Hotel Lender Survey

December 2017

RobertDouglas

Executive Summary

This survey of senior balance sheet lenders, CMBS lenders, and providers of subordinate debt financing was conducted by STR, Hotel News Now, and RobertDouglas to measure the current state of financing market conditions, and ascertain critical future expectations through the lens of the specialist hospitality lending community. A total of 61 hotel lenders participated in this fifth annual survey – together representing the source of the majority of all hotel debt originated in the U.S. in 2017, with loan balances in excess of $10 million.

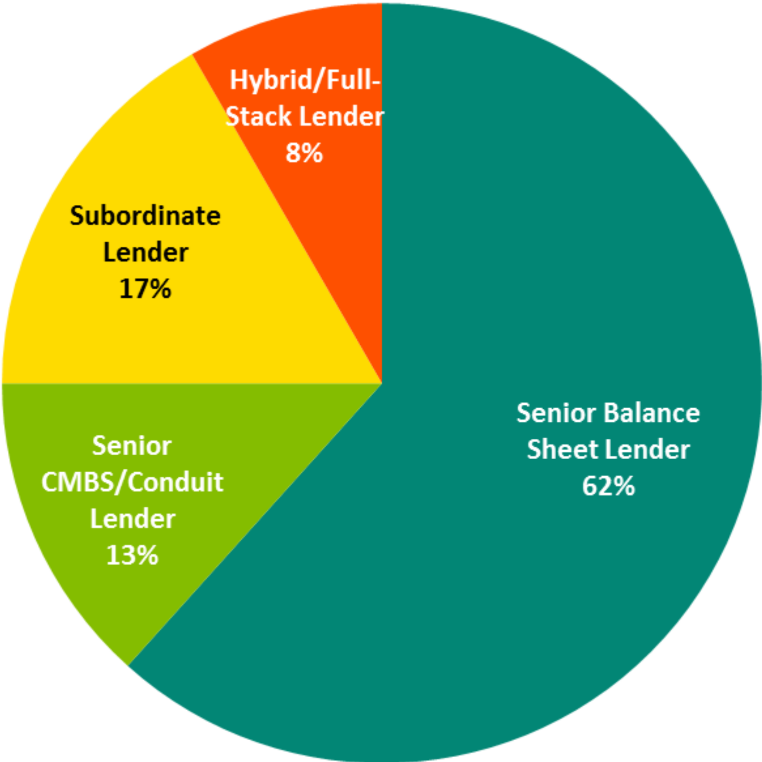
Overall, the survey results reflect stable credit risk spreads balanced by a cautious outlook of peaking asset values– all in an environment with underlying expectations of further near-term interest rate increases. This outlook remains largely consistent with last year; however, lenders are less cautious about the short-term outlook of hotel lending than in 2016.

None of the surveyed lenders believe hotel values will increase or decrease significantly in the next 12 months—more than 60% of the respondents said they expect hotel values to be flat, and only 9% anticipate values to decrease slightly during that period. Similarly, almost 70% of the surveyed lenders expect the overall hotel lending volume over the next 12 months to remain consistent with 2017 levels.

What keeps lenders up at night? For four years in a row, survey respondents cited the potential for a U.S. economic slowdown and/or faltering general macroeconomic growth as the most feared threat to a their hotel loan portfolio. The lenders' second most-cited fear remains that of increasing competitive supply. However, 40% of the respondents are comfortable with where hotel operating fundamentals are heading, while just under half of lenders remain cautious about hotel performance and/or macroeconomic trends. The segment of cautious lenders decreased significantly to 48% in 2017, from 67% only one year ago.

This survey highlights the metrics most important to lenders in underwriting, sizing, and pricing hotel loans. Over half of the surveyed lenders responded that the location and quality of the real estate is the single most important "gating" criteria for financing requests, while over one quarter of respondents stated cash-flow metrics were most important. In terms of asset class, lenders expect the least risk over the next year in financing upscale and upper midscale product, while the highest risk is expected to be concentrated in economy, luxury, and independent properties. Similarly, by a wide margin, lenders are most comfortable with financing hotels in urban locations, according to the survey results.

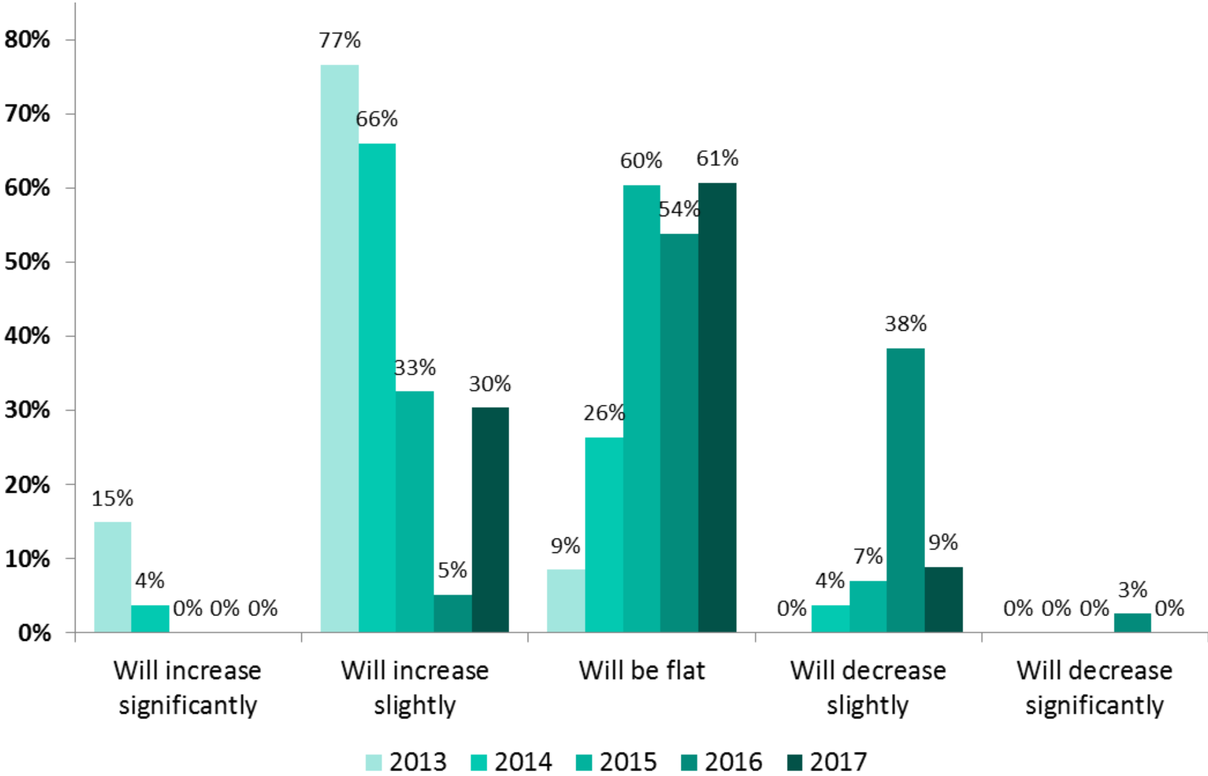
Respondent Profile



The mix of lender respondents to the survey is a fair reflection of the lodging finance market, which is predominantly composed of lenders focused on traditional senior mortgage hotel loans. Given their role in completing borrower capital stacks, the subordinate lenders are increasingly vital to achieving desired leverage levels for both value-added acquisitions with lower in-place cash flows and higher leverage refinancings.

