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Less troubled over hotel distress



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"From a technical perspective, the recession is very likely over at this point." Ben S. Bernanke (15 September 2009)

While delivered with caveats, Federal Reserve chairman Ben S. Bernanke's September pronouncement came as welcome, if expected, news. His soft declaration of the possible recession's end came on the inauspicious first anniversary of the Lehman Brothers collapse—the precipitating event to the credit market panic that brought the tagline, "since the Great Depression", into common and casual usage.



Cameron Larkin (left) and John Sturgess

More hoteliers might be dancing in their hotel lobbies after hearing Bernanke's words were it not for the now 24-month recession in our hotel industry and resulting continued distress.

Four effects of distress

At risk of stating the obvious, it can be argued that the decline in revenue per available room decline is the leading cause of the majority of distressed hotels. Among the components of RevPAR, it was occupancy that led the decline in 2008 (-4.2 percent, according to Smith Travel Research), followed by both occupancy and ADR in 2009 (projected -8.4 percent and -9.7 percent, respectively, according to STR).

If Bernanke is right, demand should recover in 2010 with occupancy essentially flat. Swings in ADR remain the wild card.

Obviously, RevPAR decline leads to deterioration in net operating income (NOI), and that brings us to the four primary effects of current hotel distress:

- excessive debt (too highly leveraged, paid too much);
- inability to refinance maturing debt;
- inability to inject new capital/equity; and,
- inability to sell the hotel at the desired price (buy-sell spread continues to deteriorate)

Broadly defined, a distressed hotel is one that is close to or unable to meet the requirements of its debt obligations, whether that includes making full monthly loan payments or violation of debt covenants such as debt service coverage or LTV thresholds.

As of 17 November there were 1,248 hotels in distress representing US \$31.4 billion in outstanding debt, according to Real Capital Analytics. Coupled with HVS's reporting that 2009 hotel values are down 42 percent from 2007 levels, it becomes clear why lenders have, to date, been reluctant to take back hotels – they're not ready to take more write-downs.

This explains why hotel investors have been frustrated with the lack of distressed buying opportunities. Coupled with Bernanke's cautious optimism of a general market recovery, lenders are anticipating some improvement in hotel property values, even with the forecasted 17.1-percent decrease in RevPAR for 2009 and continued 4-percent decrease through 2010.

Banks cannot "pretend and extend" forever. Expect to see lender patience wearing thin toward the end of 2009 as a general consensus builds that a recovery is indeed in process. Once lenders begin exposing their troubled hotel assets to the market, savvy investors will take their dry powder off the sidelines.

Once the right financing conditions prevail, the hospitality industry should be uniquely positioned for an extended recovery. The government has already made positive changes for investors utilizing SBA financing (such as no transaction fees), and Obama is considering major increases in lending minimums. This could help open more lending in the sub-US\$15 million asset class, but the US\$15 million to US\$50 million market will continue to be moribund.

According to PKF Hospitality, 113 hotel transactions took place during the first half of 2009. This is a decline of 50 percent from the first half of 2008. The median sales price per room has declined approximately 32 percent and the median age of properties sold has grown from 21 years to 26 years. The average hotel transaction size of 80 rooms in 2009 is down 29 rooms from the 2008 average.

These findings are similar to what PKF-HR observed during the 2001 to 2003 industry recession. We agree that this may not be the best time to sell a hotel asset, but the question is whether owners are able and willing to wait three to four years to sell their properties at the returns they desire. An asset with debt coming due in three years is distressed. Sophisticated investors and owners should do something today instead of waiting out the inevitable.

The last cycle peak ended in November 2007 due to a demand and financing disruption, not the typical overbuilding scenario. In fact, during the past seven years we've only had two years when supply exceeded the long-term average of 2.2 percent growth: 2008 (+2.6 percent) and 2009 (projected +3 percent by STR). Tight credit will continue to keep supply in check with expected growth of only 1.8 percent in 2010, according to STR.

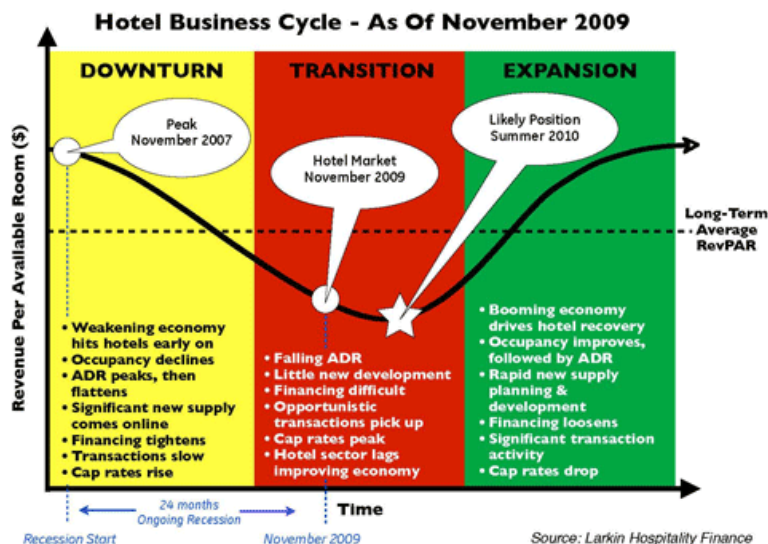
Seven indications of improvement

Some savvy investors believe the lack of visibility and certainty in the market is where the opportunity lies. They like the lack of clarity because intelligent risk-taking drives great rewards.

Getting in early on the next big market movement is the determining factor in the accumulation of the next level of wealth in our industry. Consider, for example, the savvy investors who sold at the peak in 2006 and 2007.

We offer here seven key indicators to watch as a barometer of the pending hospitality industry recovery.

- growing consensus that a broad U.S. recovery is in process (jobs data will be key);
- increased lender real-estate owned (REO) sales;
- leveling off of commercial loan delinquency rates;
- bottoming out of ADR;
- improving debt capital liquidity (i.e. more loans getting done);
- leveling off of hotel capitalization rates; and,
- unwinding of government recovery programs (TARP, TALF, SBA fee forgiveness programs, et cetera).



Recognizing improvement among the above factors will give early investors a critical advantage. One of us has an uncle who owns eight hotels, has some gray hair in the industry, and is actively buying distressed hotels. His wisdom: "If you're reading about it, you're already too late."

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