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How Does Debt Financing Impact the Value of a Hotel?

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The market for and structure of debt are key factors in determining the market value of a hotel.

For the two years leading up to mid 2007, financing conditions were robust in Canada. Debt sources were widely available, terms (including amortization periods, loan-to-value ratios, and interest rates) were favourable, and in many cases there was the ability to get multiple lenders to compete on deals. But this all changed in August 2007, when the "credit crunch/subprime melt-down" began in the US. At first, the impact was slow to be felt in Canada. Some of the US lenders, such as Capmark, were the first to go in terms of lending in Canada. Canadian conduit lenders soon followed, including Merrill Lynch.

Losing these sources of funds did have an impact on the availability of and competitive market for debt, but it wasn't until 2008 that other Canadian lenders started to become more restrictive on loans to the hotel industry. Traditional Schedule I banks have always been conservative in financing hotels, but now the once-prolific financiers, such as the Western Canadian credit unions, GE Capital, and Textron Financial, are starting to become more selective in the deals they are willing to finance.

Why is this? It all comes down to risk. It can be argued that risk was not being appropriately priced in the heady days prior to August 2007. With the massive write-offs that followed in the wake of the subprime meltdown, risk is now being analyzed and priced much more conservatively, resulting in fewer funds available for the hotel sector, which has historically been deemed one of the riskier segments of the real estate industry, and higher interest rates on hotel loans.

What does this mean for hotel values? The following table provides an example of the potential change in value for a typical 250-room hotel when the mortgage interest rate moves from 6.5%, which was common in July 2007, to 7.5%, which is closer to becoming the new norm for hotel financing, or 8.25%, which may be the norm in the near future.

As the table indicates, a 1-point increase in the interest rate results in slightly more than a 5% decline in the market value, assuming all other factors are constant, including the amortization period (assumed to be 25 years), the loan-to-value ratio, the equity dividend rate, and the hotel's net income.

These results may be a bit off-putting for hotel owners, but the softness in the economy hasn't yet had an impact on hotel net incomes, which have continued to rise. Year-to-date, room demand has increased for the country as a whole, and average room rates continue to increase. Although the increase in net income may not completely erase the impact of a tighter lending market, it should serve to offset much of the potential decline in value. ▲

Shift in Hotel Values with Interest Rate Increases

Mortgage Constant*	Loan to Value Ratio	Equity Dividend	Cap Rate	Net Income	Market Value	% Change in Value
8.0 %	65.0 %	10.0 %	8.7 %	$2,500,000	$28,654,280	
8.8	65.0	10.0	9.2	2,500,000	27,155,170	(5.2) %
9.4	65.0	10.0	9.6	2,500,000	26,101,074	(8.9)

*assumed interest rates of 6.5%, 7.5% and 8.25%

DEFINITIONS

Occupancy:	Rooms sold divided by rooms available.
Room Revenue:	Total room revenue generated from the sale or rental of rooms.
Average Daily Rate (ADR):	Room revenue divided by rooms sold.
Room Revenue Per Available Room (RevPAR):	Room revenue divided by rooms available (occupancy times average room rate will closely approximate RevPAR).

If you have any questions regarding this publication please send a message to bmacdonald@hvs.com
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