



RUSHMORE

## BUYING OPPORTUNITIES ON THE HORIZON

**As the global lodging industry heads into another down cycle**, hotel owners, lenders and operators are wondering how deep the recession will get and how long will it last. Over the years, the lodging industry has experienced cycles of peaks and valleys every seven to 10 years. Some of the recent down periods have been 1973, 1981, 1991, 2002 and now again in 2008-09. Various factors have contributed to the low points in the cycle:

**1973.** Readily available financing from newly formed real estate investment trusts that caused severe overbuilding coupled with a travel cut-back because of the lack of fuel during the Middle East energy crisis.

**1981.** Recession leading to a decline in travel and falling hotel demand

**1991.** Readily available financing from the savings and loan industry caused another period of severe overbuilding combined with a decline in travel due to yet another recession.

**2002.** Cutback in travel because of the security fears following 9/11 and the resulting recession.

Today we're facing a unique down cycle. While new hotel development had been heating up between 2005 and 2007, it didn't reach the point of overbuilding. As a result, this downturn was not induced by an oversupply problem. While there was abundant and inexpensive financing available until mid 2007, it was the collapse of the credit markets caused by the defaults in the sub-prime residential sector that led to a drying up of commercial financing starting in 2007.

These events, coupled with the ridiculous "mark to market" accounting practice, caused lenders and investment banks to write-down billions of dollars of (perfectly good) mortgage loans, which led to fears of bank defaults and loss of confidence. This perfect storm sent stock markets around the world crashing and pushed many economies into recession.

Today, we are in the "deer in the headlights" phase of this downturn. Industry players are frozen and the

doing nothing but waiting to see how bad it is going to get. While hotel values have fallen, owners have just started to feel the pain of declining travel and RevPAR. Last year they had enough cash flow to pay their debt service, but this may change in 2009. Buyers sensing rapidly falling hotel values are looking at acquisition opportunities, but most are waiting for signs of a bottom. Lenders are on the sidelines laying off their mortgage origination staff and hiring work-out specialists. Some are selling their mortgage positions at discounts to raise capital, which is a great opportunity for hotel owners with capital to get unexpected help in paying down their loans.

### WHAT CAN WE EXPECT?

Let's look at how hotel values are affected by these events and how much of a decline we might expect over the next year or two. The components that affect hotel value are the net operating income (NOI before debt service) and the cost of capital. Since hotels in the U.S. are typically financed, the cost of capital is the weighted average of the debt and equity. For example, in early 2006 the interest rate on a typical hotel mortgage was 7.0 percent and the amount of the loan equated to 70 percent of the property's total value. The equity representing 30 percent of the property's value was looking for an IRR of approximately 20 percent. The weighted average cost of this capital structure (WACC) was 10.9 percent:

### TRENDS IN CAPITAL PARAMETERS AND IMPLICATIONS FOR VALUES

	Early 2006	Late 2006	Early 2007 (Peak)	Late 2007	through mid 2008	Fall 2008
<b>Mortgage</b>						
Loan to Value	70%	75%	80%	70%	65%	60%
Interest Rate	7.0%	6.75%	6.5%	6.75%	7.0%	7.5%
<b>Equity</b>						
Equity to Value	30%	25%	20%	30%	35%	40%
Equity Yield	20.0%	19.0%	18.0%	17.0%	17.0%	17.0%
WACC	10.90%	9.81%	8.80%	9.65%	10.50%	11.30%
Implied Value on \$1,000 NOI	\$9,174	\$10,191	\$11,364	\$10,363	\$9,524	\$8,850
Change from previous period		11.1%	11.5%	-8.8%	-8.1%	-7.1%
Change since 2006		11.1%	23.9%	13.0%	3.8%	-3.5%
Change since peak				-8.8%	-16.2%	-22.1%

Source: HVS Hospitality Services

\* Stephen Rushmore is president and founder of HVS, a global hospitality consulting organization with offices around the world. Steve has provided consultation services for more than 12,000 hotels throughout the world during his 35-year career and specializes in complex issues involving hotel feasibility, valuations, and financing. He can be reached at srushmore@hvs.com or 516 248-8828 ext. 204.

Mortgage	70%	x	7%	=	.049
Equity	30%	x	20%	=	.060
			WACC		10.9%

Once the WACC is determined, it is called the capitalization rate. Dividing the NOI by the capitalization rate results in an estimate of value. Using the early 2006 capitalization rate of 10.9 percent and NOI of \$1,000, the value would be \$9,174 (\$1,000/10.9% = \$9,174).

The table shows what happened to the cost of hotel debt and equity components between early 2006 and fall of 2008, the impact on the WACC and how this would effect value assuming \$1,000 of NOI at each point in time.

In early 2006 typical hotel financing was 70 percent loan to value with an interest rate of 7.0 percent and an equity yield of 20 percent. This produced a value of \$9,174 for each \$1,000 of NOI. By 2006 and '07, mortgage financing became more competitive and loan-to-value ratios topped out at 80 percent with interest rates falling to 6.5 percent. At the peak, that \$1,000 of NOI created \$11,364 in value, a 23.9-percent increase from early 2006.

By the end of 2008, mortgage lenders were pulling back, dropping loan to value ratios to 50-60 percent and increasing interest rates to 7.5 to 9 percent. In most instances, hotel mortgages weren't even available. The value created by \$1,000 of NOI declined to \$8,850 by the end of 2008, or about 22 percent lower than the value peak.

## THE FUTURE

As we head into 2009, I don't think we will see a further increase in the WACC; thus, the 22-percent value decline caused by a higher capitalization rate will not increase. On the other hand, we are now experiencing a decline in RevPAR in many markets, which translates into a drop in NOI.

We are likely to see a great deal of economic pain for those hotel owners who over-financed their properties during the last several years. Particularly hard hit will be those who

have expiring mortgage terms and must obtain new financing. While the underlying market value of hotels rarely declines more than 20 to 30 percent in down cycles, highly distressed owners and lenders will often dump their properties at deep discounts ranging from 40 to 60 percent. The resulting liquidation pricing represents huge buying opportunities for those with capital and the belief that eventually things will get better.