

Mortgage Credit Crunch? - By Michael Sullivan

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What's it all mean for the hotel business going forward.

INTRODUCTION:

Over the summer, much discussion has arisen over the so-called credit crunch, and what effects it may have on the hospitality business both for existing hotels and to-be-built hotels, planned for the future.

Below are some of the facts that have generally taken place in the hotel mortgage markets in the last few months:

Mortgage money has gotten 'tighter', meaning lenders who say 6 or 12 months ago were most anxious to offer loan quotes on finance transactions are now less inclined to do so.

Some lenders have indeed 'walked' on committed deals. In other words, on loans that were scheduled to close, a few lenders have looked for, and found loopholes, in their commitments that have allowed them to not close and fund the deal.

Hotel mortgage interest rates (rates for refinancing of existing hotels) have generally risen, by as much as 100 bps to 150 bps.

BACKGROUND:

Wall Street investment banks through the use of Real Estate Mortgage Investment Conduits (REMIC's, or also known as simply conduit lending) have emerged as the dominant source of permanent hotel mortgage financing in the United States, and this has also been increasingly adopted in various parts of Europe. This trend started in 1994 when the major bond rating agencies, Moodys and Standard and Poors started to issue criteria for the rating of bonds (backed by pools of mortgages in these investment trusts). REMIC's are really nothing other than a pool of individual mortgages on various types of properties that have been 'pooled' together into a very large trust (often one billion dollars or more, each). In other words, a large number of individual mortgages would be originated and closed, a pooled trust would be created and then bonds would be sold, secured by the mortgages in the trust, money would be repaid to the issuer of the mortgage, and the entire process would start again. The mortgages were typically made for all property types, retail, office, multi-family, industrial and hotels. Hotels frequently only accounted for 10% to 15% of an overall REMIC. So, in a one billion dollar REMIC pool the total amount of hotel loans might aggregate say, \$100,000,000 to \$150,000,000. Hotels were generally considered attractive because the all-in interest rates that can be achieved on hotels were somewhat higher than on other property types such as multi-family. So, adding hotels to the pool raised the overall yields of the pool, making it more profitable to the pool originator, (who was usually a Wall Street investment bank, such as Bear Stearns, Merrill Lynch, etc.)

The bonds that were sold were 'tranching' meaning that there was an order of priority of payment (of both principal and interest), in the event of default by any of the mortgages that secured the bond pool. Thus, some bonds were very secure-meaning that the bulk of the mortgages would need to default before these bonds were affected and others were the first to be affected by a default- these are known the 'B Bonds' also known as junk or high risk bonds. This is where the current 'Credit Crunch' is coming from.

HOW DID THIS 'CREDIT CRUNCH' START?

Starting in April 2006, the rating agencies started paying closer attention to these B Bonds and their risk-adjusted returns. Over the last 12 to 18 months as the competition to place mortgages became more intense, credit spreads started going lower, making the all-in interest rates cheaper. The compression in these credit spreads was mostly being felt by the B Bond buyers. In other words, they were getting less yield on their investments. The rating agencies had become concerned that the risk-adjusted returns were too low, and started to gradually reflect these risk concerns in their ratings. Result: all-in spreads on mortgages began to widen. Also, B Bond buyers started to leave the market, feeling that they already had too much exposure and the credit crunch began in earnest this summer. Although unrelated to the REMIC's for commercial property loans, the melt-down in the residential markets in the US and parts of Europe, lead by the high default rates in the Sub-Prime residential markets, caused these yield-hungry credit buyers to retreat further. These types of investors often had exposure to the B Bonds, so when part of their portfolio started defaulting from residential Sub-Prime loans, it caused a major re-examination of their risk-adjusted investments in their entire portfolio.

WHAT DOES IT MEAN FOR HOTEL FINANCING GOING FORWARD?

As described above, this has largely been simply a predictable (some would say needed) market correction, mostly felt by the Wall Street lenders, based on the way they created the REMIC mortgage markets. So, with B Bond buyers retreating and requiring higher yields, the effects have been a roughly 100 to 150 basis point increase in mortgage loan rates. This time last year, borrowers could obtain rates of around 5.25% for a fairly normal 70% to 75% LTV hotel mortgages. Now those same loans may be 6.25% to as high as 6.875%. With US Treasuries currently at around 4.5%, this reflects credit spreads of 175 bps to 240 bps over UST. These are in line with more traditional, historic credit spreads, and we do not see them changing too much in the near future.

As to the viability of hotel mortgage credit? As mentioned earlier, this has largely been a Wall Street phenomenon. There are plenty of non-Wall Street lenders, insurance companies, private lenders, banks, pension funds that have largely been less active over the last couple of years, while the Wall Street banks dominated. With Wall Street generally in retreat, for now, many of these other lenders are now seeing this as their time to shine in the market.

WHAT ABOUT NEW CONSTRUCTION FINANCING?

With the re-pricing which is currently underway in this market correction for long term mortgage debt, it has caused construction lenders to reconsider their financing as well. Remember, a major concern for any construction lender is 'how am I going to get my loan repaid when the project construction is over the loan is due'. As long term interest rates rise, generally amount of permanent financing decreases. This is due to a variety of factors, including such important items as maintaining debt service coverage ratios, etc. So, the usual effects of increases on long term mortgage interest rates is a lessening of the mortgage amounts available from construction lenders (and thus more equity is required to close the gap to fund all the construction costs). Since the cost of equity is obviously more expensive than debt, only the most well-conceived new-build hotel projects will likely still be built. Obviously this is both a positive and a negative. If you are a developer trying to get a new hotel out of the ground, it now makes the challenge tougher and more expensive. On the other hand, in terms of the industry in general, less new supply will help insure the continued profitability of existing hotels, so any decrease in RevPAR due to a potential softening of the economy in general, will have a less pronounced effect on the fortunes of existing hotels, if the threat of significant new hotel supply has also been mitigated.

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