Narrowing the Financing Gap

Conventional financing may not allow most hotel projects to be funded in today's economic conditions. Several alternatives exist that can help to narrow a project's financing gap.

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Introduction

In the current economy, several hotel deals have either been put on hold or have died after reaching the financing phase. With loan-to-value ratios falling as low as 50%, equity yield rates in the range of 20%, and some interest rates above 7.0%, conventional mortgage-equity financing has become increasingly difficult, especially for full-service hotel developments. However, several alternatives can be pursued that may help to narrow the financing gap between the value of the property and the development cost. Some of these strategies work to shift a portion of the investment risk from the developer to the public sector, which then requires some form of significant economic impact benefits derived for the host community. These options include public sector subsidies, the reduction of financing costs, the downsizing of the facility program, and the reduction of operating expenses. Not all of these alternatives are viable for every hotel project, although each option may merit consideration depending on a project's individual characteristics.

Public Sector Subsidies

In general, a public sector subsidy is some type of financial incentive provided by a government entity, usually with the intention of promoting positive impacts for a community. Typically, public sector involvement requires a project to generate a substantial increase in economic activity within the community. The most common hotel developments that receive public subsidies include convention center headquarters hotels, hotel conference centers, and airport hotels. Three examples of this type of subsidy follow:

> **Property Tax Incentives –** In some locations, tax incentives may be given to new developments in the form of multi-year tax abatements. Property tax abatements reduce a hotel's total expenses, which in turn, increases the asset's net income available for debt service, thereby reducing the identified financing gap. The length and amount of an abatement can differ from one taxing jurisdiction to another and between different developments within the same jurisdiction. Once the term of the abatement has been reached, the development will be required to pay the total property taxes levied.

Frequently, these incentives are used to draw commercial and industrial developers to a particular location.

Tax Increment Financing (TIF) – This form of financing uses future increases in a district's property taxes to fund a public project that otherwise may not be built. TIF districts were originally designed to create new development, both public and private, in distressed or underdeveloped areas. In more recent years though, cities have created these districts in downtown areas and expanding neighborhoods in order to spur an increase in growth and attract new businesses. A TIF incentive can be structured in different ways. For example, a local government could use the projected incremental tax collections from a development as a source of payment for bonds that could be issued to raise funds to pay for all or part of the development project. Alternatively, some or all of the incremental tax collections could be rebated to the project's developer or owner directly to incentivize the project.

Public Investment or Public/Private Partnerships – This subsidy consists of public investment in adjacent amenities or features, such as parking structures, meeting space, or performing arts facilities. Projects that have benefited from this type of investment include the Embassy Suites hotels in Frisco, Texas, and Norman, Oklahoma. Private-sector partners may also have an interest in owning adjacent amenities, especially a restaurant or retail outlet.

Reduce Financing Costs

With today's market conditions, conventional financing parameters have become stricter as banks attempt to reduce their investment risks significantly. In order to adjust these parameters, a developer can implement an approach that shifts some of the investment risk to the public sector, which may be better positioned to accept such risk, especially if significant benefits are expected to accrue to the local community.

Tax-Exempt Bonds – Financing a hotel or adjacent amenity with tax-exempt bonds can significantly reduce the project's overall borrowing costs. Bond financing can provide substantially greater leverage and reduce the need to pay relatively higher equity yield rates required in a traditional mortgage-equity financing plan. This strategy can involve the creation of a nonprofit corporation, sometimes called a "63-20 corporation", to issue the bonds and own the hotel. A 63-20 corporation must be sponsored by a local or state government entity and meet specific requirements to qualify. Cities such as Austin, Texas, and Overland Park, Kansas, have used this financing strategy to develop hotel projects.

Credit-Enhanced Loan – This type of loan requires a third party, such as a municipality or a private institution, to issue a letter of credit or financial guarantee to the lender. Depending upon the third-party's credit rating, the overall debt-to-equity ratio for the project should increase, while a decrease in the interest rate could take place as well. The terms of the loan can be structured in various ways, which may include the third-party's financial guarantee for 100% of the project's debt. Typically, a third party that is willing to assist with a credit-enhanced loan is most likely going to expect some sort of economic impact, either direct or indirect, or fee from the project.

