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Conquering the Credit Crunch: Part I

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The "Four Horsemen"[1] that foreshadowed the Great Depression — housing distress, a tanking stock market, collapsing commodities, and surging unemployment — have ridden back as harbingers of another impending economic apocalypse. On December 1, 2008, the National Bureau of Economic Research officially declared that the U.S. economy has been in a recession for the past year[2], and some economists claim the present economic conditions will prove the worst that most will experience in their lifetime. This article examines the challenges to hotel developers and some ways to overcome them.

Declining Hotel Property Values

The biggest impacts of the economic crisis relative to the hotel industry are the frozen credit markets and higher capital costs. Capital costs have risen. Debt is virtually unavailable from traditional lending sources. Conduit financing, previously the principal source of debt capital, has all but disappeared. Insurance companies, private lenders, banks, and pension funds, whose more stringent lending criteria kept them out of much of the recent lending activity, have re-emerged as sources of mortgage debt. On average, the effect translates to a 10 to 20 percent decrease in hotel value from the peak levels recorded prior to mid-year 2007. These market conditions have negatively affected both the number of transactions and asset pricing in 2008 and are expected to endure well into 2009.

The table below illustrates the dynamics of hotel values in markets across the nation, with most showing a decline in 2008.

Estimated Per-Room Property Values For Select Markets (2001-2008)

Market	2001	2002	2003	2004	2005	2006	2007	2008*
Albuquerque	$33,718	$37,141	$35,369	$36,929	$45,176	$57,856	$56,288	$58,034
Atlanta	$64,065	$59,699	$49,720	$65,300	$89,369	$110,145	$95,541	$92,524
Baltimore	$107,316	$123,383	$124,498	$137,201	$144,981	$155,950	$135,442	$126,762
Boston	$193,054	$164,407	$113,918	$161,253	$191,883	$216,217	$260,310	$266,229
Chicago	$98,812	$89,707	$91,615	$99,546	$139,859	$199,126	$211,087	$195,603
Cleveland	$38,554	$34,032	$28,936	$36,445	$37,672	$58,259	$54,883	$54,315
Columbia	$36,033	$44,041	$43,605	$60,146	$76,192	$82,915	$77,664	$75,197
Denver	$66,196	$58,813	$51,437	$62,280	$87,173	$124,913	$132,378	$135,300
Detroit	$53,383	$42,059	$34,358	$40,333	$46,469	$59,909	$50,990	$51,227
Fort Lauderdale	$76,103	$64,849	$79,041	$117,417	$139,738	$167,163	$145,655	$155,522
Greensboro, NC	$41,023	$46,206	$49,745	$48,628	$52,564	$63,297	$48,896	$44,174
Hartford	$73,968	$65,462	$50,918	$68,714	$64,590	$65,102	$59,738	$57,234
Houston	$69,224	$63,505	$45,867	$53,708	$87,804	$104,841	$108,790	$107,495
Las Vegas	$127,803	$136,380	$185,880	$230,105	$219,955	$200,975	$210,514	$174,850
Long Island	$167,860	$146,041	$139,161	$135,171	$158,032	$148,640	$145,540	$137,635
Los Angeles	$92,088	$87,983	$91,563	$136,070	$176,738	$195,832	$216,787	$214,056
Memphis	$33,177	$36,479	$34,968	$44,749	$60,806	$77,815	$73,533	$73,296
Miami	$88,512	$61,406	$78,632	$131,086	$218,423	$229,218	$278,490	$265,409
Milwaukee	$36,047	$40,064	$41,707	$44,899	$56,566	$79,234	$71,057	$72,733
Minneapolis	$65,965	$62,572	$54,113	$70,604	$93,746	$110,910	$104,521	$103,739
New Orleans	$124,772	$121,106	$109,026	$118,400	$139,607	$116,730	$68,103	$67,627

Summary

Unemployment rates are surging, global stock markets are crashing, commodities are collapsing, and the real estate bubble has finally burst. What moves can hotel developers make during the downturn?

Comments

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New York	$137,706	$105,581	$100,000	$193,403	$318,732	$382,322	$508,521	$515,365
Oahu	$127,387	$135,069	$161,217	$232,984	$345,319	$355,513	$332,467	$318,510
Omaha	$38,878	$41,344	$43,125	$51,329	$61,931	$84,189	$77,501	$71,494
Philadelphia	$63,176	$78,246	$71,007	$85,846	$102,547	$119,993	$116,109	$115,919
Phoenix	$72,833	$64,897	$72,914	$102,663	$134,060	$171,693	$153,996	$147,211
Portland, OR	$51,344	$51,467	$48,714	$59,432	$82,761	$111,756	$116,568	$116,201
Raleigh-Durham	$49,039	$46,335	$44,856	$54,541	$58,715	$82,758	$83,069	$80,970
Rochester, NY	$38,605	$42,120	$49,842	$45,337	$51,024	$77,393	$76,397	$70,228
Sacramento	$67,087	$69,391	$72,197	$81,641	$86,928	$108,281	$84,290	$75,050
San Diego	$141,542	$146,923	$161,039	$174,814	$192,631	$231,727	$217,368	$213,173
San Francisco	$190,859	$120,129	$105,799	$149,594	$206,233	$243,121	$289,148	$301,549
Seattle	$88,425	$79,259	$82,128	$100,364	$127,011	$175,146	$172,043	$174,177
St. Louis	$45,439	$51,126	$43,471	$48,252	$56,581	$63,548	$61,665	$59,174
Tallahassee	$35,696	$42,801	$50,733	$67,699	$73,419	$71,942	$46,471	$45,585
Washington DC	$133,814	$144,639	$153,329	$204,809	$260,543	$241,279	$263,208	$234,299
United States	**$52,291**	**$51,815**	**$51,395**	**$65,497**	**$82,164**	**$99,773**	**$94,668**	**$90,937**

*Forecast

Source: HVS - 2008 Hotel Valuation Index (HVI)

Strategies for Hoteliers in a Down Market

"When we do come out of this downturn . . . the travel industry [will be] back with a vengeance." – Steve Rushmore, President and Founder, HVS

The economic minefield lies before us, but developers can take careful steps to buffer the negative impacts. Here are some recommendations to consider in reaping the most from your investment.

