

Global CMBS Newsletter

Volume 4, Issue 4, March 5, 2009



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HOTEL LOAN PERFORMANCE IN A RAPIDLY DETERIORATING MARKET

In a declining economy, commercial real estate investors want long-term leases, low tenant rollover, low expense ratios and the ability to pass along increasing operating expense to tenants. Hotel properties have none of these features. Moreover, news coming out of the hotel market is, quite simply, not good. Well, bad actually. No, make that terrifying. Predicting hotel performance over the next 12 to 18 months is like juggling chainsaws while riding a unicycle. In mid-2008, as the economy began to stall and the reality that a recession had already set in, forecasts for 2008 revenue per available room (RevPAR) growth finally moderated from approximately 3% to 0%. Only in January 2009 was it revealed that even this flat RevPAR assumption was overly optimistic. According to Smith Travel Research data, while RevPAR gains were seen in the first two quarters of 2008, the second half of the year was decidedly negative. Most telling is that RevPAR decreased 9.8% in the fourth quarter compared with the same period in 2007.

What 2009 holds is anyone's guess, but most informed market participants seem to be clustering around a high single-digit percentage decrease for RevPAR. Given the inability so far for most individuals to grasp just how bad the economy is and how bad it will get, it would not be surprising to see RevPAR decline by well over 10% in 2009. As an early indicator, Smith Travel Research's weekly updates on national RevPAR changes are an ominous sign. In the eight weeks ending February 21, 2009, RevPAR declined a staggering 17% compared with the same period in 2008. But, in the end, what does all of this RevPAR talk mean?

Hotel properties operate at relatively high expense ratios compared with other commercial property types. DBRS analyzed TreppLoan data on more than 2,000 fixed-rate commercial mortgage-backed securities (CMBS) loans securitized between 2005 and 2008. Although this data does not represent the entire fixed-rate CMBS universe for those three years, it does capture about 70% of the fixed-rate hotel loans. The data revealed an average expense ratio (including furniture, fixtures and equipment (FF&E) reserves) of approximately 70%. Typically, different categories of hotel product will have different expense ratios. Luxury resort properties, with a significant number of amenities, can often have expense ratios in excess of 80%, while extended-stay properties, with limited amenities and longer average lengths of stay, can have expense ratios as low as 50%.

In a world where all operating expenses are perfectly variable (a 1% decrease in revenue is offset by a 1% decrease in expenses), a high expense ratio would not be cause for concern. However, in the real world, expenses are fairly sticky. A review of different appraisers' approaches to the level of variability in hotel operating expense categories reveals much agreement. Certain categories are essentially fixed (insurance, real estate taxes), while some are 100% variable since they are often calculated simply as a percentage of revenue (FF&E, management fees, franchise fees). The remaining categories (departmental expenses, marketing, repairs and maintenance, etc.) are typically somewhere between 25% and 40% variable. In addition, to the extent that these last items are variable, it is mostly a function of occupancy as opposed to revenue. In the event that hotel operators choose to discount room rates in order to keep rooms full, most of these cost savings will never be realized. These figures reflect an expense structure that is only approximately 40% variable. Simply stated, for every 1% of revenue lost, only 0.4% of expenses will be trimmed. What this means for a hotel operator's bottom line can be catastrophic. Under the preceding assumptions, a 10% RevPAR decline would result in a 23% decline in net cash flow (see Table 1).

Table 1: DSCR in a Declining RevPAR Environment

	Base Case	10% RevPAR Decline	15% RevPAR Decline
Revenue	\$10,000,000	\$9,000,000	\$8,500,000
Fixed Expenses	\$425,000	\$425,000	\$425,000
Partially Variable Expenses	\$5,225,000	\$5,050,000	\$4,975,000
Fully Variable Expenses	\$1,350,000	\$1,225,000	\$1,150,000
Total Expenses	\$7,000,000	\$6,700,000	\$6,550,000
Net Cash Flow	\$3,000,000	\$2,300,000	\$1,950,000
Debt Service	\$2,150,000	\$2,150,000	\$2,150,000
DSCR	1.40	1.07	0.91

That hotels exhibit higher cash flow volatility than other property types is not a new discovery. Compared with other property types with leases of at least one year, hotels suffer from what is basically a *daily* market-to-market of revenue as well as occupancy. While this is great in a strong market, it can have devastating consequences in a falling one. The DBRS CMBS model incorporates this dynamic, as have lenders in the past. Lenders would require that new hotel loans exhibit a debt service coverage ratio (DSCR) of 1.40 times (x) as opposed to 1.20x for multifamily or 1.30x for other commercial property types. As seen in Table 2, the actual DSCR across vintages is fairly strong, but even this is misleading. The previously mentioned 1.40x DSCR required for hotel loans was based on a loan that is amortized over 20 or 25 years as opposed to the relaxed requirements of 30 years or interest-only applied to recent vintages.

