



# FINANCING IN THE FACE OF FEAR AND FUNDAMENTALS

*"When the well's dry, we know the worth of water." - Benjamin Franklin.*

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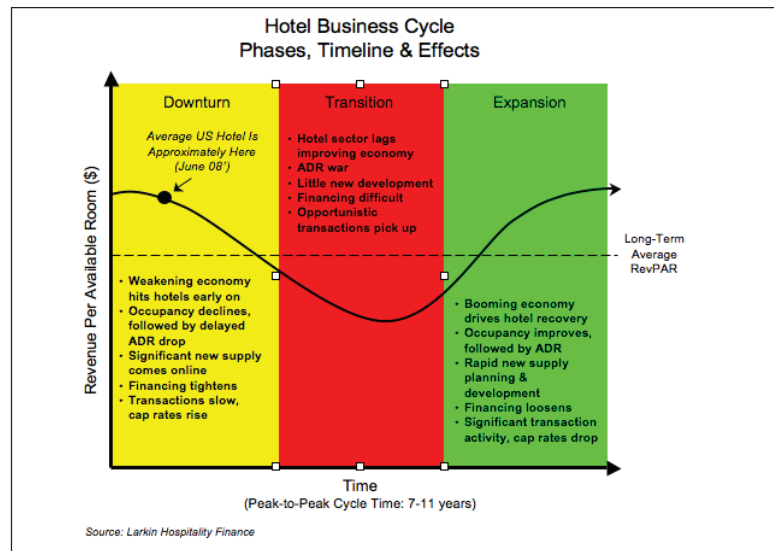
While the title of this article is a bit of a tongue-twister, its components speak to key and sometimes counterintuitive factors impacting our industry today: Financing challenges, recessionary fears, and the surprisingly robust market fundamentals — both hotel industry and broader economy — that should keep AAHOA's membership from sitting on the sidelines during this time of uncertainty.

## FINANCING

The increasing difficulty and costs of debt financing are slowing many hotel transactions, killing more, and eroding asset values as cap rates creep upward. However, hoteliers are less inclined to view the current credit environment with alarm. They understand the natural ebb and flow of the hotel business cycle (see accompanying chart) and are in the business for the long term. In fact, many took advantage of the past heady credit environment both to lock in attractive long-term financing and put away funds for future opportunities.

Lenders, however, tend to focus on current market conditions as a predictor of future loan performance. To get "comfortable" with a loan on a hotel today some lenders will lower leverage (e.g. 60-70 percent), increase the interest rate to "price-in" the perceived increase in risk, lower amortization (e.g. 20-25 years), increase personal guarantees/recourse, and/or require additional credit enhancements (e.g. letter of credit, cross-collateralization).

The result is that lender comfort is likely "over-priced" today relative to hotel lending over the past few years. We can stomp our feet in



frustration, or we can exploit the inconsistencies prevailing in the credit markets to an advantage.

What's most striking is the broad variation in debt financing terms on hotel projects today. For instance, given the same loan package, a targeted group of lenders may come back with fixed interest rates ranging from 6.00 percent to 7.80 percent, leverage from 60 percent to 75 percent, non-recourse to full recourse, no prepayment penalty to a declining percentage starting at 5 percent, and amortization from 20 to 25 years. A year ago a loan targeted to a handful of known hotel lenders would have come back with all offers virtually indistinguishable from one another — the "auction" nature of the past lending market meant lenders were putting their best foot forward, yet they could still fine-tune offers to match particular clients needs.

Today, the environment is such that historically good loan terms are still available. But the inefficiencies created by the "credit crunch" mean one has to refine lender targeting even further and go in with a very complete package. Many lenders have

pulled back from the market, and those still active are swamped with loan requests — the demand for capital outweighs constrained supply. The only way to get a loan seriously considered is to ensure all required information is presented well the first time. Just as importantly, when there is a loan offer that substantially meets the right needs, jump on it quickly! It has been a generation since markets have been as fluid as they are today. Terms offered last week might no longer be viable this week if the term sheet/application wasn't signed. Speed is key.

