

Optimism and Hotel Financing in a New Phase of the Business Cycle

By Cameron J. Larkin

“When the well ‘s dry, we know the worth of water.” - Benjamin Franklin’s ‘The Way To Wealth’

Americans are optimists. The core of the American Dream is the belief that we can overcome any obstacle and accomplish anything through hard work and the right attitude. Many, if not most, hoteliers achieved their success by testing this belief and as a result are often extreme examples of American optimism.

So it is with this background that we find our optimism currently tested amid conflicting economic accounts from the media, government, industry, and trade magazines. President Bush says our economic fundamentals are sound, but the Democrats speak only crisis. Alan Greenspan came out of retirement just long enough to

ruminate on a probable long, deep recession while other notable economists speculate the worst is already behind us. Some luminaries in the hotel industry brush off anyone who mentions a pending downturn as “pundits” with a flair for the dramatic, their argument buttressed by the reality of continued strong hotel market fundamentals. An optimist by nature, I myself could have used some antidepressants during several downbeat sessions at the recent annual Mortgage Bankers Association gathering of thousands of cheerless commercial lenders.

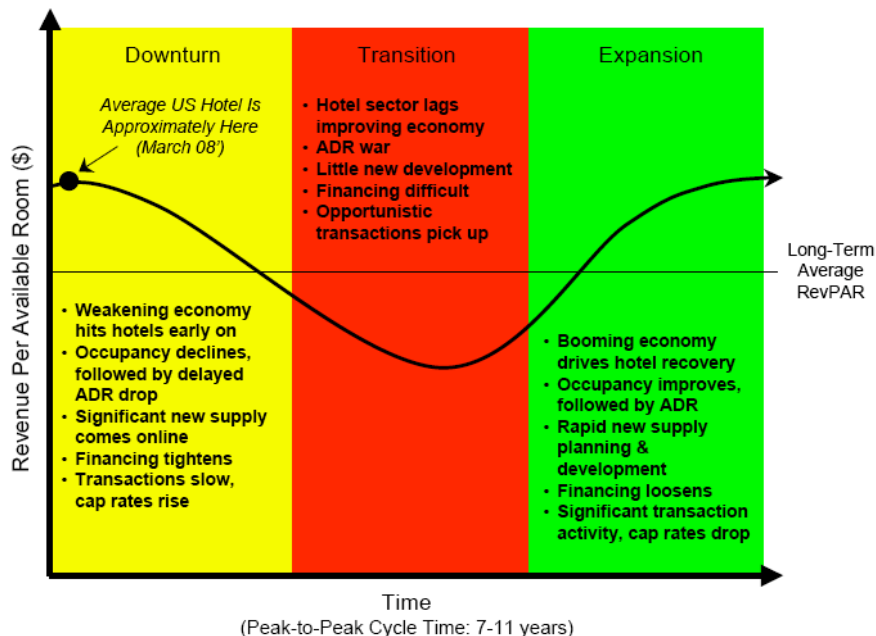
So who’s right? Should we plan for the worst or prepare for the next stage of growth? The answer isn’t clear, but a slowing economy in the near term will touch the hotel business. There are enough predictable effects within the

natural rhythms of the hotel business cycle to provide a useful guide.

Economic uncertainty, whether generated by real market weakness or unjustified panic (the effect is the same in the near term), creates unique challenges in the hotel business: fewer travelers, less pricing power, slowing/declining net operating income, more expensive financing, rising cap rates, and fewer active investors.

After a robust expansion in the hospitality industry, the stage was set for some trigger event to expose weakness in important economic inputs driving the expansion.

Hotel Business Cycle Phases, Timeline & Effects



Source: Larkin Hospitality Finance - Dallas Office

History will be a better judge, but the cause of the current economic events will likely be pinned on the confluence of a bursting housing bubble, sub-prime residential loan failures, high oil prices, and war spending. We’ve been here before and come out just fine. In fact, some hoteliers will use this correction to strengthen their market position.