Focusing only on changes in net cash flow and the borrower's ability to make debt service payments would fail to paint the whole picture as hotel valuation metrics will also be changing substantially in the future. As seen in Table 2, implied cap rates based on appraised value at origination and current net cash flow vary significantly by vintage and are as low as 6.7%. Even 2005's implied cap rate of 9.8% is inflated simply because cash flow has increased substantially since issuance. The cap rate implied by net cash flow at securitization for this vintage was much lower at 7.9%. While sales activity is almost non-existent, cap rates for hotel properties have historically been at least 10% and often times higher. It is quite likely that these levels will be seen again in the near future.

Table 2: Performance Metrics for 2005 to 2008 Vintages

	2005	2006	2007	2008
Hotel Loans as % of Annual Issuance	7.6%	10.4%	10.0%	14.2%
Current Implied Cap Rate¹	9.8%	8.1%	6.7%	7.3%
NCF Δ Since Issuance	27.8%	16.4%	1.0%	0.7%
Current DSCR	2.27	1.81	1.55	1.58
Stressed DSCR²	1.49	1.19	1.02	1.03
Stressed LTV³	107.7%	145.7%	172.6%	115.1%
Stressed Value Δ	-35.5%	-46.7%	-55.9%	-43.7%
% <1.0x Stressed DSCR	18.0%	38.0%	56.0%	57.9%
% >100% Stressed LTV	48.3%	77.2%	92.1%	88.4%

Note: All figures presented are weighted averages based on current loan balance.

1. Cap rate calculated by dividing current net cash flow by the appraised value at issuance.

2. Stressed DSCR is based on a net cash flow (NCF), with RevPAR assumed to decline 15%.

3. Stressed loan-to-value (LTV) is based on the NCF used in Stressed DSCR and a 10% cap rate.

Given the preceding information, it appears that the 2005 vintage will be able to withstand the upcoming market stress comparatively better than 2006, 2007 and 2008. Only approximately 18% of the loans (by current balance) would have a DSCR below 1.0x in the event of a 15% decrease in RevPAR and, combined with a reversion to a 10% cap rate, the weighted-average loan-to-value (LTV) would be 108%. Considering the environment, these results are quite good. This vintage will benefit from the fact that, on average, net cash flow has increased nearly 28% since issuance. This is a result of the fact that loans in this vintage would have been underwritten based on year-end 2004 financial statements. Since that time, there have been three years (2005, 2006 and 2007) of very strong RevPAR growth.

The clear losers are the 2006, 2007 and 2008 vintages, with 2007 far and away the worst in order of magnitude of expected loss. Based on the above assumptions, the weighted-average LTV in 2007 would be a staggering 173% and 56% of the hotel loans would have a DSCR below 1.0x. Although representing a smaller percentage of overall CMBS issuance, the 2008 vintage is in the same boat, with an even higher concentration, and the 2006 vintage seems only marginally better.

It is important to realize that a borrower won't necessarily default on a loan just because the LTV is greater than 100%. If the DSCR remains greater than 1.0x, the borrower would certainly collect the positive cash flow and pray that over time a combination of long-term increases in cash flow combined with a favorable market will allow for a successful refinance. The decision making occurs when the DSCR is less than 1.0x and the borrower has to fund debt service shortfalls out of pocket. For loans of recent vintages, however, it is not really much of a decision. Borrowers will likely only fund debt service shortfalls to the extent that prevailing cap rates are less than or equal to the debt constant. Given the low interest rate environment and lack of amortization required, most borrowers are paying to a debt constant below 8%, with many below 6%. Combined with cap rates that could be well in excess of 10%, this is a recipe for some rather spectacular defaults. One situation DBRS expects to see with some frequency is the borrower requesting short-term debt service relief if it feels that a rebound in cash flow in the medium term would restore some of its equity. While this option would result in a transfer to the special servicer, in some instances it may be far more favorable than disposing of a hotel in a very bad market.

