Hotel News Resource

Return to 'Normalcy' or 'Irrational Pessimism'? - By Jim Butler, author of www.HotelLawBlog.com

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The 13th edition of The Lodging Conference in Phoenix is very unique. For the first time in many years, there does NOT seem to be an overwhelming consensus about what is happening -- at least as to the credit markets, and that is the big news here. Lodging fundamentals continue very strong, although occupancy may slip a small amount in 2008, and RevPAR growth will likely slow down (but it will continue to grow).

For many years there has been a clear and prevalent industry "mood" for hotel industry conferences (see for example, last year's reports on www.HotelLawBlog.com on The Lodging Conference ("Ebullient Foreboding"), The January 2007 ALIS Conference, or even the NYU Conference in June 2007 ("forecast of 'sunny skies' for the hotel industry.")

But this week's conference has a fair number of knowledgeable people sounding like Chicken Little warning about the sky falling, and others claiming that we are just returning to a more normal scenario. The only clear consensus is that -- for at least a while -- this will NOT be "business as usual" for credit markets. Interest rates will be higher -- at least 100 to 150 basis points. Loan to value (LTV) and debt service coverage (DSC) will be tougher -- LTVs are likely to be more in the 65 - 75% range, and DSCs of 1.0 will more likely be 1.2 to 1.4. Construction lending will be very difficult to find in the near future, and underwriting will likely be much stricter. Here is what some industry leaders have to say.

Setting the scene.

As a hotel lawyer seeing 1,400 of my closest hotel industry friends at the Lodging Conference this week, I heard some interesting things from the "thought leaders" of the industry. Some of the items making my list of notable quotes were taken from private meetings, and some from the Lodging Industry Investment Council, the lodging industry's "think tank."

SLOPPY LOANS AND THE GIANT HILTON FINANCING CLOGGING THE MARKETS?

The CMBS markets are "constipated." They are backed up with billions of dollars of hotel loans that can't be sold in the public markets right now. These include some badly underwritten loans -- or at least loans with high LTVs and lower DSCs, and maybe underwritten on the basis of proforma income (as opposed to trailing twelve months' income). And the backlog includes the debt for Blackstone's purchase of Hilton. Some wonder whether Blackstone's funding sources will abort the financing, finding a big break up fee to be less painful than losses they might suffer to move the debt in the current market. What would the unwinding of the Hilton acquisition do to the market? (See: "Blackstone buys Hilton for $26 billion.") Wow!

So what did the experts say?

Frank A. Anderson, SVP & Intl Head of Hospitality, Gaming & Leisure, HSH Nordbank AG

As early as May, at JMBM's Meet the Money(R), we were forecasting an approaching credit market problem -- not from a decline in fundamentals, but rather from shoddy underwriting. And this has contributed to the problem now as lenders are getting loans off their books and into the secondary market. Ironically, the subprime melt down and credit market issues could contribute to illiquidity. Some people are reopening the spigot, but underwriting is not getting any better. As one of the few big "balance sheet lenders" serving the hospitality industry, we are overwhelmed with a tidal wave of new would-be friends. I literally have to decide who I call back personally and who I will have my assistant call back.

Daniel H. Lesser MAI CRE CHA, Senior Managing Director-Industry Leader, CB Richard Ellis

Until mid August, we were incredibly busy . . . and then the spigot turned off! Now it seems to be back on. From my perspective, looking back over the past 25 years, this seems to be small correction. Fundamentals seem extremely strong. With [the market for U.S. goods] in China and India, we are "really bullish on the outlook."

Patrick K. O'Neal, National Products Manager / Hotels, PNC Real Estate Finance

Maybe some lenders have turned off the spigot, but at PNC we are open for business and writing loans.

Clyde E. Guinn, Senior VP - Operations, Stanford Hotels

We are at the point when occupancy is pulling back a little while rates are still climbing. That usually means we are approaching a peak. If I look to 2008, I expect to see some more drop in occupancy, and rates will not continue to climb as they have up to now. Clouds on the horizon include increased costs from wages, energy, and brand standards. The global economy is an amazing thing, but it is not clear how it will shake out for us in the lodging industry. Things will be clearer by ALIS.