But this time is different; we’re even better prepared. The hotel industry has never been stronger. We’re coming off several years of

record profitability, Hotels are increasingly owned by a professional class of operator who understand this management intensive business. The health of the industry can be tracked more transparently through abundant and readily available market operating data. Supply of new hotel rooms reaching the market has been

constrained by both high construction costs and longer development timelines. Stricter franchisor brand management continues to improve product quality in every corner of the country.

Each phase of the hotel business cycle creates opportunity (and outright fortunes) for those able to take advantage. Arguably one of the biggest challenges in this environment will be financing hotel acquisition and refinance projects. During times of economic uncertainty lenders that don't truly understand hotels tend to back away from the industry. In the current credit crunch some lenders have left the commercial market completely or are not lending on hotels. The conduit/CMBS market is all but shut; their return is unlikely before the fourth quarter of this year at the earliest.

Indeed, financing during the remainder of 2008 will become the key element to project viability for many hoteliers. The winners will achieve competitive advantage by minimizing the rising cost of debt while maximizing loan program flexibility (e.g. floating rate option to take advantage of LIBOR's steep decline, prepayment schedule allowing for free/inexpensive repayment when the CMBS market returns, etc.).

Balance sheet lenders (lenders that originate and hold loans on their books) that understand the hotel finance business will be more important to our industry than they have been in the recent past. Knowing how to effectively present, negotiate, and close a complex loan proposal with this dwindling pool of lenders will also give brokers and investment bankers an opportunity to show clients their true value.

While the numbers of lenders lending on hotels is smaller and their underwriting criteria more rigid, interest rates,

loan proceeds, and terms are still historically favorable for qualifying deals. For example, we're currently working on a Comfort Suites refinance with proceeds at 75% loan-to-value (LTV), interest rate pricing in the mid-6's, limited recourse, and the option to fix or float the rate. On another refinance project, a newly opened Hilton Garden Inn, we've obtained a recapitalized loan offer at 75% loan-to-cost (LTC) with 18 months of interest-only payments (then 25-year amortization) and pricing in the low 7's. On an acquisition of a Homewood Suites asset we received 75% LTV proceeds at fixed-rate pricing in the low 6's.

Deals with the right combination of brand, market, and sponsorship can still get done at terrific terms. But everything is more difficult and poor performing hotels simply will not find financing today. Some lenders won't even take the time to listen to your story; those still lending are covered up with loan requests and often will filter out all but the easiest-looking deals. Banks want more up front information on each project and won't necessarily dig into a package if the required information isn't readily available. Loans marketed to the wrong lenders wastes time and risks the integrity of the deal. Offers can expire quickly, only to be re-priced higher if borrowers delay decision-making.

As we view the remainder of 2008 from the current peak of the recent expansion phase, optimistic hoteliers are planning how to shore up their position during the downturn. While each hotel cycle is unique, there are certain predictable effects that need to be managed. The winners of this next business cycle are already hard at work.

About the Author



Cameron J. Larkin is the Managing Director and Founder of Larkin Hospitality Finance (www.larkinhf.com), a national investment-banking firm focused exclusively on meeting the financing needs of hotel owners and developers. He leads financing placement activities for clients across the US and has been involved with financing hotels and the financial industry for over 16 years. Mr. Larkin has authored several hospitality financing articles, is frequently published and cited in the major industry periodicals, and is frequently invited to attend hospitality investment, hotel franchisor, and commercial lending conferences. He has an MBA degree from Columbia University, a BS degree in Business Administration from the University of Vermont, and holds the following designations: CCIM candidate (Certified Commercial Investment Member Institute), Quality Six Sigma MBB (statistical certification).

Contact

Cameron J. Larkin, Managing Director
Larkin Hospitality Finance
Direct (469) 916-8518
Email cameron@larkinhf.com
Office 5050 Quorum Drive, Suite 140, Dallas, Texas 75254
Web <http://www.larkinhf.com>