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2019 Canadian Hotel Lending Survey

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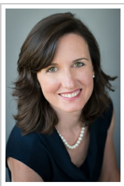

Canadian Lending Environment Overview

Supported by the persistence of generally favourable economic conditions, the Canadian lodging market sustained a marked improvement in 2018, as evidenced by a record-breaking RevPAR performance. Interest in hotel development has been steadily increasing in recent years. While demand has remained strong for core markets with high barriers to entry, such as Vancouver, Toronto, and Montreal, lenders continue to look for opportunities in select secondary and tertiary markets with promising outlooks. Supported by the strong performance fundamentals, the financing environment in the hotel sector is currently favourable. As a result, many financial institutions that were not active in the hotel sector in the past are now looking for opportunities to enter the sector, especially in markets with high demand.

The availability and cost of debt have a direct impact on hotel values. Consequently, hotel financing parameters play a significant role in the feasibility of new hotel developments and the transactions of existing hotel properties. Given the importance of debt parameters for hotel investment and development, we conducted a survey of hotel lenders that are active both nationally and regionally in January 2019 to assess the sentiments on the Canadian hotel lending environment at that time.

As economic conditions can differ between urban and rural markets, we have taken market tier into account as a factor that affects lending parameters. Where applicable, we have categorized our findings according to type of market: primary, secondary, and tertiary. Primary markets are metropolitan areas with a diversified economic base and robust business activities, and generally contain a major international airport; secondary markets are mid-size cities, suburban areas of primary markets, and generally contain a major educational institution; tertiary markets are rural markets which typically have smaller populations, low economic diversity, and lack a depth to retail and other amenities and services. The survey also addresses the availability of debt by asset type and chainscale, as well as borrower characteristics that are important to lenders in making a lending decision. Lastly, based on the survey results and our conversations with Canadian hotel lenders, we have summarized the outlook on lending criteria and highlighted the markets with a positive outlook or cause for caution.

The article aims to provide a general overview of the Canadian hotel lending environment for hotel developers and lenders alike. However, it is worth noting that the findings represented in this article are aggregated results from individual surveys and interviews. Lending parameters are subject to the vicissitudes of economic change, and they can vary greatly from market to market, project to project, asset to asset, and site to site. Special considerations may be necessary for specific projects.

Lending Parameters

The loan-to-value (LTV) ratio is a measure of assessing lending risks that lenders often examine before granting a loan. High LTV ratios are typically associated with larger loan amounts and higher risks for the lender; lenders are typically inclined to grant a higher LTV ratio under preferable economic conditions. Additionally, lenders are more likely to offer more favorable LTV ratios in more stable markets where greater interest in hotel developments and a more diversified economy cause less volatility in asset values and performance. All respondents indicated an

Summary

HVS reviewed and analyzed the current lending environment for hotels following a comprehensive survey conducted among Canadian hotel lenders.

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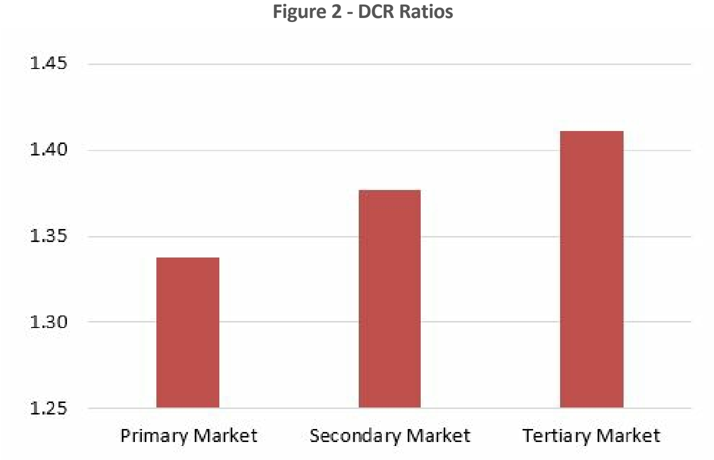
LTV ratio at or above 50% in all three market tiers. For primary markets with high barriers to entry, quality assets could achieve an LTV ratio as high as 75%. The following graph illustrates the average LTV for each market tier and reflects the perception of risk between different markets.

Figure 1 - LTV Ratios

Source: HVS

Debt coverage ratio (DCR) measures a company's ability to make its debt payments from its operational cash flow. A high DCR reflects strong cash flow from a hotel operation and indicates lower risk for the lender. The survey respondents reported DCR requirements ranging between 1.2 and 1.6, which is a relatively narrow range considering the degree of variation in economic performance across the country. However, it should be noted that many large financial institutions do not provide hotel financing for tertiary markets because the risk is incongruent with strategy; in Canada, many tertiary markets are subject to greater volatility in operating performance and investor sentiment owing to their less-diversified economic base and smaller population. Consequently, the DCRs for these markets reported in this survey reflect the requirements of lenders that are active in these areas, which includes the Business Development Bank of Canada (BDC), as well as regional lenders and credit unions. In general lenders in tertiary markets have more conservative lending parametres, such as a lower LTV ratio and higher rates relative to primary and secondary markets, in order to mitigate the increased risks that are inherent to projects in these markets.