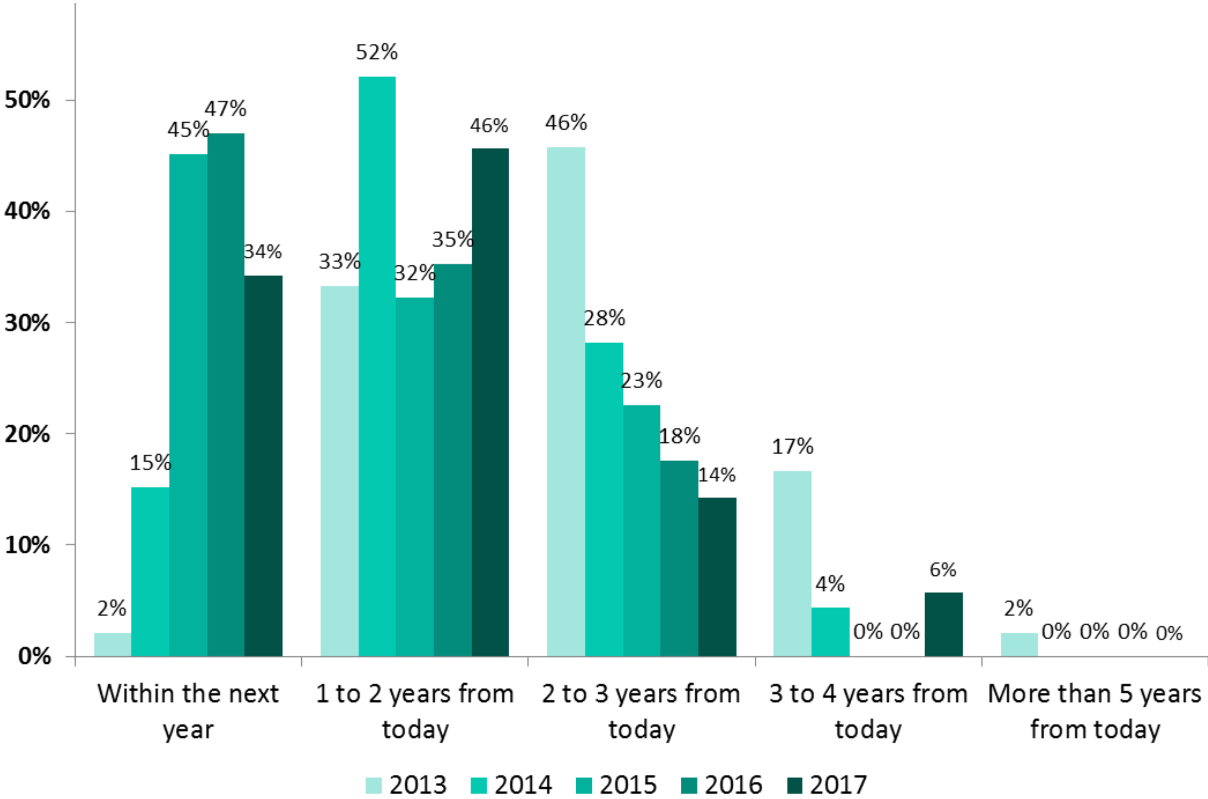
Total domestic conduit originations increased by 26% in 2017 to $87 billion across all asset classes, with hotel originations increasing from roughly 20% to 28% of that total. The consensus for 2018 among conduit originators is for overall CMBS originations to decline from 2017 volumes, due to a drop-off in the number of loans available for refinancing.

Overall, where are hotel property values going over the next 12 months?



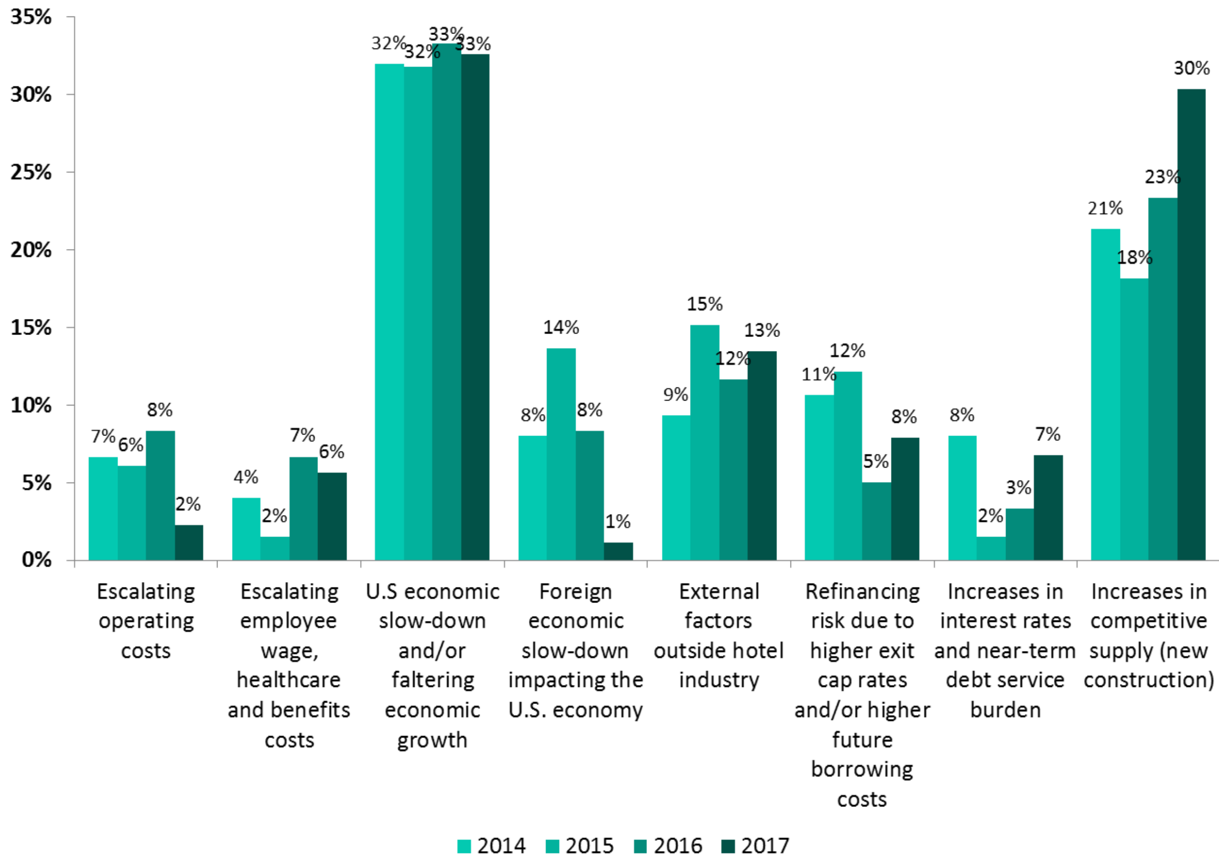
While a majority of the lender respondents anticipate no substantial change in hotel valuations in 2018, the outlook appears to be more optimistic than a year ago. In fact, 30% of lenders project slight increases in hotel property values, while only 9% anticipate slight decreases. This is a reversal of last year's survey in which 38% expected declines in hotel values, and only 5% expected slight increases. No respondents expect significant positive or negative swings in hotel property values over the next 12 months.

How many years will it be before this current period of growth in hotel asset valuations peaks?