Condominium-Style Strategy – With this strategy, a developer could sell some of the hotel rooms or limited rights to use hotel rooms in the property. Several condominium hotel projects have adopted variations of this financing strategy during recent years. This option is generally reserved for resort locations or locations with major sporting events that create peak demand throughout the entire market area a few days each year. The developers of a new hotel for the University of Texas in Austin raised money from alumni by offering them limited rights to hotel rooms during home football game weekends. Most lenders, however, have greatly reduced or completely eliminated their funds available for condominium-style hotel projects over the past several months.

Operator/Brand Capital Contribution – A capital contribution from the hotel's operator or brand can help to alleviate the total amount of equity needed for a proposed project. This practice is common in the industry for larger convention or conference hotels, although some operators will contribute a small portion for upscale, limited-service properties as well. Hotel companies, such as Marriott International and Hilton Hotels Corporation, that want the presence of a particular brand in a market, are more likely to contribute money to a project and are typically repaid through management fees.

Downsize Facility Program

By downsizing a project's facility program, a developer can reduce overall development costs. The two main areas of a hotel's program that can achieve the largest cost savings include the guestrooms and the public space. Although design alterations will decrease a project's cost, these changes can also likely hinder the revenue potential of the hotel.

Decrease Room Count – For a project to achieve its maximum productivity, the appropriate number of guestrooms must be developed. A property that is too large may be able to capture a significant amount of market area demand during peak times, but it will most likely experience very low occupancy levels during slow periods. A property that is too small will presumably sell out most nights of the year, but in doing so will lose room nights that it cannot accommodate because that demand will seek lodging at other hotels in the market. Moreover, a hotel whose room inventory is too small may not be able to cover its fixed expenses because revenue potential is limited. The overall impact of changing the number of guestrooms can be great and should be studied under multiple scenarios before a final decision is made.

Decrease Public Space – There are various public space areas of a hotel that can be reduced in size in order to cut development costs. A hotel can have an elaborate and ornate lobby, which may add to the property's attractiveness and guest satisfaction, but does not directly generate revenue for the asset. A property's meeting space, which is a direct revenue generator, needs to be the appropriate size for the hotel's location and demand generators. A common industry standard for full-service, upper-upscale, branded hotels is roughly 60 square feet of meeting space per guestroom. If a decrease in a project's public space is decided upon, it needs to be made in the appropriate area of the property and in a manner that will decrease project costs more than project value.

Reduce Operating Expenses

One of the basic finance strategies to achieving a higher net operating income is to reduce operating expenses. Most of these costs are evaluated and controlled after a hotel opens. However, future savings on two expenses – insurance and utilities – can be addressed at the design and development stages.

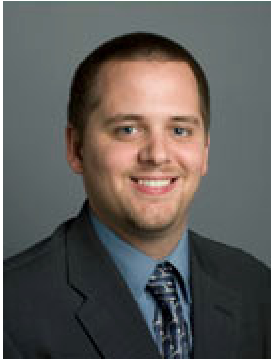
Insurance Savings – In cases where a hotel asset is publicly owned, or owned by a company that holds several hotels, it may be possible to achieve savings on insurance expenses if the owner is able to negotiate a reduced rate as part of a larger insurance contract that covers multiple buildings. Depending upon the location of the property, insurance savings can differ greatly.

Utility Savings – Certain emerging technologies aimed at improving energy efficiency in new buildings may lead to significant savings on utility expenses over time. A "green building" is one that reduces its overall impact on the environment by producing low amounts of waste while efficiently using energy, water, and other resources. If a project adheres to a strict set of guidelines, it is able to become LEED (Leadership in Energy and Environmental Design) certified. Some "green" practices include the use of solar panels, building materials with recycled content, large energy-efficient windows that allow for abundant natural lighting, and high-efficiency plumbing fixtures. Industry practitioners offer a range of opinions about whether energy savings fully offset the potential cost premiums sometimes associated with these energy-efficient technologies and materials; recent projects indicate these cost premiums can sometimes be eliminated with proper planning and design.

Concluding Remarks

After a project is deemed not feasible and before it is considered dead, each one of the above strategies needs to be researched and evaluated. It is often necessary to consider various public-private partnerships or incentives to make major, upscale full-service hotel projects feasible. Understanding alternatives to conventional mortgage-equity financing in the current credit climate could give you the competitive advantage in closing a deal. More resources for evaluating types of financing strategies can be found in the HVS library or by contacting HVS directly.

About the Author



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