The Hotel Yearbook 2023

The Uncertainty New Normal

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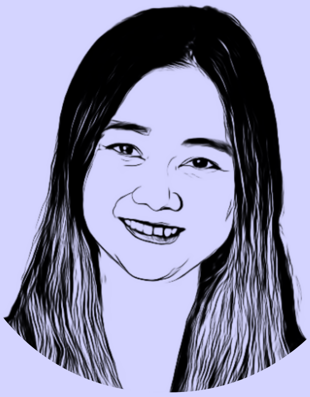

Hotel Financing Trends: What’s up for 2023?

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Synopsis

Aareal Bank's Kimberly Yoong writes the hotel financing industry faced turbulence in 2022 due to the pandemic, political instability, and inflation which led to a rise in interest rates and focus on debt serviceability of loans. This resulted in restrictions on new financings and higher financing costs, leading some investors to reconsider their strategies and a slowdown in the hotel transaction market. In 2023, the hotel industry is expected to remain robust as demonstrated by its quicker than expected recovery, but a keen eye on market trends and solid industry know-how will be key to navigating the uncertainty.

2022 was a tumultuous year of economic uncertainty, political instability, and an endlessly lurking pandemic; during which, inflation soared and interest rates saw hike after hike in attempts to tame inflationary pressures.

For lenders, the rapid rise in interest rates shifted the focus of many towards the debt serviceability of loans, which in some cases led to restrictions on new financings in terms of loan quantum and/or covenant structures. The heightened risk environment led to an upward pressure on loan pricing and contraction in availability of debt capital, particularly in the hotel financing space as some lenders unfamiliar with the sector sought comfort in asset classes they may have perceived to be less risky.

Consequently, lesser debt and higher financing costs prompted some investors to rethink their strategies, while much of the hotel transaction market went into 'wait-and-see' mode, especially as pricing expectations between buyers and sellers remained wide. As we move into 2023, the jury is still out on which direction the scale will tip towards, and a keen eye on market trends coupled with solid industry know-how will be key to manoeuvring the continued uncertainty.

JUST AN ILLUSION? FORECASTING SUSTAINABLE HOTEL CASH FLOWS

At the onset of the pandemic in 2020, the crystal ball prophesied that occupancy would recover by 2023/2024, followed by rates in the years shortly after. The opposite rang true in 2022, as travel restrictions were further lifted, and tourism roared back to life. Hotel rates began booming as revenge travellers were willing to dish out the cash, and savvy hoteliers pursued a rate strategy in a strive to compensate for rising utilities and labour shortages – a phenomenon evidenced by several hotel markets even seeing average daily rates (ADRs) surpass pre-pandemic levels in the last year.

However, as the revenge travel hype wears thin and labour shortages persist, prompting more guest complaints as they pay more for less service, the big question is – how sustainable are these rates? Coupled with inflation potentially depressing propensity to spend, as well as continued pressure on operational costs including utilities and labour, 'stabilised cash flows' are only becoming more difficult to forecast.

Accordingly, vigilant underwriting will be crucial to making sound investment and financing decisions in the coming year, as cash flows must be achievable and sustainable for lenders seeking sufficient buffer in debt service coverage ratios (DSCRs) throughout the loan term.

UP IN THE AIR: THE THREAT OF RISING INTEREST RATES AND REFINANCING RISK

For years, the hotel transaction market had reaped the benefits of continuous revenue and net income growth, together with a low-interest environment; money came easy and so did levered returns.

As long as interest rates remain high, however, the availability of debt will likely remain constrained, firstly as DSCRs continue to be tight due to the higher debt service and secondly, higher interest rates (i.e. higher costs of debt) should lead to declines in market value – as all else remaining equal, investors would not be willing to pay the same prices as they strive to maintain their returns.

Together, this would mean lower ceilings on the loan quantum that assets may obtain, as lenders' DSCR and/or loan-to-value (LTV) thresholds become harder to meet. Meanwhile, existing loans maturing this year will come under scrutiny as all-in interest rates have nearly tripled if not more, compared to five years ago.

Accordingly, these assets would need to ensure that cash flows are sufficiently robust to meet the higher debt service required, in order to secure a full refinancing. Conversely, hotels that do not generate sufficient cash flows may be restricted by DSCR covenants that could see some loans being sized down, creating the risk of a financing gap for owners.

While declining values or lower loan sizes are unlikely to cause much concern for lenders, particularly senior lenders who have been prudent in structuring loans conservatively, especially in terms of LTV, owners or investors may need to be prepared to inject more equity or source alternative forms of financing such as mezzanine debt.

In fact, owners may find themselves faced with the refinance-or-sell dilemma: as loans may need to be paid down or as net cash flows shrink with rising financing costs, selling the asset may in fact bring a better overall return in some cases, especially if the proceeds can be better reinvested – which would in turn help to rekindle the hotel investment market.

BUZZING FOR HOTEL TRANSACTIONS

The one certainty amongst today's uncertainty is that the fundamentals of the hotel industry remain robust, as demonstrated by the sector's quicker than expected recovery and proven reputation as an inflation hedge, given its ability to reprice rooms daily. Accordingly, investor interest in hotels have remained strong, but pricing expectations between buyers and sellers have been wide, partly driven by the high interest rates and the contraction of debt capital for hotels.

After a dearth of hotel transaction activity in recent months, many are eager for the bid-ask spreads to narrow and for more assets to come onto the market, i.e. to stimulate more hotel transaction and financing activity – which is not a far-off fantasy as more loans approach maturity in today's high interest environment, together with large amounts of uncalled capital remaining for hotel investments.

With mounting pressures for both parties, many are expecting more activity by the later months of the year. At the same time, as senior lenders remain cautious in loan sizing, cash-rich investors may find themselves at an advantage, while junior/mezzanine lending could help provide that extra bullet of debt capital, especially for less well-capitalised investors.

LOOK BEFORE YOU LEAP

With war, recession, and a pandemic hanging in the balance, it's difficult to tell how the world will emerge at the end of yet another 'roller coaster year', or even what else there is to come. However, as past crises have shown, navigating hotel financing in a tricky environment may be difficult, but not impossible – strong expertise and industry knowledge to appropriately underwrite and structure deals may not be a crystal ball, but certainly at least a trusty trump card for wanderers of the unknown.

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Kimberly is part of the hotel financing team at Aareal Bank, where she is involved in analysing, structuring and managing hotel financing deals, as well as in the ongoing monitoring and management of existing hotel loans. Prior to joining Aareal, Kimberly worked in hotel real estate consulting at Cushman & Wakefield. She started in hospitality with a background in hotel operations and graduated from EHL in Switzerland with a Bachelor of Science in International Hospitality Management (High Honors).

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