Henry G. Vickers Jr., Principal, AEW Capital Management LP

AEW has been sitting on the sidelines since this past spring. There is a major repricing of risk in all asset classes that is ongoing. It is "stabilizing down." It is not just a matter of repricing for debt and equity. The syndication market is shut down now. Lenders are trying to get loans off their books. There is more CMBS debt currently on lender's books at this moment [waiting to be sold into the CMBS market] than was originated in the entire year of 2005. The markets are constipated! CMBS cannot be sold. Something will happen. This will not take 2-3 years.

Angelo V. Stambules, Vice President, Hospitality, Capmark Finance Inc.

Until lenders move existing loan product through the system, they cannot originate new product. The newer loans [with better underwriting and lower LTVs and DSCs] will have an easier time. There will be liquidity but not nearly what there was in 2005-2006. We think that opportunities will be better in the next 6 months than they have been. Calls we are getting now look better from our perspective. Things we acquiesced to in loans before, we are getting back. We will start seeing better terms from a cash flow perspective and document perspective. We were writing loans at 1:1 DSC on proformas that were clearing the market. As of now, a 1.3 or 1.4 coverage is the norm. this has to affect value as well as the repricing of equity. And the rates that have increased by 100 - 150 basis points are not coming down in the next 30 days, although the spreads are starting to come down already.

Robert B. Stiles, Principal & Managing Director, Cushman & Wakefield Sonnenblick Goldman

Buyers cannot get financing now. So sellers either take the deposit and move on, or work with buyer to deal with it. Everything is being repriced or retraded now. And once the idea of volatility is introduced -- the markets will not accept the same pricing levels again.

There are a number of players buying mezz paper. Archon has been buying paper aggressively. Investment grade paper is starting to move. Some private transactions are going. It is the B piece that is dead now -- nothing going on.

Patrick J. Deming, Managing Director, Eastdil Secured

The Hilton deal is clogging the market. This lets some lenders be "irrationally bearish". I am pleased that the pendulum has swung so hard and fast to the negative, because now we can work back to the positive. Some CMBS lenders have seen the light already, and are issuing quotes that they were not issuing 2 weeks ago, but the traditional B-piece markets are empty now, as Rob Stiles says.

Craig Mueller, Vice President Development, InterContinental Hotels Group

We have not seen much of a blip in IHG's pipeline, interest in deals, or getting deals done. This is significant, because so much of our deal flow is new development. Of course, we are often signing up deals before the financing is in place. As always, the developers are pretty optimistic, but we will have to see what happens. In the U.S., we had 7 new InterContinental hotels in the pipeline as of June 30. We are signing in the neighborhood of 30 Crowne Plazas a year. Almost all of our InterCon deals are managed. We are pushing close to double digit growth in RevPAR for InterCon.

J. Mark Tobin (Mark), President, HREC Asset Management

HREC is not having a lot of challenges in helping clients with financing needs. There was hyper liquidity which created the issues being thrashed out now. But on investment grade assets, we are not seeing a problem, and certainty of execution remains strong. Over the past couple of years, lenders did not correctly price investment risk and development risk into their underwriting. We are looking to do $600-800 million in next 12 months.

Adam Valente, Vice President, Rockbridge Capital, LLC

Who says leverage is down? At Rockbridge, we start talking at 75%. We are seeing 75-85% leverage. But you pay to climb that high in the capital stack. On a $30 million loan today, to take leverage on an asset from 50 or 65% to 75 or 85%, the mezz piece will be priced in the high teens to low 20s. We think the mezz opportunity will continue to increase for us. The construction side of our business has not slowed down at all.

WHAT IS THE IMPACT OF ALL THIS ON HOTEL VALUES?

Douglas N. Dreher CHA, President, The Hotel Group

We think that there is 10 or even a 20% reduction in value right now. There is a bid-ask gap now. But sellers are lowering their prices. This is creating some interesting opportunities for us on the buy side. We are seeing deals we passed on now coming back to us that are being repriced to be more attractive. RevPAR gains are still there. We are seeing expense increases.

