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## Debt Service Coverage Declines, Foreclosures To Rise

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PKF Hospitality Research has completed a special analysis of two critical issues facing hotel lenders today as the industry enters what could be one of the worst years on record: the borrower's ability to meet their debt-service obligations and the underlying value of their collateral. The research, based on the firm's proprietary data, found the number of full service U.S. hotels lacking the cash flow needed to pay their debt will increase by 25.0 percent in 2009, and property values will likely decrease another 20.1 percent (after a 14.1 percent decline in 2008).

The combination of a weak economy and rising levels of supply have caused one of the deepest and longest recessions in the history of the domestic lodging industry. As a result, the newest forecast produced by PKF-HR, based on preliminary year-end data from Smith Travel Research (STR), projects that the average U.S. hotel will experience a 9.8 percent decline in the revenue received from the rental of guest rooms (RevPAR) in 2009, after having already declined an estimated 1.8 percent in 2008.

"The drop in RevPAR for 2009 will be the fourth largest annual decline in this important measure since 1930," says R. Mark Woodworth, president of PKF-HR. "Further, PKF-HR is forecasting that the nation's hotels will not experience a year-over-year quarterly increase in RevPAR until the third quarter of 2010." The projected eight consecutive quarters of declining RevPAR, beginning with the third-quarter 2008 decline of 1.1 percent reported by STR, marks the longest stretch of falling revenues endured by U.S. hotels since the firm began tracking performance data more than 20 years ago.

"Few hotel lenders have had to deal with such precipitous declines in revenues. Therefore, they are unprepared to gauge the pending impact on the ability of their borrowers to repay their obligations," Woodworth surmised.

### Actual, Not Hypothetical Results

To examine how full-service hotel debt-service coverage is affected by such a significant decline in RevPAR, PKF-HR extracted information from its Trends in the Hotel Industry database of 6,000 actual hotel financial statements. An analysis was performed on full-service hotels that experienced significant RevPAR declines on a year-to-year, same store sales basis. "This analysis allowed us to observe actual historical relationships between movements in full-service hotel revenue and the resulting changes in profits. These are not hypothetical results," Woodworth said. For the purpose of this analysis, profits are defined as Net Operating Income (NOI) or income after capital reserves expense but before deductions for rent, interest, income taxes and amortization.

Given the high fixed-cost nature of the lodging industry, the survey sample was divided into two groups based on their previous year operating thresholds (high occupancy and low occupancy). "The borrower's ability to pay their mortgage is dependent on the hotel's performance prior to a recession," Woodworth noted. "Our analysis proves the theory that the strong are better equipped to survive an industry downturn."

### High Occupancy Hotels Will Not Appear On Lender Watch Lists

For purposes of the research, full-service hotels with occupancy greater than 70 percent were deemed "high occupancy" properties. On average, significant declines in revenues at high-occupancy full-service hotels resulted in a relatively small decrease in debt-service coverage. The high-occupancy properties studied averaged a 13.0 percent decline in RevPAR, a 6.9 percent decline in total revenues, and an 8.6 percent decline in profits. Applying relevant industry averages for financing, the decline in profits results in a lowering of debt-service coverage from 1.45 to only 1.33.

"While no lender likes to see debt-coverage ratios drop, they should be reassured that most stable full-service hotels will still be able to generate enough cash flow to pay their mortgages," Woodworth said. "Of course, the lower debt-coverage ratios leave less room for error, so the operations need to be carefully monitored. Asset management is now more important than ever before. Yield management becomes critical to ensure the most profitable top-line, and the proper controls must be in place to keep costs in check."

### Low Occupancy Hotels May Become Delinquent

While it appears that full-service hotels performing above market averages prior to the current recession will have the ability to continue to pay their debts, those properties already behind in performance are most vulnerable to potential delinquency.