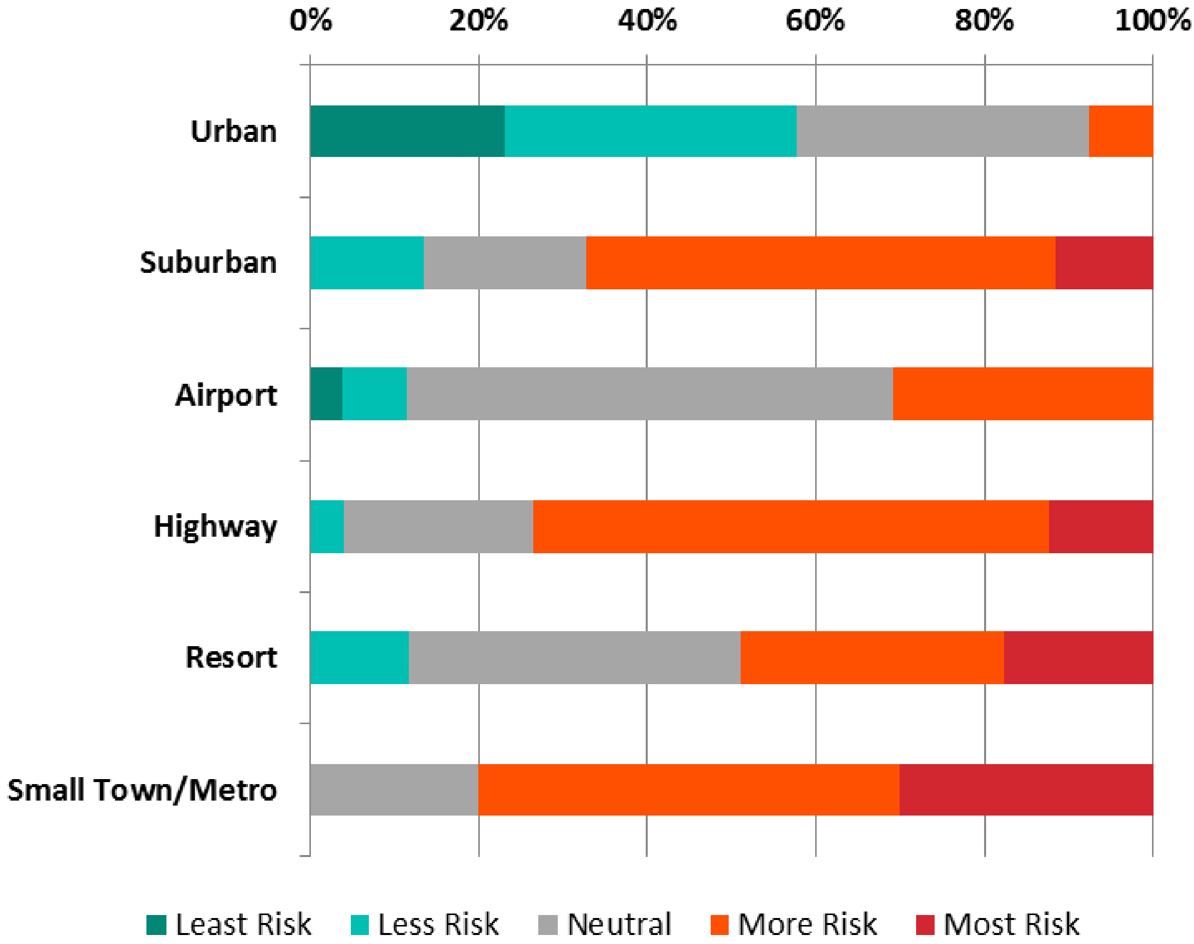
Nearly half of all lenders (46%) anticipate hotel asset valuations to peak at some point in 2019, with 34% of respondents predicting the peak to occur within the next year. Interestingly, 6% of lenders predict that this cycle of expanding asset values will last three to four more years; this is the first time since 2014 that any lenders have believed the current period of growth could continue for more than three years.

What do you perceive as the biggest potential threat to your existing hotel loan portfolio?



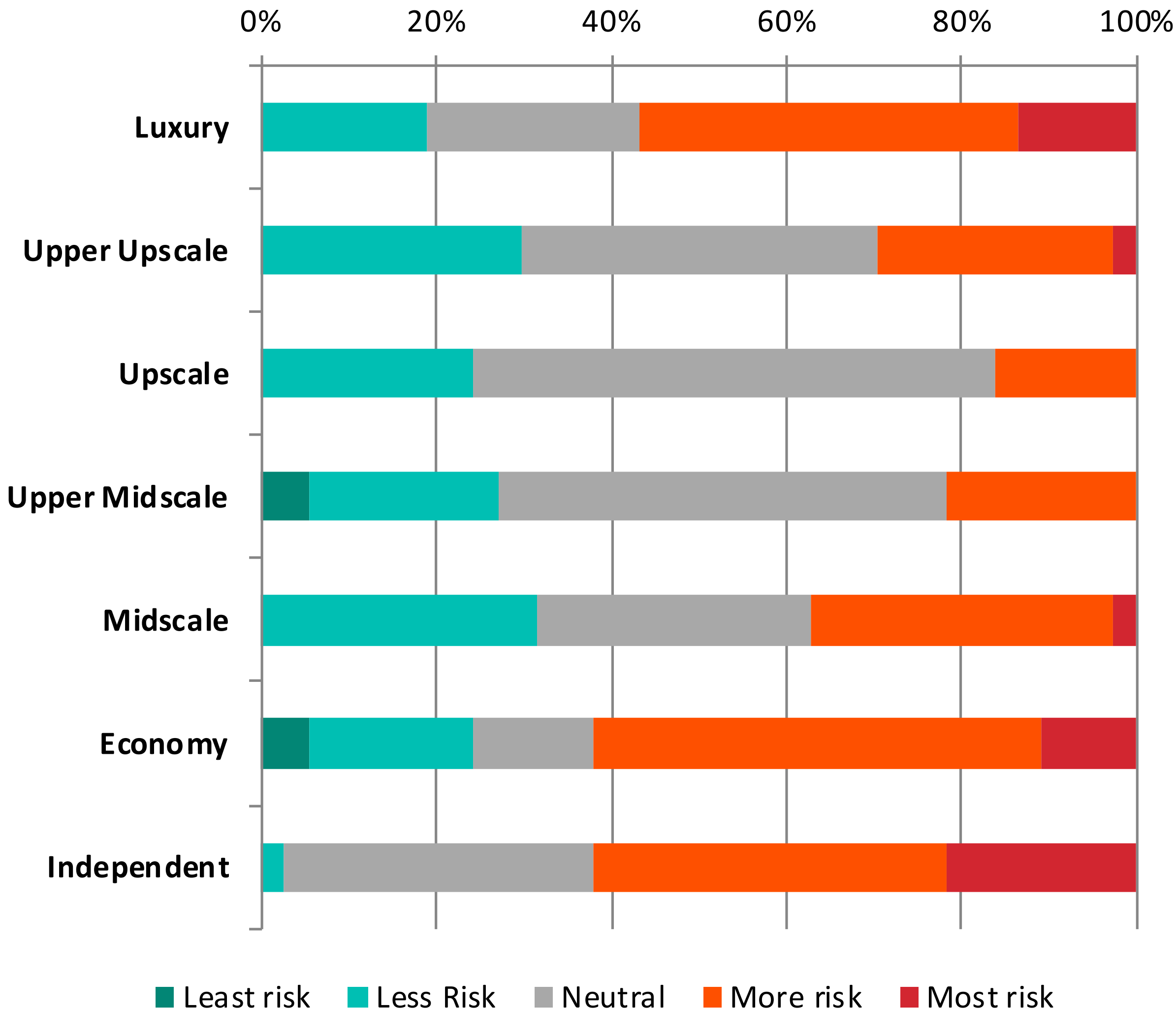
For the fourth year in a row, approximately a third of surveyed lenders cited the potential for an economic slowdown and/or faltering general macroeconomic growth as the most-feared threat to their hotel loan portfolio. The fear of increasing competitive supply continues to grow as the second most-frequently-cited threat (30%) by hotel lenders. Factors outside the hotel industry remain a concern for many lenders, with 13% of respondents indicating that external factors were the biggest potential threat. Among the balance of lenders, threats originating from the capital markets, such as increasing interest rates and refinancing risks, are more feared than rising costs impacting hotel profitability, which is a return to the trend observed in 2015.

Where do you see financing risk generally, by location, for the next 12 months?



By a wide margin, lenders are most comfortable with lending in urban markets. This logical perception of risk is most likely because assets in major markets fared best through the last recession – not only in terms of RevPAR and profitability performance, but also in terms of continued sale liquidity. This view might also be influenced by the notion that there are higher barriers to entry to build new product in urban in-fill environments, where sites are more scarce and expensive than any other market category except oceanfront resorts.