## FEAR

Fear itself has become a self-sustaining epidemic in the U.S. whether it be anxiety over collapsing home prices, panic on Wall Street, alarm from spiraling sub prime mortgage failures, or any of the numerous bugaboos worrying Americans today. Certain fears complement and build on each other, creating market paralysis culminating in the granddaddy of economic phobias — recession.

Some fears are justified. The ex-



cesses of each cyclical economic expansion create problems that only become apparent as markets slow. Available and inexpensive debt generated historic hotel transaction activity, drove cap rates down, and allowed many marginal deals to get done. For example, can a tertiary market really support a new 104-room Holiday Inn Express and an 84-room Hampton Inn? Small markets with large inventories of independent hotels are increasingly adding up-market, flagged properties. Many of these hotels were built to be sold and simply will not meet projections. Or how about the Comfort Suites purchased at a six percent trailing 12-month cap rate that only spun an acceptable return with both an exceptionally optimistic pro forma and interest-only debt? Try refinancing that maturing bridge loan today.

The opposite of chance is planning, and the opposite of fear is optimism. Working off expansionary excesses during a slowdown generates some real loss and even more fear of loss. Still, many of the risks of hotel ownership can be planned for and managed given the relative predictable effects during each phase of our cyclical business. The professionalism of the hotel industry over time has structurally improved its ability to weather adversity — think revenue management, marketing sophistication, financing tools, market data availability, brand management, quality standards, and development of management talent.

Hoteliers are a less fearful and more naturally optimistic group of entrepreneurs. It's therefore incumbent on us to continue our evangelism of the merits of the business to those who support the hotel industry. Many outside the business believe the correlation of the hotel industry to movements in the broader economy is an excuse to back away when a slowdown looms. True partners don't enter and exit the market as "the right" conditions prevail.

#### FUNDAMENTALS

The health of the hotel industry is well-reported, so I won't restate what

we already know — RevPAR growth has slowed, supply is in check, and the industry will continue to benefit from record profits that largely have been reinvested within the business.

The health of the broader economy is less well understood. But reason for optimism also stands. Consider that 95 percent of all people who want a job in America have one today. Further, substantial stimulative "economic medicine" was applied over the past year through government policies that should get the economy moving and restore confidence — taxpayer rebate checks, accommodative monetary policies, steady Fed interest rate cuts, mortgage market intervention, tax breaks for businesses, etc. In fact, during the week of June 4, the Fed signaled an end to further interest rate cuts, an indication the powerful doses of economic medicine are taking effect.

Other promising news includes May's stronger-than-expected payroll and productivity data, contributing to firming stock and bond prices on Wall Street. The light at the end of the tunnel appears to be growing brighter.

While a small portion of all current commercial and consumer debt obligations possess significant default risk today, the vast majority are sound. Hotel loans, in particular, are backed by continued strong cash flows and balance sheets. The "dirty little secret" on Wall Street is that the mortgage crisis is more about "write-downs" of good loans for which there are no buyers (e.g. the conduit/CMBS secondary market) versus "write-offs" of bad loans. Moreover, the lack of buyers isn't due to lack of buying power but

rather fear prices will go lower.

According to James Paulsen, Ph.D. at Wells Capital Management, every financial crisis has two key components — fundamental balance sheet/income statement problems and "fear." Given that both the economy and credit creation continue to expand, albeit more slowly, what's left is fear.

The "safe" thing to do today is to buy risk-free government bonds and accept returns in the range of 3 percent to 4 percent. Capitalist hoteliers, however, won't sit idly and ignore the potential market-beating returns of a well-run hotel. A great deal of wealth was created during the recent hospitality market expansion, and seeds are being planted today for the next phase of the industry's evolution. **ALB**

Cameron J. Larkin is the Managing Director and Founder of Larkin Hospitality Finance, which can be visited on the Web at [www.larkinhf.com](http://www.larkinhf.com).

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