual property sales and reflect the fact that trades have been concentrated on class-A properties in gateway markets. Since peaking in 2007, hotel sales volume has been tepid. More than $100 billion of lodging properties changed hands in 2006 and 2007, with some $64.6 billion in 2007 alone (source: RCA). Since the beginning of 2008, only $45.1 billion of hotels have been sold, including $16.5 billion year-to-date in 2011 through October (source: RCA).

Sources: Trepp, Real Capital Analytics, PREI Research
Much of the sales volume in early 2011 involved luxury and upscale assets acquired by REITs, whose stock prices were booming. But hotel REIT stock prices dipped in the second half of the year as investors became more bearish on the economy and its impact on the sector.

As mentioned, Green Street Advisors calculates that overall hotel prices remain 27% below peak levels (Chart 6). There remains little interest in limited-service properties and those located in secondary and tertiary markets. In fact, market convention is that the initial yield is 4-6% for trophy properties, 6-8% for upscale properties and 8-10% for limited service hotels. This bifurcation of investor demand is likely to continue into the near future and maybe longer.

**Hotel performance.** Although hotels have had two years of better-than-expected positive performance, the sector in many ways is still digging out of the hole created by the Great Recession. As a segment heavily dependent on consumer and business confidence and overall economic growth, hotels were hit harder than other sectors in the recession. Occupancy and average daily rates dropped by more than 8% apiece in 2009, prompting revenue per available room (RevPAR) to plunge by an unprecedented 16.6% year-over-year, according to Smith Travel Research (STR).

However, since the beginning of 2010, consumer demand for hotels has increased dramatically. STR estimates that total demand in 2011 will approach an all-time high of nearly 1.1 billion rooms (Chart 7). Hotel performance is largely a function of the economy, as most metrics of performance track closely to GDP growth and the number of jobs created. The sector’s performance reflects pent-up demand from consumers, as well as rising corporate travel as companies loosen purse strings at a time when they are earning record profits. Some 85% of corporations surveyed said they would travel more in 2012 than in 2011, according to Deloitte’s 2012 Business Travel Survey. Smith Travel projects demand will grow by 1.1% in 2012, although the forecast has moderated over the course of the year. As late as August, STR forecast demand to grow by 2.5% in 2012, but in November the demand forecast was reduced to 1.1%.

Sources: Green Street Advisors, Smith Travel Research (STR), PREI Research
Hotel RevPAR in the US has risen by nearly 14% since the beginning of 2010, and the 8.2% rise through November 2011 marks one of the best years ever for the industry (STR, Chart 8). However, unlike the record levels of demand, absolute RevPAR remains below the 2007 peak because room rates remain lower than peak levels and supply has increased.

The US average daily rate of $102 per room remains below the $107 per room peak established in 2007 (STR, Chart 9). Hotels lured customers back in part through aggressive price cutting, and it has been difficult for operators to wean themselves from the competitive mode. That is especially the case today due to ubiquity of online travel agents (OTAs) such as Orbitz or Hotels.com, which makes it increasingly easier for consumers to shop for cheaper rates.

OTAs are a cause of division between many local operators and hotel chains. Executives at hotel chains generally prefer that local operators hold the line on prices even if it means lower occupancy rates, while the operators are often more motivated to book through OTAs in order to generate revenue. Most brands have set up rewards programs in an attempt to generate customer loyalty, but the effectiveness of such programs is still uncertain.

While there are indications that the hotel industry’s momentum will continue in 2012, the question remains how much. Economic sentiment in the US has swung wildly in recent months, and crucial problems such as the European sovereign debt crisis, large deficits in US state and national governments and lingering high unemployment remain unsolved. The uncertainty and growing pessimism have prompted most analysts to downgrade their forecasts for hotel performance as the year has progressed.

Sources: STR, PREI Research
For example, Smith Travel downgraded projections three times during the year. In April, the firm projected another strong year of RevPAR growth in 2012, at 8.6%. That 2012 forecast was steadily reduced and in November was dropped to 3.9% as a result of concerns that economic growth would be weaker than previously anticipated.

Chart 10 details STR’s change in RevPAR forecast at the beginning and end of the year, broken down by chain scale segment. The luxury and full-service end of the chain scales are expected to continue to outperform the lower end, as they have consistently done during the rebound, but even the outlook for all segments has gotten more bearish as the year has progressed.

**Supply To Remain Low for Years**

With the notable exception of a few major cities, hotel construction has slowed to a crawl across the US. Hotel inventory in the US will rise by 0.8% in 2011 and the increase in new supply will continue at that same level for the next few years, according to Lodging Econometrics. The dearth of new supply is driven by the reluctance of banks to finance new hotel development and the delay of projects that were on slated to be developed. Between 2011 and 2013, an average of 360 hotels and 39,000 rooms are projected to open each year in the US (Lodging Econometrics, Chart 11).