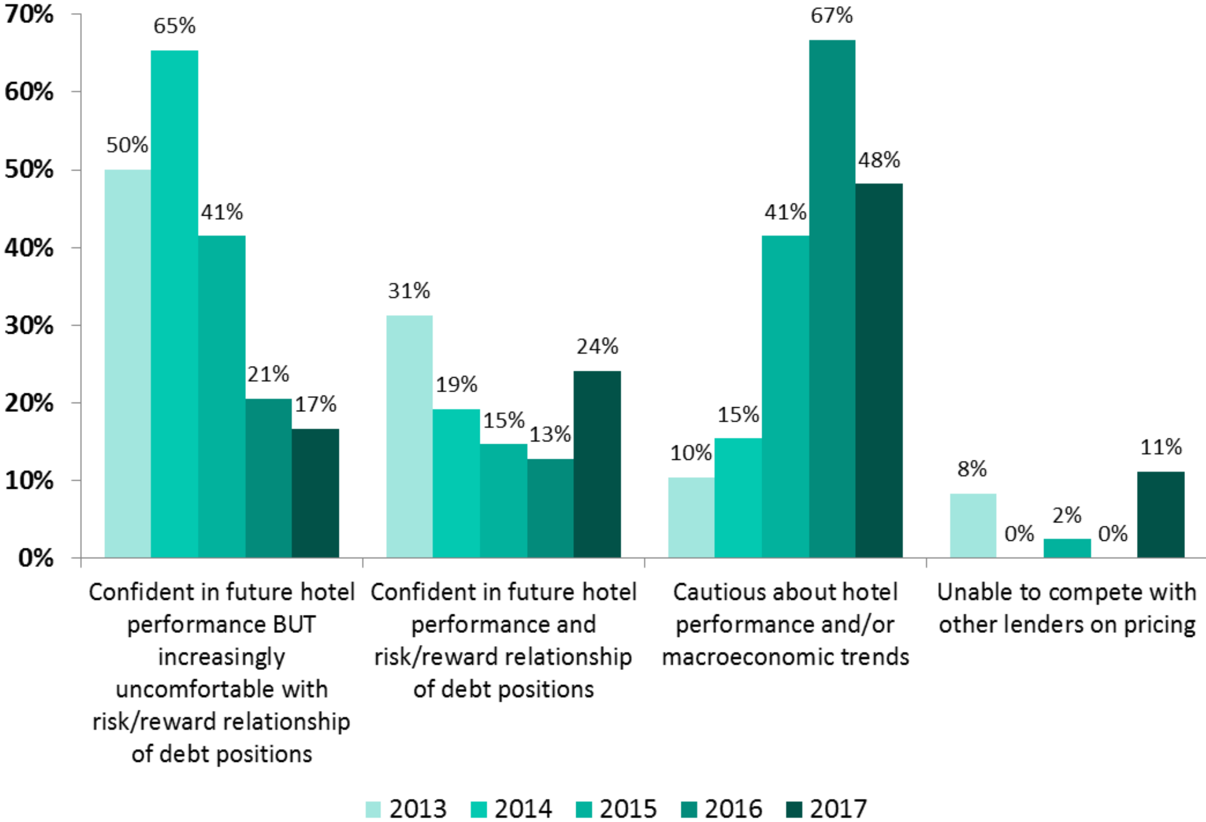
Where do you see financing risk generally, by price point, for the next 12 months?



Overall, lenders see the least risk over the next year in financing upscale and upper midscale products, despite the fact that these two chain scales have experienced the most new supply growth and only modest RevPAR gains in recent years. The most overall risk is seen to be concentrated in independent and luxury products. At the luxury end of the chain scale, the risks are more varied and include increasing operating costs given high service levels and peaking market values. Truly independent properties may be viewed as increasingly risky, as the major brand families have all introduced “soft branding” alternatives that are resulting in the effective brand affiliation of many of the leading previously independent hotels.

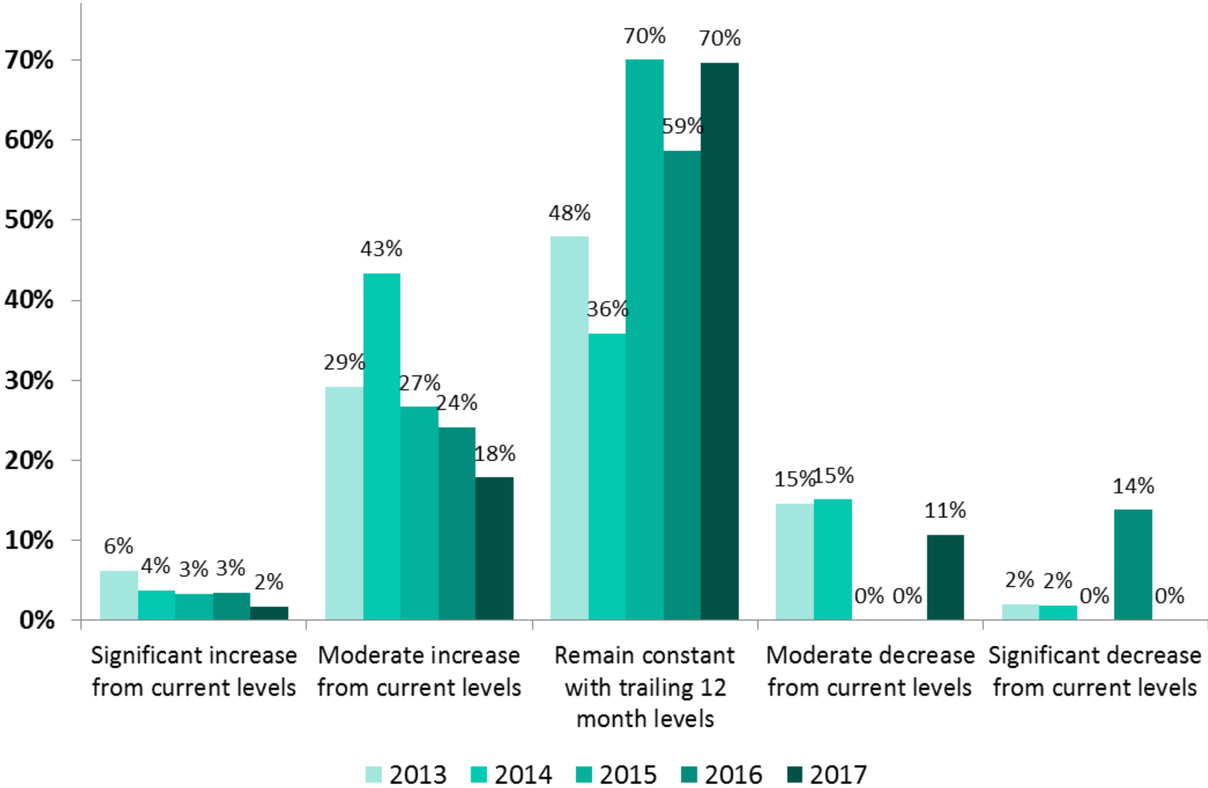
Outlook

What is your current view of hotel lending?



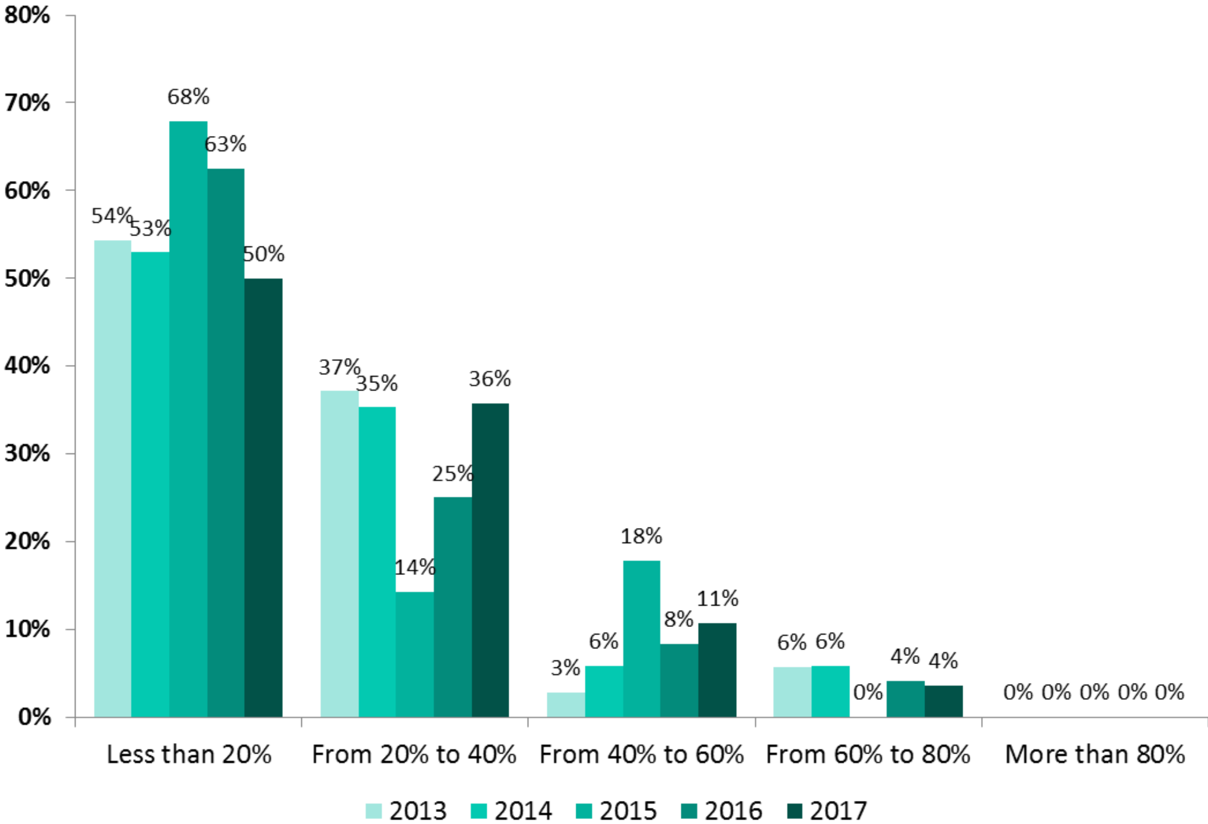
Lenders remain cautious about hotel lending with 48% responding that they are cautious about hotel performance and/or macroeconomic trends. However, lenders are less cautious than in 2016 when 67% of respondents answered with caution. In fact, 41% of respondents are confident in future hotel performance, though they continue to differ on whether they are being adequately compensated for the risk/reward relationship of their debt positions. This was the first year of the survey in which the number of respondents confident in the risk/reward relationship was greater than the number of lenders that are uncomfortable with it. Also for the first time, over 10% of lender respondents feel that they are unable to compete with other market participants on pricing.

