

Canadian June 2008 Lodging Outlook



SMITH TRAVEL RESEARCH

How Does Debt Financing Impact the Value of a Hotel?

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The market for and structure of debt are key factors in determining the market value of a hotel.

For the two years leading up to mid 2007, financing conditions were robust in Canada. Debt sources were widely available, terms (including amortization periods, loan-to-value ratios, and interest rates) were favourable, and in many cases there was the ability to get multiple lenders to compete on deals. But this all changed in August 2007, when the "credit crunch/subprime melt-down" began in the US. At first, the impact was slow to be felt in Canada. Some of the US lenders, such as Capmark, were the first to go in terms of lending in Canada. Canadian conduit lenders soon followed, including Merrill Lynch.

Losing these sources of funds did have an impact on the availability of and competitive market for debt, but it wasn't until 2008 that other Canadian lenders started to become more restrictive on

loans to the hotel industry. Traditional Schedule I banks have always been conservative in financing hotels, but now the once-prolific financiers, such as the Western Canadian credit unions, GE Capital, and Textron Financial, are starting to become more selective in the deals they are willing to finance.

Why is this? It all comes down to risk. It can be argued that risk was not being appropriately priced in the heady days prior to August 2007. With the massive write-offs that followed in the wake of the subprime meltdown, risk is now being analyzed and priced much more conservatively, resulting in fewer funds available for the hotel sector, which has historically been deemed one of the riskier segments of the real estate industry, and higher interest rates on hotel loans.

What does this mean for hotel values? The following table provides an example of the potential change in value for a typical 250-room hotel when the mortgage interest

rate moves from 6.5%, which was common in July 2007, to 7.5%, which is closer to becoming the new norm for hotel financing, or 8.25%, which may be the norm in the near future.

As the table indicates, a 1-point increase in the interest rate results in slightly more than a 5% decline in the market value, assuming all other factors are constant, including the amortization period (assumed to be 25 years), the loan-to-value ratio, the equity dividend rate, and the hotel's net income.

These results may be a bit off-putting for hotel owners, but the softness in the economy hasn't yet had an impact on hotel net incomes, which have continued to rise. Year-to-date, room demand has increased for the country as a whole, and average room rates continue to increase. Although the increase in net income may not completely erase the impact of a tighter lending market, it should serve to offset much of the potential decline in value. ▲

Shift in Hotel Values with Interest Rate Increases

Mortgage Constant*	Loan to Value Ratio	Equity Dividend	Cap Rate	Net Income	Market Value	% Change in Value
8.0 %	65.0 %	10.0 %	8.7 %	\$2,500,000	\$28,654,280	
8.8	65.0	10.0	9.2	2,500,000	27,155,170	(5.2) %
9.4	65.0	10.0	9.6	2,500,000	26,101,074	(8.9)