Properties performing at less than 70 percent were deemed "low occupancy" hotels. This sample averaged a 16.3 percent decline in RevPAR, a 12.2 percent decrease in total revenues, and ultimately a 44.8 percent drop in profits. "The current PKF-HR forecast calls for a 57.2 percent industry-wide average occupancy in 2009 – thus it is clear that many hotels fall into this low performance category," Woodworth added.

"Because fixed costs already comprise a large portion of the total expenses for these low-occupancy hotels, management's ability to further reduce costs is minimal. This is why we see such dramatic declines in profitability," Woodworth said. Given the extreme fall-off in profits, PKF-HR observed an equally dramatic decline in the ability of these hotels to cover their debt service obligations. For the low-occupancy, full-service hotels, debt-service coverage fell from 1.45 to 0.80.

"Clearly, for hotels that are already under performing, the prospects for surviving the current recession are bleak," says Woodworth. "For the lenders to these hotels, careful consideration should be given to two critical issues: (1) management's planned operational strategies and (2) the underlying value of their collateral."

### Debt Deficiencies

PKF-HR believes the number of hotels in the U.S. that will experience a debt-service coverage deficiency will increase by 25 percent in 2009. Of the 6,000 hotel financial statements in PKF-HR's proprietary database, an estimated 15.9 percent were unable to generate sufficient cash from operations to cover their debt service payments in 2008. Based on

current RevPAR and NOI forecasts, PKF-HR estimates this number will increase to 19.9 percent in 2009.

"More and more owners will have to reach into their own pockets to meet these expected debt service shortfalls. When these shortfalls occur there are two outcomes based on the specific situation. Foreclosure by the lender may result, or some form of work-out with the borrower might be appropriate," says Bob Eaton, executive managing director of PKF Capital/Hotel Realty, the brokerage affiliate of PKF Consulting.

Unfortunately, future options may be limited when dealing with these distressed properties. "When looking at the characteristics of the low-occupancy hotels, there were some consistent factors among the sample. Old age, poor location, questionable affiliations, and improper market orientation were common attributes in the low-occupancy sample. Some of these factors can be changed, some cannot," Eaton observed.

#### Lower Values Also Impact Behavior

Declining cash flows should not be the only concern for hospitality lenders. Based on projections of fluctuating profits and rising capitalization (cap) rates, PKF-HR is estimating that full-service hotel values will decrease 35.4 percent from 2007 to 2011.

Even though PKF-HR is forecasting profits to begin to accelerate in 2011 for these hotels, the outlook for cap rates is not as rosy. PKF-HR estimates that full-service hotel cap rates will increase 240 basis points from 2007 to 2011. "The rise in cap rates, combined with the significant declines in hotel income levels, leads to these sizeable reductions in hotel asset values," says John B. (Jack) Corgel Ph.D., the Robert C. Baker professor of real estate at the Cornell University School of Hotel Administration and senior advisor to PKF-HR.

"Given the state of the financial and real estate markets, we are entering a unique period when a solvent borrower might find it more beneficial to default on their loan," Corgel warns. "With hotel values on such a precipitous decline, paying debt obligations could be viewed as good money chasing bad money."

#### Benchmarking For Lenders

PKF Consulting frequently assists lenders with asset benchmarking to evaluate the growth of future property level income and asset values. However, in today's depressed operating environment, the purpose and benefits of benchmarking have changed. "Lenders should now ask the question 'What does the bottom look like, and when will it get better?' The results of this analysis reveal that income and value declines will be dramatic," Eaton said.

The PKF Consulting family of companies offer a variety of reports and services that hotel owners and lenders can use to assess the solvency of their hotel assets. Hotel Horizons<sup>SM</sup> forecast reports present five-year projections of supply, demand, occupancy, ADR, and RevPAR for 50 markets in the U.S., as well as six national chain scales. Benchmarking reports allow a lender to evaluate the relative profitability of a hotel.

Parties interested in PKF-HR's reports and services should visit their website at [www.pfk.com/store](http://www.pfk.com/store). or call (404) 842-1150, ext 237.

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