How do you anticipate your overall hotel lending volume to change over the next 12 months?



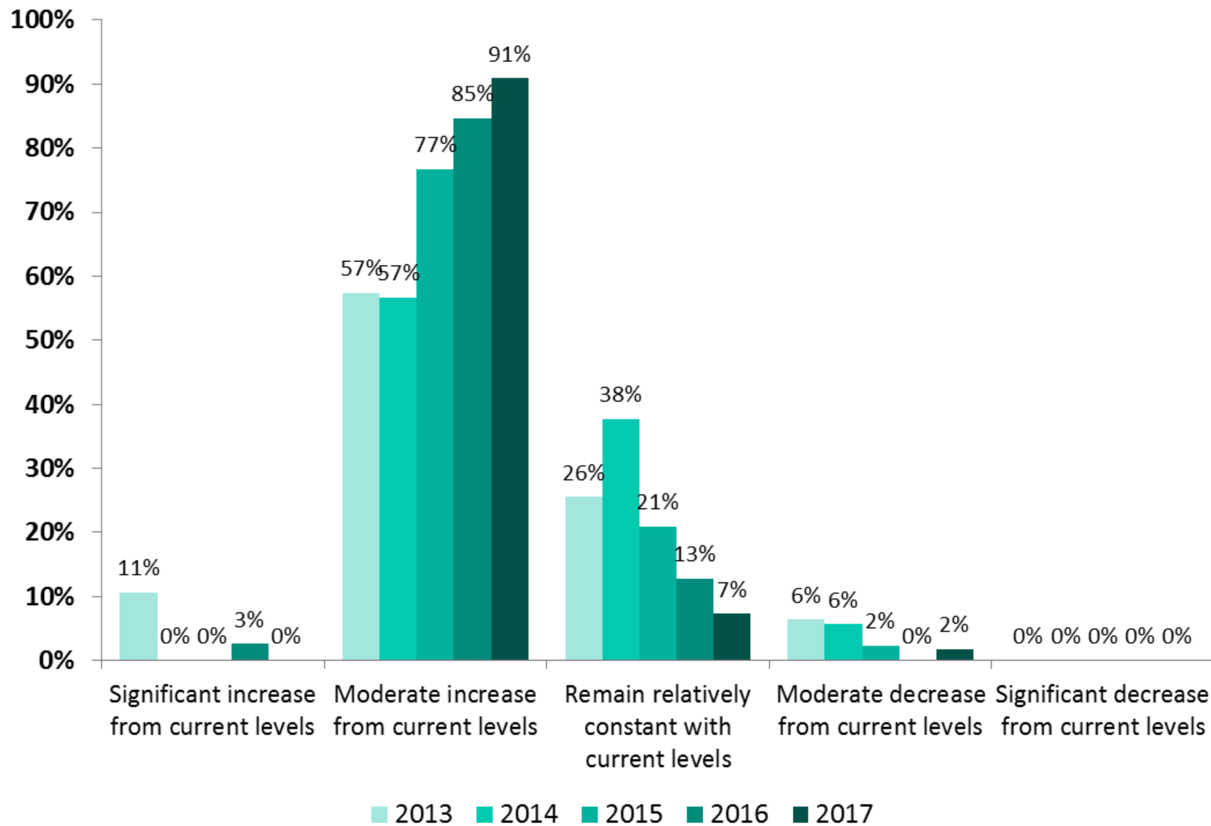
Approximately 70% of all lender respondents forecast that they will originate a constant level of hotel sector financing in the next year. Lenders who forecast moderate or significant increases in lending in the hotel sector continue to decrease as a percentage of all respondents, while 11% of respondents predict they will moderately decrease their hotel lending volume in 2018. No respondents expect to significantly decrease hotel lending volume, another shift from last year when 14% forecasted a significant decrease.

What percentage of your total lending volume do you anticipate loan extensions and renewals of existing mortgages will comprise over the next 12 months?



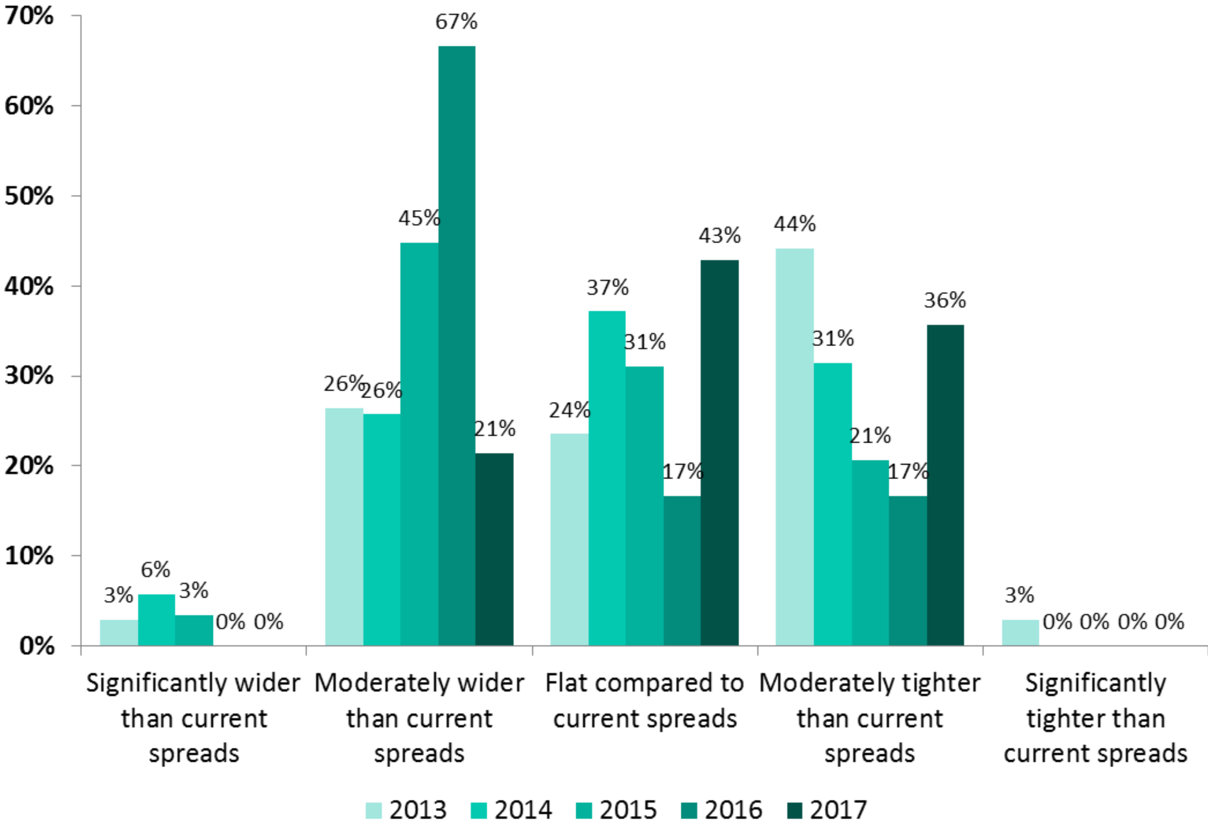
The percentage of expected renewals and extensions remains at relatively low, albeit increasing, levels, which bodes well for continued liquidity to finance new acquisitions and value-add renovations. There is a slight upward trend in 2017, with 50% of respondents indicating that renewals and extensions would make up over 20% of their business over the next year, compared with only 37% in 2016. The largest increase in respondents was in those who believe renewals and extensions will comprise between 20% and 40% of their business in the coming year, with 36% of lenders indicating so versus 25% last year.