Much of the development will be concentrated on major markets. New York and Washington DC have the largest pipelines by number and percent of total stock. New York’s pipeline encompasses 18,000 new units (18.5% of stock), while Washington’s pipeline contains 19,000 units (18.4% of stock). Overall, the pipeline for the Top 25 markets in the US is 125,000 units (8.1% of stock) and for the US as a whole it is 347,000 units (7.1% of stock), according to Lodging Econometrics.

However, much of the new stock will be built far into the future. Washington has the most units in its pipeline, but only 3,100 (3% of stock) are projected to be completed between 2011 and 2013. In way of contrast, New York has the strongest near-term growth, with just under 8,000 units (8.1% of stock) projected to be completed by the end of 2013. Other cities with above-average near-term pipelines include Houston, Dallas and Philadelphia (Chart 12).

Sources: Lodging Econometrics, STR, PREI Research
All told, between 2011 and 2013 supply will grow by a total 2.5% the Top 25 markets and 2.4% overall in the US (Lodging Econometrics). The lack of near-term supply is a positive development for hotel owners. It should enable them to raise rates in line with demand growth, since there will be little competition from new properties. While growth in operating income is unlikely to be enough to make a serious dent in the upcoming default problem, any increase in profits will help to mitigate the distress in individual loans.

**Top Markets Outperforming the National Average**

Where a hotel is located is an important factor in performance and the potential need for restructuring. Like much of the commercial real estate market at the present, properties in major markets are performing better and are more in demand than those in secondary markets. Hotels in the Top 25 markets cities have higher occupancies and have been able to raise rates more than properties in secondary markets, enabling them to produced higher RevPAR than the market at large. Year-to-date through October 2011, the average occupancy of the top 25 markets was 68%, versus 59% for the US as a whole (STR). Daily rates in the Top 25 markets averaged $123 during that time, an increase of 5.1% year-over-year compared to $90 and a year-over-year increase of 3.8% for the total US.

As a result, RevPAR in the Top 25 markets was $84 year-to-date through October, versus $53 for the US as a whole (STR, Chart 13). RevPAR for hotels in the Top 25 markets grew 9.4% year-over-year compared to 7.2% for all other markets. Gateway markets benefit from strong demand from a variety of sources, including business, leisure and international travelers. The weak dollar makes the US a cheap destination for international visitors, who focus on coastal cities such as New York and San Francisco and on luxury resorts. One exception is Washington, where RevPAR grew 0.6% year-over-year due to a slight decline in occupancy (-0.4%) and weak 1% growth in ADR. Washington’s struggles are a consequence of the political stalemate in the federal government.

Sources: Lodging Econometrics, STR. Prudential Real Estate Investors
Meanwhile, luxury and upscale segments have consistently outperformed the midscale and economy segments coming out of the recession. One reason is that upper-income households have not been impacted by the recession as much as middle- and lower-income households. Another is that lower room rates in wake of the recession have helped the upscale properties proportionately more. As the chain scales squeezed together in price, travelers are more likely to choose a hotel with more amenities for a marginally higher price. This phenomenon is bound to end as average daily rates rise across the hotel segments.

**Need for Capital Expenditures**

Another headache facing many hotel operators is the need for property upgrades. When revenues dropped in 2008 and 2009, in order to survive hotel owners tightened belts and cut expenses, including routine improvements to properties. The need for capital expenditures will play a role in the restructuring of loans. Lenders are more likely to restructure underwater loans with borrowers that have the means to sink capital into repairs, which will benefit property performance. At the same time, lenders will be more aggressive to foreclose on owners who don’t have the means to keep properties from sinking into disrepair.

**Conclusion**

The hotel sector has been the recipient of some much-needed good news this year, as performance this year has increased beyond expectations and better than any other segment of commercial real estate. Even so, though, by many metrics the sector still hasn’t reached some of the peaks it climbed during the last cycle, which speaks to depth of the last downturn. The near-term outlook for demand and revenue looks positive, although how much and for long remain dependent on the performance of the economy.

The effort to improve hotel performance will take place against the backdrop of the funding gap issue. Hotel performance is a key component of loan restructuring. As hotel net operating income grows, hotels can afford to pay more debt service and can borrow higher amounts of debt. The result is that performance will have an impact not only on the total number of defaults, but on the amount of capital that will be needed to repair loans that are delinquent in some way.

Yet no matter how much property values recover or how much more aggressive lenders are willing to be over the next few years, many hotels are secured by debt that won’t be able to be refinanced at the same level of proceeds. Some of the worst loans have already been restructured, but lenders have largely pushed the problem into the future. Given the reluctance by banks to pursue foreclosures, and the probability that they won’t be much more eager to take control of hotels going forward, the market is unlikely to see wholesale liquidations in the sector. Instead, look for banks and special servicers to craft a variety of creative solutions for individual loans that will meet their needs along with the needs of property owners and the investors that will inject necessary capital.
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