Debt yield is another simple statistic that illustrates the magnitude of leverage on hotel loans from these vintages. Debt yield is simply cash flow divided by loan balance. Although not discussed widely until recently and certainly never as popular as DSCR or LTV as gauges of leverage, debt yield is quite useful. Where DSCR and LTV can be misleading if interest rates, amortization schedules and cap rates are far off their historical norms, debt yield gives a straightforward picture of how many dollars are being lent for each dollar of cash flow. According to the article "Debt Yield Emerges as Lender Gauge" in the February 20, 2009, issue of *Commercial Mortgage Alert*, many lenders are now looking to debt yield as a guide to how much money to lend on a given property. The article mentions a 12% debt yield as a standard hurdle in the market, but the figure for hotel properties has historically been 14% or greater.

Table 3 illustrates debt yield statistics based on current net cash flow and also using a stressed net cash flow assuming a 15% RevPAR decline. The 50th percentile debt yield figures indicate the median debt yield for each category, while the 75th percentile debt yield indicates the point where 75% of the debt yields are higher (better) than that amount. While it is apparent that the median current debt yield looks strong for 2005 and 2006 and fair for 2007 and 2008, the 75th percentile debt yield in 2006 to 2008 are quite low. What is worse, the stressed debt yields indicate that some portion of the loans in all vintages could be at risk. In particular, the median debt yields for 2006 to 2008 are well below 9%. Assuming that a 13% debt yield is required (and this may prove to be too low), the median loans from 2006, 2007 and 2008 would be able to refinance no more than 67%, 56% and 58% of their respective current outstanding balances. More frightening still are the loans that fall into the lowest quartile. These loans would only be able to refinance less than 54%, 45% and 53% of their respective current outstanding balance.

The debt yields displayed below also help make an important point regarding loss severity assumptions. While assumptions based on historical observations may be appropriate for loans that exhibit leverage characteristics that conform to historical norms, they will not be high enough for recent CMBS vintages. A blanket 50% loss severity may seem high, but an impaired loan with greatly reduced cash flow that carries a 4% debt yield may experience losses of 70% or greater. Investors should ensure that loss severity assumptions are based on cap rates and debt yields reverting to historical norms.

Table 3: Debt Yield Analysis

	2005	2006	2007	2008
Current Debt Yield – 50th %	16.0%	13.3%	11.1%	11.6%
Current Debt Yield – 75th %	12.9%	10.7%	9.0%	10.5%
Stressed Debt Yield – 50th %	10.5%	8.7%	7.3%	7.6%
Stressed Debt Yield – 75th %	8.4%	7.0%	5.9%	6.9%

Note: All figures presented are weighted averages based on current loan balance.

The stresses being applied to these loans are averages, and it is clear that not every loan will face the same cash flow and valuation challenges. Certain markets will fare worse than others, and some properties' cash flows will actually increase this year. That being said, any CMBS investor with a remotely diversified portfolio will be exposed to the worst loans in addition to the occasional bright spot.

It is often lamented that hotel concentrations have become quite high over the past several years, and it is indeed true. According to data provided by *Commercial Mortgage Alert*, from 2005 to 2008, hotel loans represented 9.6% of total fixed-rate issuance. This figure is especially significant when compared with the historically low post-9/11 years of 2002 to 2004, when hotel concentration averaged only 2.4%. Most concerning are the 24 transactions issued since 2005 where hotel loans represent greater than 15% of the pool since issuance. Notably, only one of these transactions is from the comparatively conservative 2005 vintage, while 12 are from 2007, the vintage exhibiting the highest leverage.

Although hotel loans can clearly contribute to disproportionate losses in CMBS pools, concentrations are not sufficient to cause a principal loss in the super-senior or mezzanine AAA classes . . . without a modicum of help from the other asset classes. However, losses from hotel loans accumulating to even less than 5% of the pool could easily consume several below-investment-grade and low-investment-grade classes and, in addition to losses expected from other property types, will cause downgrades at the A-J level and call an isolated A-M class into question. Investors should look not only to those deals with significant hotel loan concentrations, but specifically to those with significant hotel loan concentrations that have a current debt yield below 8%.

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