Do you expect interest rates to increase, decrease or stay the same over the next 12 months?



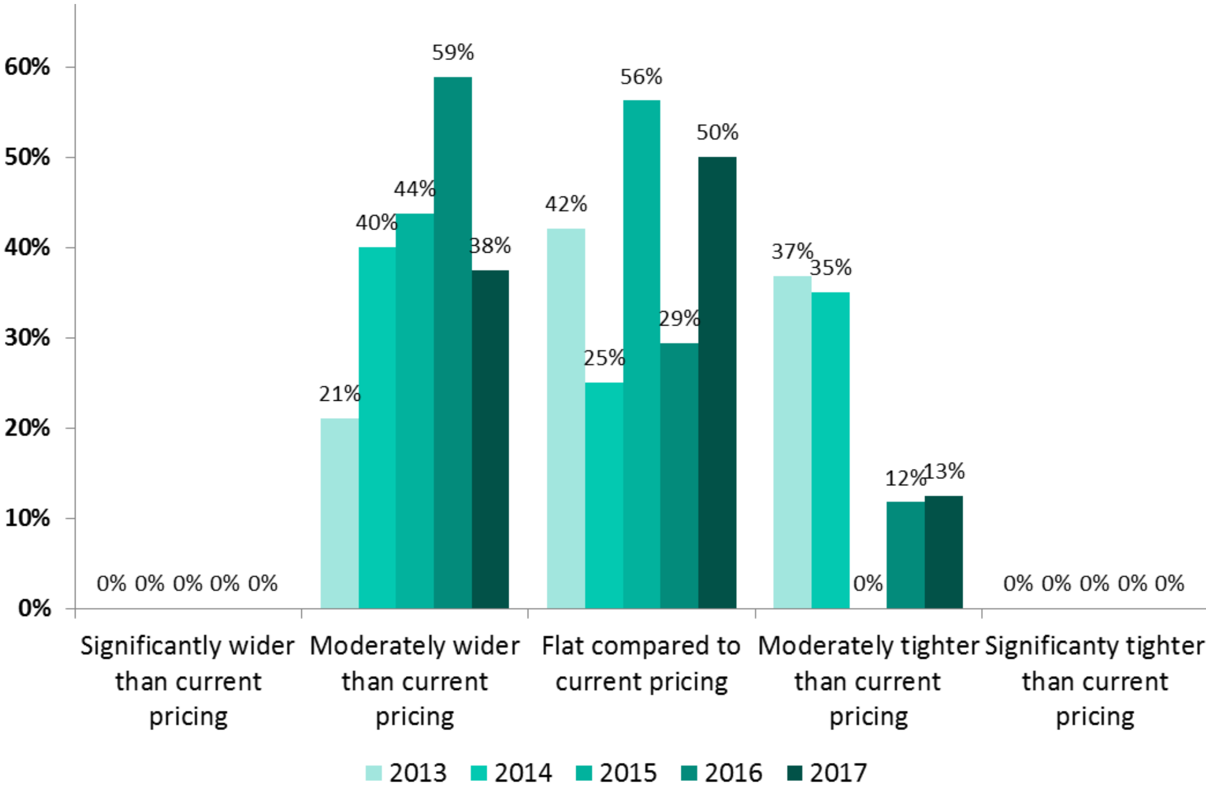
Unsurprisingly, 91% of lenders expect interest rates to moderately increase over the next year, as we have witnessed a 110-basis-point increase in 10-year treasuries since the November 2016 election. The role the Federal Reserve plays in setting monetary policy will be closely watched to balance or mitigate the effects of implementing the foreign trade and domestic spending policies of the new administration. The Fed raised the federal funds rate three times in 2017 with the stated intention to continue to raise rates in 2018.

Where do you believe senior mortgage credit spreads will be 12 months from now?



Given lenders' general view of the lodging industry and a consensus expectation of stable to increasing liquidity to the hospitality finance sector, over two-thirds of hotel lenders expected moderately wider credit spreads in 2016, while less than a quarter of lenders surveyed in 2017 expect moderately wider spreads looking forward. This year, 43% of lenders expect no change in credit spreads, while 36% expect tighter credit spreads. Overall, this is a clear shift toward the expectation of flat or tighter credit spreads for 2018.

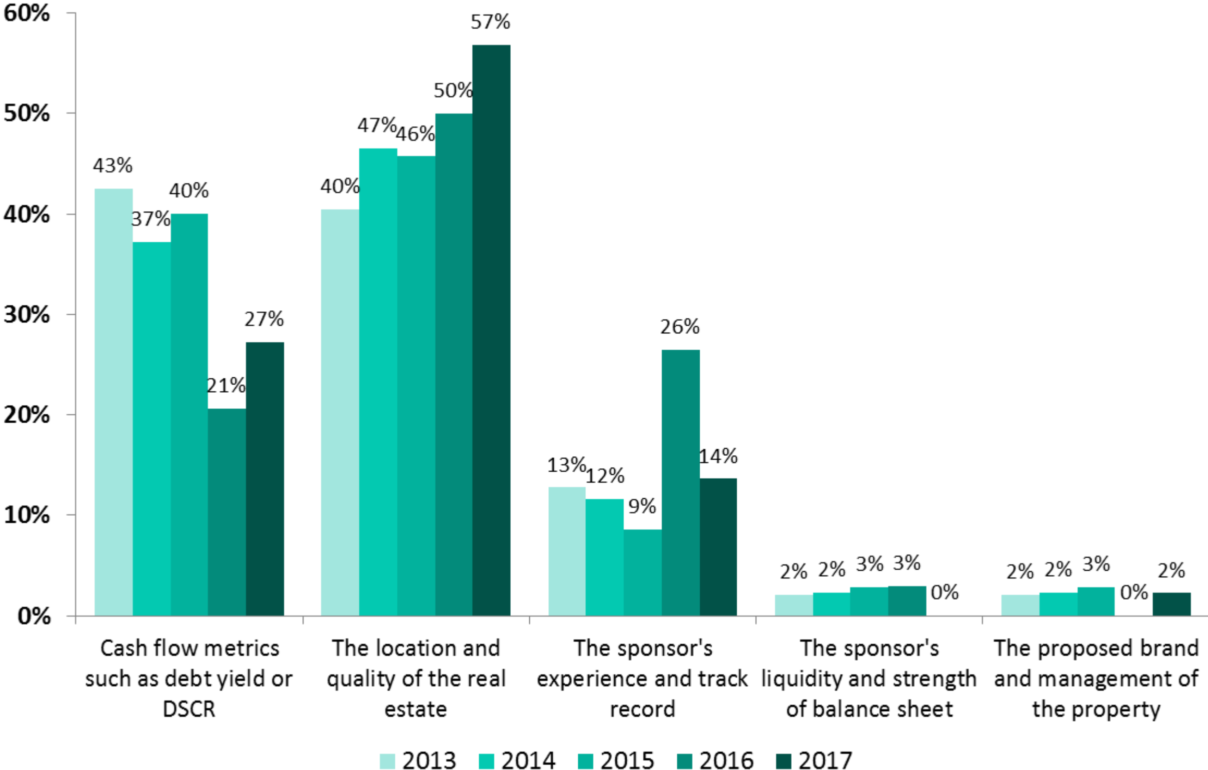
In which direction do you believe pricing will move over the next 12 months for subordinate financing?



Similarly, subordinate lenders have also somewhat shifted expectations toward tighter pricing on their debt for 2018 originations. Half of subordinate lenders expect no change in current pricing this year, while 38% expect wider debt pricing, down from 59% last year.