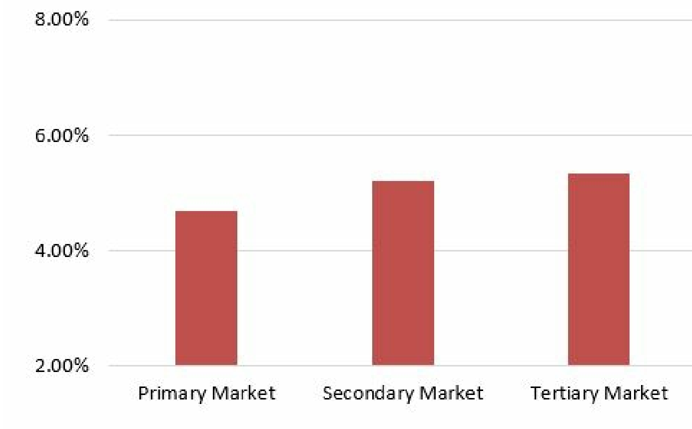
Figure 2 - DCR Ratios



Source: HVS

Respondents of the survey reported fixed interest rates ranging from 4.30% to 6.53% for Canadian Hotels. Lenders reported a fixed interest rate of 4.70% for primary markets on average and reported a premium of 25-50 basis points for secondary markets. An additional 25-50 basis-point premium is generally applied for loans in tertiary markets. When lending on a hotel asset, lenders will typically apply a premium to the fixed interest rate that is used for other commercial assets due to the higher risks. A 50-basis-point premium on prime rate or a 200-basis-point premium on the minimum bond yield would be granted for trophy assets in metropolitan markets; for tertiary markets, premium on the minimum bond yield could be up to 400 basis points. Most lenders offer fixed interest rate on a 5-year term, with select lenders, predominately those that are crown corporations (such as Agriculture Financial Services Corporation (AFSC) and BDC) offering longer terms up to the length of the amortization period.

Figure 3 - Fixed Interest Rates



Source: HVS

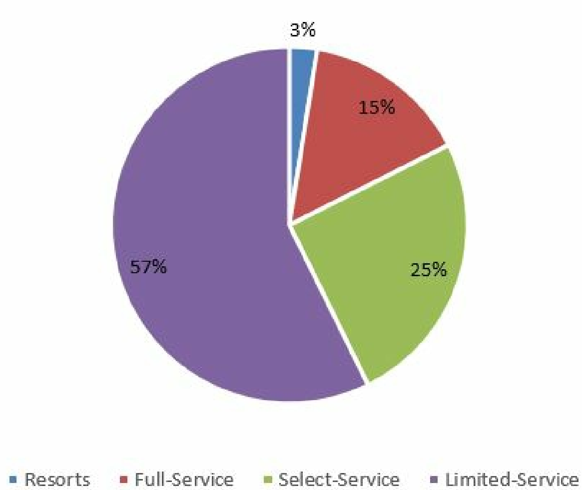
Availability of Debt

Large financial institutions tend to offer a higher LTV ratio because they gravitate toward projects associated with lower risk; the statement is more true for lenders who have just recently become active in the hotel sector and that are looking to gain market share through more competitive parametres. For these lenders, the most attractive deals generally involve the acquisition of branded hotels and the refinancing of well-performing hotels. Nonetheless, the Canadian lodging market has recently seen a significant increase in new developments: 49 new hotels have opened in 2018, and another 62 are currently under construction. As such, the percentage of loans issued for new hotel construction to the total number of loans issued has increased.

Given the fact that many independent hotels exist in rural, tertiary markets, regional credit unions and crown corporation lending institutions are the most active in financing the acquisition of independent hotels. With the exception of select resorts, independent assets are typically eschewed by large institutional lenders.

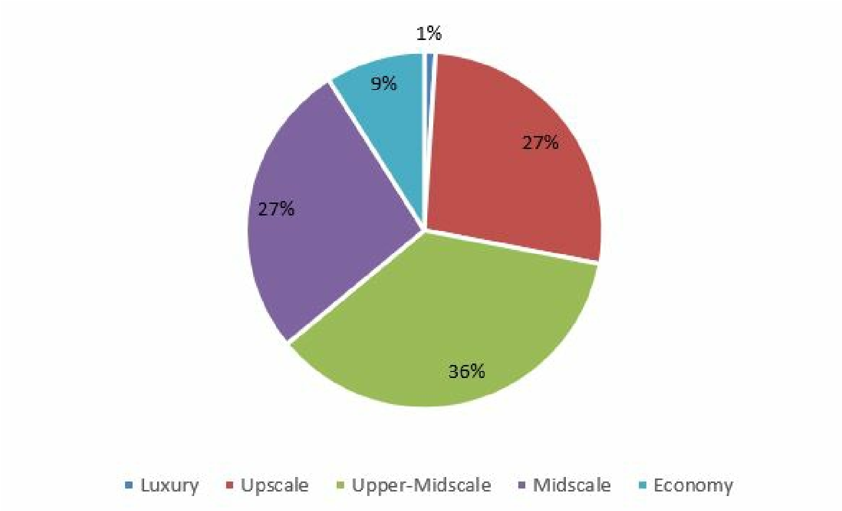
The survey respondents were active across the hotel financing cycle, offering hotels loans for existing branded and independent hotel acquisitions, refinancing, new construction, as well as renovations and expansions. The following graphs illustrate the reported average percentages of loans granted for each asset type and chainscale by the survey respondents.