Lesser. Why are they selling now then? Values should not be down, but the only sellers today are distressed sellers, because there is no reason to sell today.

Deming. I disagree. Prices are not down. Fundamentals are good.

Vickers. There is 10% price decline . . .easy.

Lesser. There is not nearly the capacity in the portfolio lender area. If something like 70% of the loans are CMBS, there is not much capacity left. The Hilton deal has clogged the pipeline.

Vickers. This affects the value of the assets.

Stiles. We will work through this. It is a process of expectations. Until liquidity returns, seller expectations must be adjusted. If you are in the market today, values have gone down.

J. William Blackham, (former) President & CEO, Eagle Hospitality Properties now evaluating new opportunities in hospitality

I am happy to say that we successfully completed the sale of Eagle Hospitality to Apollo in mid August, and there was no repricing of that deal, but it had been signed prior to market changes and was a fair deal with investment grade assets. There is a market disruption, and I think restabilization may well take 12 months. It will be a gradual process. Importantly, what was done last year, is not the "norm." We are now gradually going back to a norm or back to a "new norm" that will still be defined.

But here is something to think about: The rating agencies are just starting to go in and do a re-rating of all the CMBS markets. What could that do? I think ultimately there will be a higher price of capital, and that has to affect the price of real estate.

Michael D. Blahosky, First Vice President -Regional Director, CB Richard Ellis

Values are affected. There is no doubt about that. We just don't know how much. Nobody has figured that out yet. Sellers will be reluctant to market properties until this has sorted out.. We have not been affected by deal flow this year because deals were locked in, but the next 6 months will be interesting to watch.

Joseph V. Green, Chief Executive Officer, Key Bridge Capital LLC

Key Bridge Capital provides entity level financing for companies with hotels and any other kind of real estate. Valuation is a critical issue for us because it determines how much of the company we get for our capital as an entity level financing source. We think that owners of companies with real estate and hotel assets, recognize that recent events have had an impact on asset values -- maybe not a 10%, but 25 -50 bps in cap rate.

EQUITY REPRICING?

Stambules. There is a lot of equity out there that can make up part of the capital stack, it will be repriced too.

Deming. I don't think that equity is getting repriced.

Vickers. Equity has to reprice.

Richard C. Conti, President, The Plasencia Group, Inc.

We are in a transitional period now. Prices will readjust, but have not adjusted yet with sellers. In the next few months, there will be limited deal flow. It always takes 3-6 months for these adjustments. It will be driven by the yields that are required.

What's it all mean?

Nobody knows. We have a lot of smart, experienced people expecting widely different outcomes and time frames. It is a great time to take two aspirin and call the doctor in the morning if you don't start feeling better.

This is Jim Butler, author of www.HotelLawBlog.com and hotel lawyer, signing off. We've done more than $40 billion of hotel transactions and more than 100 hotel mixed-used deals in the last 5 years alone. Who's your hotel lawyer?

About the Author

Jim Butler is recognized as one of the top hotel lawyers in the world. He devotes 100% of his practice to hospitality, representing hotel owners, developers and lenders. Jim leads JMBM's Global Hospitality Group(R) -- a team of 50 seasoned professionals with more than $40 billion of hotel transactional experience, involving more than 1,000 properties located around the globe. In the last 5 years alone, they have brought their practical advice to more than 80 "hotel-enhanced mixed-use" projects, a term Jim coined to fill a void in industry lexicon. This term describes one of the hottest developments in real estate-where hotels work together with shopping center, residential, office, retail, spa and sports facility components to mutually enhance the entire project's excitement and success.

Jim and his team are more than "just" great hotel lawyers. They are also hospitality consultants and business advisors. They are deal makers. They can help find the right operator or capital provider. They know who to call and how to reach them. They are a major gateway of hotel finance, facilitating the flow of capital with their legal skill, hospitality industry knowledge and ability to find the right "fit" for all parts of the capital stack. Because they are part of the very fabric of the hotel industry, they are able to help clients identify key business goals, assemble the right team, strategize the approach to optimize value and then get the deal done.

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