All Lenders

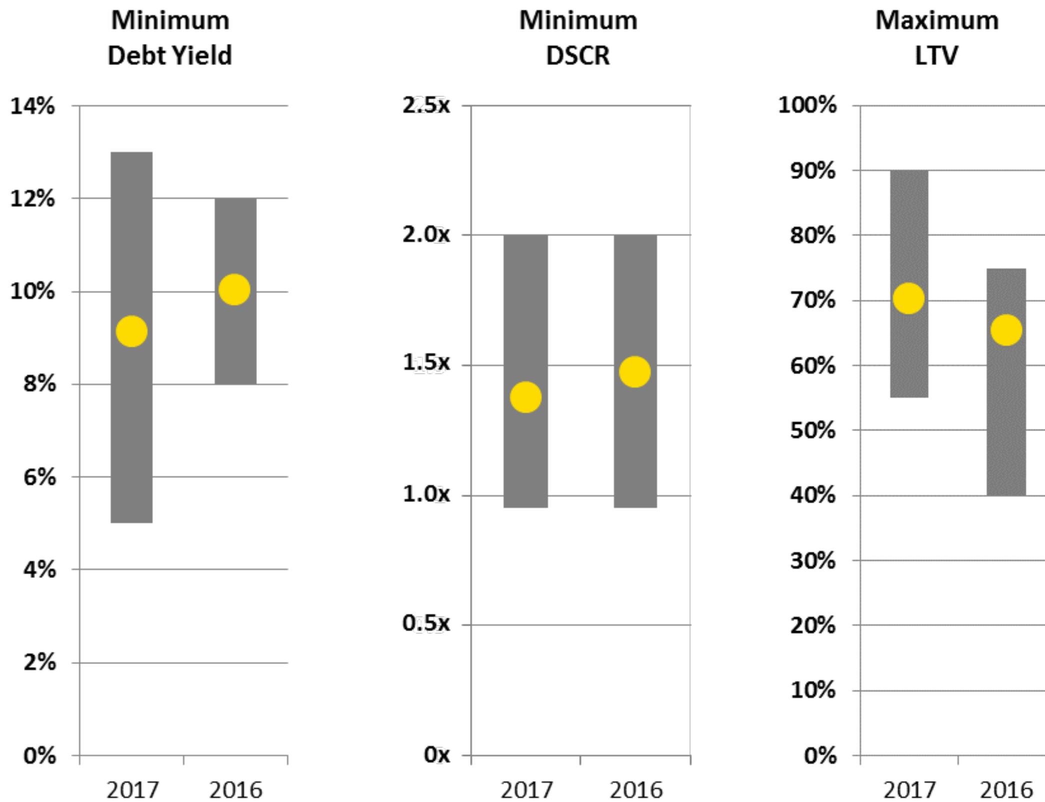
While all aspects of a hotel loan request are relevant, what is the single most important "gating" issue for you to even look at a deal?



Lenders continue to focus on the location and quality of the real estate, with over half of the surveyed lenders saying that was their primary "gating" criteria for financing requests. The responses in 2017 returned to trends seen prior to 2016, with the cash flow metrics emerging as the second most commonly chosen "gating" issue, and the balance of respondents showing a focus on the sponsor's experience and the proposed brand and management of the property.

Senior Lenders

Other metrics aside, what is the current minimum debt yield/minimum debt service coverage ratio/maximum loan-to-value ratio that you require on lender underwritten cash flow for an existing hotel?



Minimum Debt Yield

Average: 9.1% High: 13.0% Low: 5.0%

Minimum Debt Service Coverage Ratio

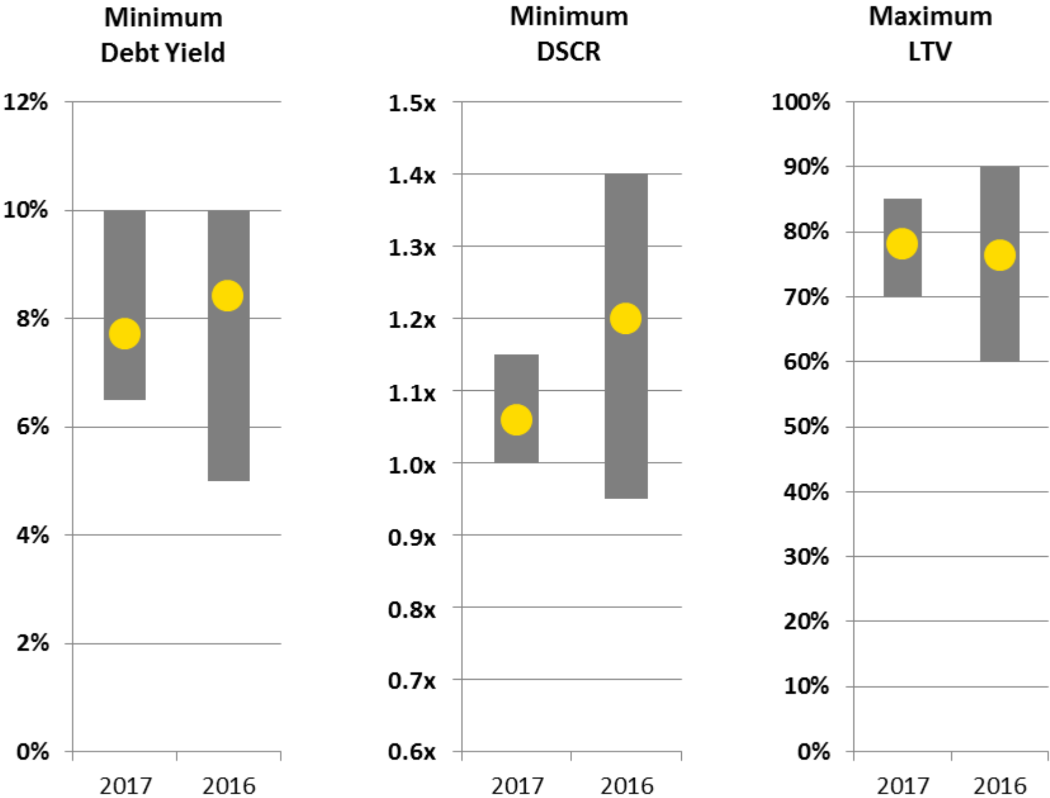
Average: 1.40x High: 2.00x Low: 0.95x

Maximum Loan-to-Value

Average: 70% High: 90% Low: 55%

Subordinate Lenders

Other metrics aside, what is the current minimum debt yield/minimum debt service coverage ratio/maximum loan-to-value ratio that you require on lender underwritten cash flow for an existing hotel?