*assumed interest rates of 6.5%, 7.5% and 8.25%

June 2008	Number of Rooms	Occupancy Rate (%)		Average Room Rates (in \$CAD)		RevPAR (in \$CAD)		Room Supply % chg	Room Demand % chg
		2008	2007	2008	2007	2008	2007		
Nova Scotia Area	1,424	62.3%	61.0%	\$109.11	\$100.62	\$67.98	\$61.38	1.6%	3.8%
Halifax, NS	3,477	82.0%	79.6%	\$143.27	\$137.81	\$117.48	\$109.70	-1.3%	1.7%
Montreal Downtown	9,791	74.8%	77.3%	\$189.39	\$191.98	\$141.66	\$148.40	2.5%	-0.8%
Montreal Area	6,011	66.7%	73.7%	\$114.37	\$115.07	\$76.28	\$84.81	5.8%	-4.2%
Quebec City, QC	3,933	81.0%	74.1%	\$177.40	\$148.19	\$143.69	\$109.81	0.2%	9.6%
Quebec Area	5,798	59.3%	61.5%	\$128.78	\$125.71	\$76.37	\$77.31	-0.1%	-3.7%
Toronto Downtown	13,826	84.5%	84.1%	\$187.78	\$188.83	\$158.67	\$158.81	0.4%	1.0%
Toronto North/East	6,887	71.2%	73.2%	\$120.85	\$119.02	\$86.05	\$87.12	4.3%	1.5%
Toronto Airport/West	7,996	69.0%	73.1%	\$117.58	\$113.13	\$81.13	\$82.70	3.2%	-2.6%
Ottawa, ON	6,561	80.9%	82.2%	\$146.86	\$142.80	\$118.81	\$117.38	0.0%	-1.6%
Ontario East	4,287	64.7%	69.8%	\$109.64	\$107.20	\$70.94	\$74.83	1.3%	-6.1%
Windsor/ Ontario SW	3,757	58.6%	63.3%	\$108.68	\$105.07	\$63.69	\$66.51	6.9%	-1.0%
London/ Kitchener	7,243	57.8%	64.2%	\$105.90	\$102.94	\$61.21	\$66.09	5.4%	-5.2%
Ontario North/ Thunder Bay	2,204	75.1%	79.1%	\$94.82	\$90.98	\$71.21	\$71.97	0.0%	-5.0%
Ontario NC/ Sudbury	4,552	65.6%	65.0%	\$112.29	\$109.61	\$73.66	\$71.25	1.4%	2.5%
Niagara Falls, ON	9,538	72.8%	72.6%	\$139.89	\$140.73	\$101.84	\$102.17	0.1%	0.4%
Ontario Central	3,835	62.7%	62.7%	\$111.48	\$108.67	\$69.90	\$68.14	1.8%	1.9%
Mississauga, ON	5,847	65.7%	68.9%	\$112.00	\$110.35	\$73.58	\$76.03	0.4%	-4.3%
Winnipeg, MB	3,353	76.0%	78.4%	\$113.32	\$101.57	\$86.12	\$79.63	-0.9%	-3.9%
Regina/Saskatoon, SK	4,573	78.2%	78.7%	\$116.83	\$105.68	\$91.36	\$83.17	2.2%	1.6%
Calgary, AB	8,477	80.4%	83.8%	\$173.87	\$155.44	\$139.79	\$130.26	1.0%	-3.0%
Edmonton, AB	7,823	71.1%	77.2%	\$121.63	\$120.30	\$86.48	\$92.87	3.9%	-4.3%
Alberta North Area	3,033	67.1%	72.1%	\$179.37	\$171.20	\$120.36	\$123.44	3.6%	-3.5%
Alberta South Area	10,043	70.7%	72.0%	\$164.78	\$160.32	\$116.50	\$115.43	3.2%	1.3%
Vancouver Downtown	8,361	88.3%	90.1%	\$198.74	\$189.90	\$175.49	\$171.10	0.9%	-1.2%
Vancouver/ Burnaby Area	1,853	83.8%	85.2%	\$131.57	\$125.81	\$110.26	\$107.19	0.0%	-1.7%
Richmond-Surrey/ East Area	5,941	76.3%	78.1%	\$124.27	\$117.77	\$94.82	\$91.98	2.1%	-0.3%
British Columbia Area	6,247	64.9%	60.6%	\$135.53	\$127.61	\$87.96	\$77.33	0.4%	7.4%
Kamloops/ Kelowna Area	4,728	67.5%	66.4%	\$121.99	\$113.51	\$82.34	\$75.37	0.9%	2.6%
Vancouver Island	4,227	76.2%	76.8%	\$149.59	\$143.33	\$113.99	\$110.08	0.5%	-0.3%
Provinces									
Alberta	29,376	70.7%	74.3%	\$145.38	\$135.90	\$102.78	\$100.97	3.0%	-1.9%
British Columbia	30,502	71.1%	71.4%	\$134.72	\$126.67	\$95.79	\$90.44	0.8%	0.3%
Manitoba	4,276	66.4%	71.8%	\$97.60	\$86.13	\$64.81	\$61.84	-0.4%	-7.9%
New Brunswick	3,719	57.0%	57.5%	\$105.03	\$97.66	\$59.87	\$56.15	5.6%	4.7%
Newfoundland	1,833	79.8%	82.1%	\$125.35	\$116.02	\$100.03	\$95.25	0.0%	-2.7%
Nova Scotia	4,901	65.0%	60.0%	\$122.73	\$116.94	\$79.77	\$70.16	0.4%	8.7%
Northwest Territories	124	INS	INS	INS	INS	INS	INS	INS	INS
Ontario	76,533	68.9%	70.9%	\$124.63	\$122.02	\$85.87	\$86.51	1.8%	-1.1%
Prince Edward Island	1,004	55.6%	57.6%	\$123.29	\$122.54	\$68.55	\$70.58	0.0%	-3.5%
Quebec	25,533	64.4%	68.4%	\$138.60	\$132.92	\$89.26	\$90.92	1.4%	-4.6%
Saskatchewan	6,256	72.9%	72.2%	\$98.53	\$90.34	\$71.83	\$65.23	0.9%	2.0%
Yukon Territory	731	77.9%	76.4%	\$106.83	\$104.42	\$83.22	\$79.78	0.0%	1.9%
Canada	184,788	67.5%	69.2%	\$127.56	\$121.04	\$86.10	\$83.76	1.6%	-0.9%

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Halifax, NS	3,477	64.2%	65.6%	\$127.23	\$122.07	\$81.68	\$80.08	2.2%	0.1%
Montreal Downtown	9,791	59.7%	62.2%	\$150.73	\$150.51	\$89.99	\$93.62	3.0%	-1.2%
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DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

*If you have any questions regarding this publication please send a message to bmacdonald@hvs.com
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