- **Commission a market and/or feasibility study for your hotel project(s).** Planning, architectural design, and the acquisition of mandated permits for a new hotel can take months or years to complete. Economists suggest the credit markets and overall economy will begin to recover by mid-year 2009[3]. Due diligence now will put you ahead of the curve, and lenders will be more eager to engage projects for which a professional market or feasibility study has been conducted. HVS reports provide exceptional detail and analysis that lenders look for when deciding which projects to finance and how appealing the terms of that financing will be.

- **Shift from Wall Street to Main Street**. Don't feel that financing options are limited to Wall Street institutions—local and regional lending still exists. Most community banks were not heavily entrenched in the sub-prime fiasco and thus remain more viable sources of capital, though leverage has been cut back. Banks are shifting back to the basics in terms of loan criteria, focusing on a borrower's flexibility, additional collateral, liquidity, as well as relationship lending. Similar to the big banks, local lenders place great emphasis on a qualified market or feasibility study in determining which projects will receive financing.

- **Capitalize on municipal incentives such as tax-abatement zones**. Some communities offer developers tax advantages to encourage neighborhood revitalization. Look for such benefits when conducting your initial due diligence. The State of New York, for instance, offers partial exemption of real estate taxes through its Industrial and Commercial Incentive Program (ICIP). The program provides tax abatements for varying periods of up to 25 years for eligible industrial or commercial buildings that are constructed, modernized, rehabilitated, expanded, or otherwise physically improved. Municipal incentives are simple ways to greatly reduce future tax burden, allowing for more profitable projects.

- **Recycle buildings**. Converting existing structures to lodging facilities is among the latest trends in the hotel industry, as a drive around Boston will show. Notable conversions in the city include: the Hilton in the Financial District, formerly an office building; the historic Langham Hotel, which served as a Federal Reserve Building; the Marriott Long Wharf, once a warehouse; the Jurys Hotel, the former headquarters of the Boston Police;

and the latest installment, The Liberty Hotel, which was formerly the Charles Street Jail. The Liberty Hotel's conversion, as with most adaptive-reuse developments, benefits two parties: the community gains a property-tax generating, reinvigorated building, while the developer reaps tax credits at the federal and state levels.[4]

- **Mix things up**. Another increasingly popular trend in the lodging industry is pairing a hotel with a residential, retail, and/or office component. Many unfeasible hotel-only projects gain the "green-light" by extending their scope to encompass a mixed-use development. Mixed-use projects are typically undertaken as joint ventures. Shared overhead expenses, reduced (per-allocated) development costs, and operational efficiency are just a few of the incentives. From a consumer's perspective, a hotel within walking distance to entertainment, retail, and/or dining venues is more appealing than one where such amenities are only in reach by car.

- **Become a LEED-er**. Developed by the United States Green Building Council (USGBC), the Leadership in Energy and Environmental Design (LEED) certification is the national benchmark for high-performance green buildings. The program addresses all building types and emphasizes state-of-the-art strategies for sustainable site development, water savings, energy efficiency, materials and resources selection, and indoor environmental quality.[5] Installing motion sensor lights in public areas, replacing windows with energy-efficient models, and utilizing Compact Fluorescent Lighting (CFL) are just a few low-cost ways to make a property more energy efficient and advance closer to a LEED certification. These practices positively affect not only the environment but the bottom line by reducing operating costs, increasing operating efficiency, and positively impacting a property's image among environmentally conscious travelers.

By employing some of these suggestions between now and the inevitable economic upturn, hotel developers can better position themselves to capitalize on a revitalized market. The Four Horseman of the economic apocalypse may be on the stampede, but HVS can help see you safely through. Please visit us at **http://www.hvs.com/Services/Consulting/Boston** to learn more.

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[1] **http://www.doctorhousingbubble.com/the-four-horsemen-of-the-economic-apocalypse-lessons-from-the-great-depression-part-xx-housing-distress-stock-market-tanking-commodities-collapsing-and-unemployment-surging/**

[2] **http://wwwdev.nber.org/dec2008.html**

[3] **http://money.cnn.com/2008/10/08/news/bazooka.global.fortune/index.htm?postversion=2008100814**

[4] **http://www.buildings.com/articles/detail.aspx?contentID=6569**

[5] **http://www.usgbc.org/DisplayPage.aspx?CMSPageID=124**

About Brian F. Bisema

Brian Bisema is a Managing Director and Partner with HVS Boston. Brian brings over 15 years of hotel expertise, delivering appraisals, valuations, and consulting services that provide clients with credible results to make confident investment decisions. He has completed hotel valuations and appraisals on hotel real estate with an aggregate value of over $20 billion. For more information, contact Brian at +1 (781) 454-8930 or .