Figure 4 - Percentage of Loans by Asset Type



Source: HVS

Figure 5 - Percentage of Loans by Chainscale



Source: HVS

Respondents of the survey report that the majority of their hotel loans are issued to limited-service and select-service properties ranging from midscale to upscale, which also reflects the available lodging supply in Canada, as mid-range hotels with select- or limited-service offerings account for the majority of the national room supply.

Borrower Characteristics

According to the lenders we interviewed, the most important form of collateral for securing a hotel loan is the land and registered mortgage. Personal guarantees, such as cash, liens, and other assets as collateral are usually a secondary consideration but are seen as less important. Management and/or operator guarantees may be required for conservative lenders or for large, full-service properties, but these are generally the least important form of collateral for lenders.

Survey results indicate the most important factor affecting a positive lending decision in relation a hotel asset is the borrower’s track record and reputation. For borrowers without a track record in the hotel sector, their track record, portfolio, and solvency in other sectors will be considered. The borrower’s relationship with the lender and the borrower’s current portfolio were ranked as the least important factors for securing hotel loans.

Outlook

The collective sentiment for the lending environment in the Canadian lodging sector is positive. Many respondents anticipate increases in the amount per loan granted and the proportion of hotel loans in their respective institution’s overall portfolio, which reflects the robust growth in the Canadian hotel sector. Despite the anticipated increase in the loan amount, most respondents expect the number of loans issued to stay the same and the loan-to-value ratio to decrease, which suggests that Canadian lenders are gravitating toward more valuable assets. The survey in the beginning of the year also suggested that most lenders were expecting an increase in interest rates; however, the Bank of Canada recently announced that it will be holding its benchmark interest rate steady, so lender sentiments have likely changed accordingly.

Figure 6 - Outlook on Lending Criteria

Amount per Loan Granted	↑
Overall number of Loans	=
Loan-to-value Ratio	↓
Debt Coverage Ratio	=
Proportion of Hotel Loans in Overall Portfolio	↑

Proportion of Hotel Loans in Overall Portfolio	↑
Interest Rates	=

Source: HVS

Overall, the Canadian lending landscape remains conservative relative to other international markets. This conservatism served lenders well in some regions, particularly in resource markets, where market volatility impacted values and cash flow. In many cases, despite the challenging environment loans have not become distressed, and where they have, the investment community has remained patient. The approach taken by the lending community has allowed for greater accommodation for borrowers in these markets.

Looking forward, lenders are optimistic towards urban markets such as Vancouver, Toronto and Montreal. More broadly, lenders have an optimistic outlook for the provinces of BC, Ontario, and Quebec as the economic performances in these provinces continue to excel relative to other provinces in the nation. Now that liquid natural gas (LNG) projects in northwestern BC are gaining momentum after an extended period of uncertainty, interest in hotel development has been spurred in communities that stand to benefit from the resource activity and export industry that will develop, particularly in Kitimat and Terrace.

Hotel lenders still practice caution in issuing loans for resource-driven markets, which have been negatively affected by the downturn in commodity prices. Many of these markets saw a combination of lower demand, increased rate competition, and in some cases new supply which dramatically impacted operating fundamentals, and resultingly, valuations, causing lenders and buyers to stay on the sidelines in the near-term. Further, a momentous turnaround does not appear to be imminent. As such, lenders that have seen volatile conditions in these markets are more hesitant to originate new loans.

Conclusion

Looking forward, the lending environment is expected remain accommodating to the needs of the industry with suitable options for owners and investors across the spectrum of a hotels lifecycle. While select areas are likely to see increased caution, lenders continue to exercise patience during the downturn in select markets that have seen forbearance and the non-performance of loans. With strong market fundamentals and favourable economic conditions in many regions across the country, debt remains available for most project types, and investor interest in the hotel sector is expected to continue on an upward trajectory.

HVS regularly collects sentiments on hotel lending parametres in the Canadian lodging market. For lenders that wish to provide additional insights or participate in the next Canadian Hotel Lending Survey, please do not hesitate to contact the authors below.

About Carrie Russell

Over the course of her 20-year career with HVS, Carrie has been involved with appraisals and/or feasibility studies for over 2,000 hotel properties throughout Canada and the United States. She speaks regularly at industry conferences and has authored several articles on various topics relevant to the industry. As a member of the Appraisal Institute of Canada and the US Appraisal Institute, Carrie combines her hotel industry experience and education with her real estate credentials to assist clients in making informed hotel investment decisions. Phone: (604) 988-9743 Email: