HOSPITALITY LENDING

by Steve Brown

If there is one lending sector that has outperformed all others, it is hospitality lending. After 9/11, many independent bank hotel loans rose to a 7% delinquency rate and credit dried up. Since that time, hospitality delinquencies have dropped to a mere 75bp. Pricing, while compressed since 2004, has remained fairly robust and now averages Libor + 3.28%. While returns are more volatile than almost every other CRE sector, this volatility has been falling in 2006. Our short-term projection for hospitality lending is currently "stable," with an expectation for slight improvement. Corporate spending on travel should increase next year and vacation travel is expected to remain steady. Going into 2007, we make one recommendation based on this hospitality loan performance data. Banks should reduce their holdings of the economy-line hotel sub-sector, as it is slated to deteriorate past 2008. When it comes to hotels, we monitor some 32 metro markets and in almost each one, luxury and ultra-luxury room rates have become more sensitive to demand and supply. This rate stability has served to make earnings more predictable, which is a positive characteristic. Part of this rate sensitivity is a result of better analytics being employed by many hotel firms, part is greater reliance on the internet for bookings and part is higher demand by consolidators. These factors have resulted in many hotel properties being more accurate in their supply conditions and more reactive to changes to those conditions. As a result, we have seen higher occupancy and higher revenue per available room. This has allowed loans to higher-tiered brands to increase their DSC despite rising interest rates. On the other hand, properties such as Holiday Inn, Comfort Inn and Best Western have produced lower DSC in the past 12 months. We would normally recommend increasing exposure to this sub-sector at this stage of the economic cycle (since lower-priced brands normally increase occupancy in a down cycle relative to luxury properties). However, increased room rate sensitivity has changed hotel lending risk. Greater sensitivity means upscale hotels are more likely to cut their rates, stealing market share from economy chains. During the first week in April in Seattle, Hyatt was below plan and cut their rate from $360 per night to $195. As a result, occupancy increased and rates are trending back up. Back in the 1990's, it would have taken the hotel chain 2 or 3 months to adjust pricing. Another input into our hotel model is the increased strength of luxury hotel operator balance sheets. Given superior performance over the past 2Y, hotel operators now have more cash and lower debt. Owners of properties with Westin, W, Ritz-Carlton and to some extent Marriott flags, usually also have lower projected default rates than other operators. For users of our Loan Pricing model, you can get up to the month projections on independent delinquency rates and recommended reserve levels. For other bank's not yet using our model, know that delinquencies should remain stable, with higher-end properties expected to outperform many other lending sectors for the next several years.

Related Links:
Loan Pricing Web Demonstration

LOAN PRICING

appropriate book yield, NIM, loss allowance, ROA and ROE. If you ever wondered how Bank of America, Citibank, Wells Fargo, or US Bank justify their lending decisions, this model demonstrates how national banks currently calculate their ROE and ROA numbers and how they substantiate their loan spreads. If you are interested in seeing a 30-minute web demonstration of this model either today, Weds. or Friday at 3pm, 8am or 10am, respectively, follow the link located below.

BANK NEWS

M&A

1st Constitution Bancorp ($382mm, NJ) will acquire a branch from Sun National Bank ($3.2B, NJ) for and undisclosed sum.

M&A

An equity analyst speculated that KeyCorp might be acquired by Bank of America. He based his decision on the fact that while BofA could not acquire any of the top 11 banks in the country due to a 10% maximum national deposit concentration (BofA could absorb another $54B in deposits before they would cap out at the 10% maximum allowed), the bank could acquire any of the remaining institutions and still be below the threshold. Key was mentioned as a possible target because it would give BofA a Midwest presence, something the bank has been lacking.

SOX

The WSJ reported on Friday that regulators will propose guidance next month to help businesses interpret Section 404 to reduce the cost of compliance. The guidance will reportedly focus on matters relevant to financial results and include an asset size cut.