Minimum Debt Yield

Average: 7.7% High: 10.0% Low: 6.5%

Minimum Debt Service Coverage Ratio

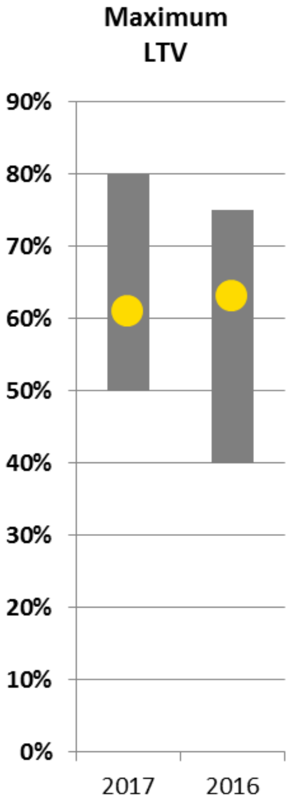
Average: 1.10x High: 1.15x Low: 1.00x

Maximum Loan-to-Value

Average: 78% High: 85% Low: 70%

Construction Lenders

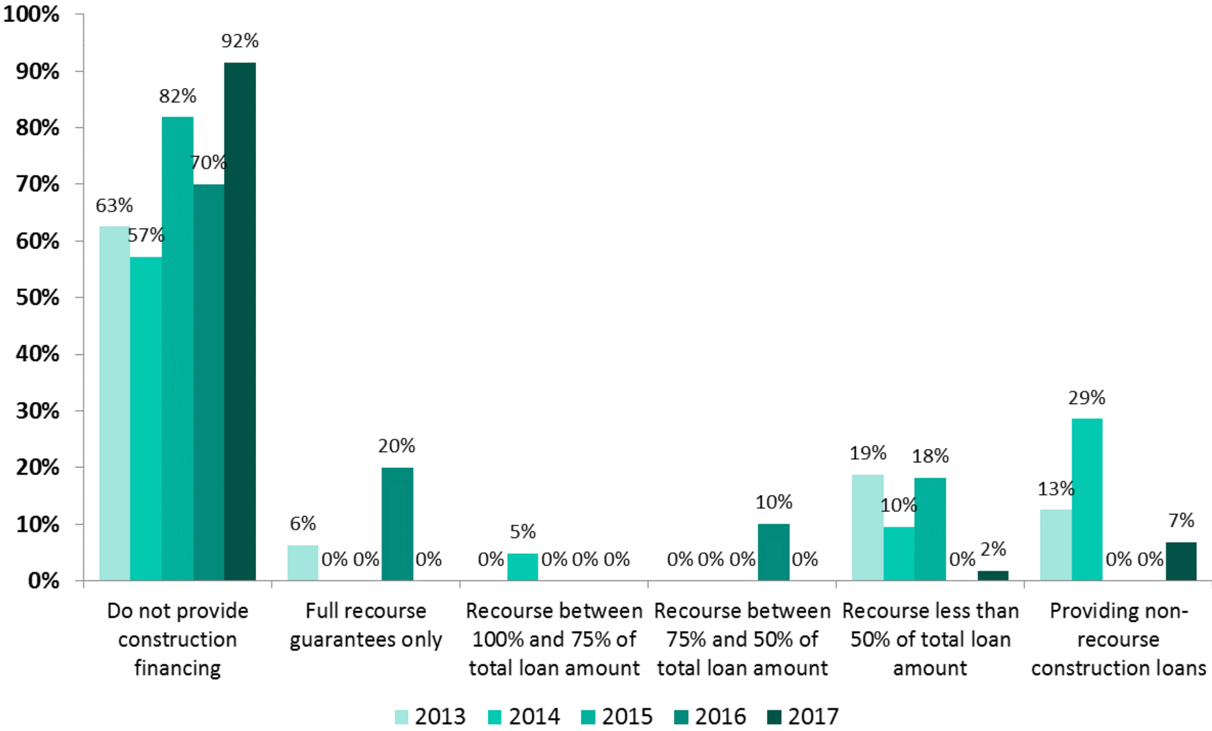
Other metrics aside, what is the current maximum loan-to-value ratio that you are prepared to fund for an existing hotel?



Maximum Loan-to-Value

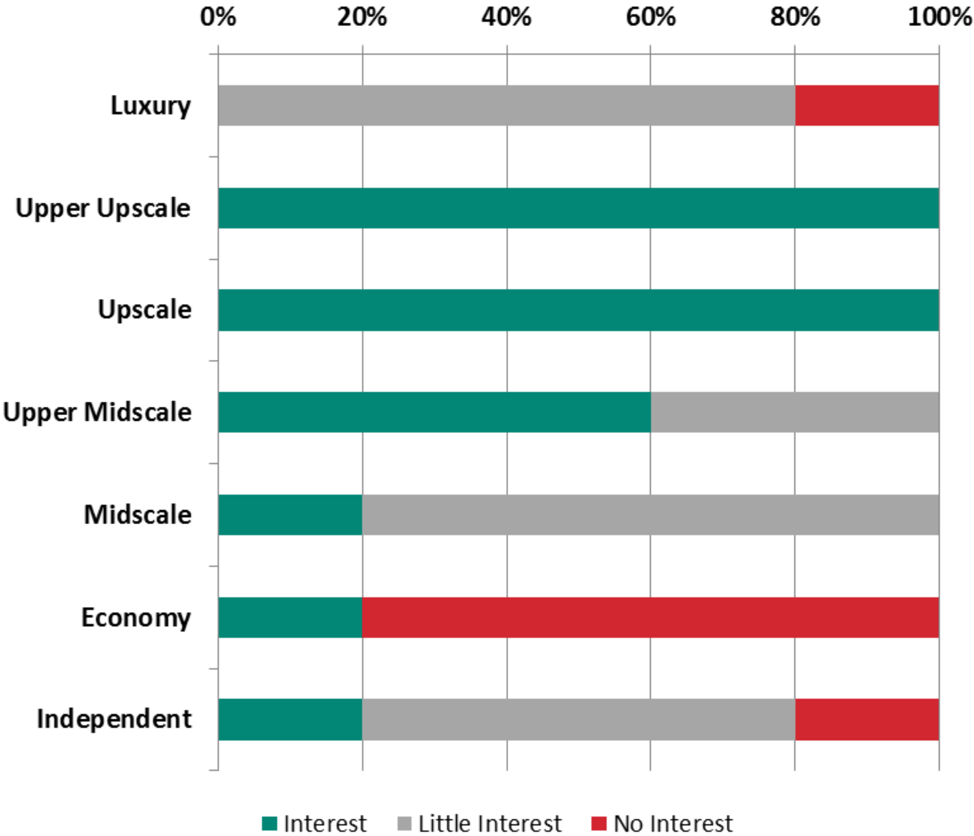
Average: 61% High: 80% Low: 50%

If you provide construction financing, what level of recourse are you currently requiring from the borrower for a new hotel development project?



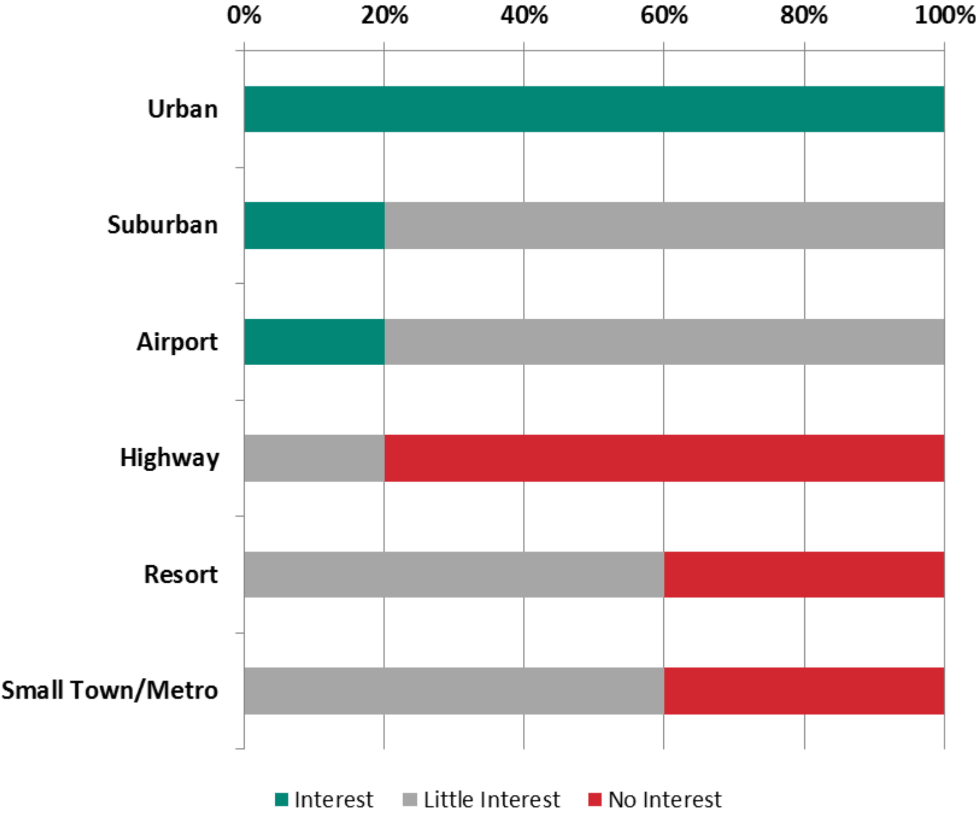
Less than 10% of all lenders surveyed will consider any kind of construction financing, and among those that will finance construction, most indicated that they would provide non-recourse construction loans. This is a reversal of last year when 20% of respondents stated they needed full recourse guarantees, and 10% expected more than 50% of the total loan amount.

Where will you consider hotel construction financing?



Similar to last year, lenders' current lending interest closely follows their views on where there is less risk – with branded assets in the upper upscale and upscale markets leading the way, followed by upper midscale and midscale properties. Notably, there is little to no interest among respondents for construction lending in the economy and luxury sectors, which reflects their concern for the operating fundamentals at the extreme ends of the lodging spectrum.

Where will you consider hotel construction financing?



Similarly, lenders unanimously agreed to consider construction financing in urban infill locations. Beyond that, lender interest drops off substantially for suburban and airport locations; and there is little to no interest among surveyed lenders for highway, resort, or tertiary markets.

Contact information

STR
11001 W. 120th Ave., Suite 250
Broomfield, Colorado 80021
concierge@str.com | STR.com

Hotel News Now
14650 Detroit Avenue, Suite 450
Lakewood, Ohio 44107
615 824 8664 | hotelnewsnow.com

Robert Douglas
350 Fifth Avenue, Suite 5310
New York, NY 10118
212 993 7424 | robert-douglas.com