

What Is The Reality Of The Hotel Capital Markets

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I have just returned from the Lodging Conference 98 where one panel after another conveyed the sense that Armageddon had arrived during the past week. Supposedly there is no equity or debt available, and values have dropped by 20% or more on assets, and 40% or more on public lodging companies. The big question everyone asked was where is the bottom? There was talk of a global recession. In summary, the herd was in full stampede.

What is reality? We are experiencing a full scale financial markets panic not totally dissimilar to 1907, where fear has replaced logic. A big problem is that Wall St thought it had found the holy grail in securitization, As with all good financial market ideas, there is a downside. There were too many lenders with too much capital chasing too few good deals, which meant spreads became too low relative to the risk, and, at the same time, underwriting standards declined. Since the Russia crisis there has been a flight out of all types of bonds and into US Treasuries resulting in no buyers of the non-rated pieces of the securitizations. Spreads even on the rated pieces have widened by as much as 140 basis points in the past two weeks. Nobody is sure where to price anything. As a result, there is almost no active market for originating loans. Only a few banks and insurance companies which are able to hold loans in portfolio are able to make loans right now. If Wall St has to be left holding the subordinated non rated pieces in securitizations, they can't create new loans as it constricts their capital.

Yields on Treasuries have plummeted while yields on mortgage backed bonds skyrocketed. The underlying mortgages held in inventory awaiting the next securitization by the lenders had low coupons due to the low spreads caused by the heavy competition to make loans. The mortgages were suddenly worth a lot less than face value due to their low yields. This caught the lenders holding around \$20 billion of loans which were now worth anywhere from 1% to 10% less than face value. Hedge funds who had bought mortgage backed securities also now had losses in their portfolios. The result was large margin calls from the institutions who extended lines of credit to the mortgage lenders and hedge funds against the collateral of the mortgage backed securities. In addition, there were losses on large short positions against Treasuries used to hedge against rises in interest rates. The mortgage REITs were unable to raise new capital for themselves in order to make new loans, and CRIIMIE MAE, a major mortgage REIT went bankrupt. This combination caused huge losses at most lenders, and a near total cessation of new lending by Wall St and other lenders who cannot hold the paper in portfolio. The lenders were so quick to criticize the hotel industry for over expansion when the real over expansion was in the capital markets, not the hotel industry. Volume became a goal to achieve larger securitized pools.

When the flight to quality hit and spreads shot up, a lot of low yielding paper was still on the books of the lenders.

Some of the less disciplined equity funds also raced to put money out just to get bigger faster, which meant bigger asset management fees and potential profit shares. REITs were formed even though they never made any sense for the hotel industry. Whenever I asked what happens when the downturn comes and no more equity or debt can be raised, I was told that it was all about saving taxes. Maybe because I lived through the early eighties and the foolishness of tax shelter deals, I had learned that doing deals driven by tax savings leads to bad deals. Hotels are operating entities and should be financed as such. They need to retain cash flow to maintain the quality of the property and to grow the portfolio. Paying out 90% of the cash flow when new capital is not available, will inevitably lead to contraction of the portfolio, or less well maintained properties. It makes no more sense for Starwood or the other hotel companies to be a REIT than it does for Walmart to be a REIT.

What is the good news? We are currently in a worldwide financial markets panic which could lead to a recession. However, that does not mean anything like a repeat of 1990-1992. Then, we had many unqualified and undercapitalized owners, far too much leverage, interest rates of 11% or more, a near collapse of the banking system, substantial overbuilding, and a terrorism scare which caused travelers to stay home. That downturn caused most of the weak and unqualified owners to be washed out through foreclosure or other forced sales. At the same time debt was restructured or reduced through write downs, which meant leverage went from 110% or 120%, to 70% in most cases. Much stronger and more professional owners bought up the failed properties and now own a substantial portion of the dollar value of the industry. Many uneconomic hotels were closed or converted to other uses. Everybody began to focus on the need to run efficiently resulting in break even dropping to around 55% occupancy from 63%-64%. Interest rates have declined by 300-400 basis points. Debt service today takes about 50% less of each revenue dollar than it did in 1991. In 1991 the industry was losing billions and had been losing money for eight straight years. Today industry profits are at record high levels and have been for several years. Most owners are financially in quite good shape after several years of excellent profits as opposed to the eighties where many owners were losing money, over leveraged, and had no liquidity. Today the industry is the healthiest it has ever been. Where there was real overbuilding in the eighties, today there is only scattered overbuilding. This time the new construction boom got nipped due to the collapse of the capital markets before it flowered into the excess capacity that had always occurred in the past.

Interest rates are at a historically low level, inflation is flat, and despite the recent stock market declines, most of the people who travel on leisure are still sitting on some gains in their portfolios from the past three years. Unemployment is at near record lows, and is at a level which is well below what was considered full employment just a few years

ago. All levels of government are in surplus which means there is no crowding out of the private sector from the capital markets. Alan Greenspan is still in charge and has done a wonderful job of managing the economy. The dollar is sound and at a reasonable level. In summary, while we may yet have a recession, the country is in far better shape to deal with it today than it has ever been. Leverage is much lower than it had been in earlier recessions, the banking system is very strong and able to keep liquidity flowing into the economy, and government has the capacity to easily have extra spending to help pump up the economy and still not have a major deficit. Unemployment will increase, business travel will be reduced for awhile, and occupancies will decline further, but not below 1991 levels. ADR will likely level off for awhile, or only increase one or two percent, but that does not mean losses nor loan defaults becoming widespread.

In 1993, when I defied the prevailing, completely negative view of hotels at the time, and created the hotel first mortgage conduit, we began with very conservative underwriting. As a result, the loans made in 1994-1996 are likely producing debt coverages today of 1.8-2.0. In 1991 60% of all hotels had a negative debt coverage and the rest were probably at 1.2 or less. None had real FF&E escrows and most had no tax or insurance escrows. Breakeven occupancy was at 63% so it did not take much to drive properties into default. In 1998, breakeven is around 55% and debt coverage is generally 1.4 or better on most hotels. Although some are leveraged higher, the number is relatively small. Debt service today for hotels is about 7% of revenue vs 14% in 1991. The dollar value of hotels in REITs which are leveraged only 50%, is far greater than any dollar value of over leveraged hotels. In addition, the default rate on commercial mortgages is at a 30 year low. In summary, even if we have a recession, the likelihood of any large number of defaults is quite low.

What is the bottom line? Those who have cash available now will make extraordinary profits over the next two or three years by being buyers when everyone else is hiding in the cave. Many of the young people at lending institutions are in real fear of losing their jobs in the next few weeks. It is hard for them to be objective or optimistic under such conditions.

It is hard to see the sun if you are hiding in the dark back of the cave afraid of the wolf at the entrance waiting to devour you. We must climb out and look at the long view from the top of the hill. Seize the moment. There is money and great profit awaiting if you know where to look, how to structure the deal, and how to price the risk. At today's rates, even with very high spreads, just get the capital and don't let the price be the issue. Having access to capital is the key to real profit. This is 1993 again, not 1991.