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Room Rates Trump Occupancy In Latest Hotel Loan Deals

By **Natalie Rodriguez**

Law360, New York (January 29, 2014, 6:16 PM ET) -- Prompted by concerns that a limited supply of lodging may be skewing occupancy rates across the country, lenders are putting a new focus on whether a hotel can pull in a higher average daily room rate than its rivals before signing off on a loan deal, experts say.

Traditionally, occupancy rates would shoulder more of the weight when calculating a good candidate for a loan. But with hotel room supply still limited after years of a dry construction pipeline, lenders and creditors believe most occupancy levels could be skewed and are instead placing more emphasis on ADR, experts said.

"Lenders would rather see you increase ADR and keep your occupancy at 70 percent," said Lynn K. Cadwalader, a San Francisco partner with Holland & Knight LLP.

Many lenders and hotel investors are comparing hotels' current ADR with their historical peak rates, according to Steve R. Hennis, director of hospitality data firm STR Analytics. What they're finding is that most room rates are still below what the hotels were able to charge in 2007 or 2008, even though occupancy rates are at or above past peak levels. And the industry is still at least two years from new construction significantly affecting occupancy, he said.

Lenders and creditors are so concerned that occupancy rates may be artificially inflated by low supply that they're capping the occupancy rate they will take into consideration when doing calculations, according to Stephen E. O'Connor, a principal and managing director with hospitality financing firm RobertDouglas. If, for example, a hotel in an urban market is running at 90 percent occupancy, most lenders and creditors will cap the rate taken into consideration at 80 percent.

Lenders "take the view that, over the long term, all markets return to mean," O'Connor said

In the current market, meanwhile, ADR gives lenders a window into where the hotel property stands against its competitors and whether it's holding its own by offering a better experience than its rivals, according to experts.

Lenders "want to know you're competing on amenities and location and not just a pure price," said Thomas F. Kaufman, a Washington, D.C.-based attorney with Goulston & Storrs PC.

What a hotel can charge its visitors also helps a bank figure out whether it truly is competing somewhere in the prized luxury or upscale markets, according to experts. A recent survey of hotel financiers, undertaken by STR and RobertDouglas, showed that banks perceive that the least risk lies in the upper-upscale, luxury and upscale hotel markets — in that order.

"They're paying attention to ADR because that's an indicator of where you fall within that spectrum," O'Connor said.

But above both ADR and occupancy rate, revenue per available room and debt yield reign supreme when working out loan deals.

For example, senior lenders are generally requiring a minimum debt yield of 10.1 percent on underwritten cash flow for an existing hotel when figuring out the size of a loan, according to the hotel lender survey. And when it comes to determining whether a hotel is worth the risk of a loan, revenue per available room is still the most important metric, according to Kaufman.

But hotel lenders are still a little gun-shy when evaluating hotel candidates. They are digging deep into all of a property's data points to ensure that the hotel is stable and its cash flow will still be strong several years down the line, according to experts, and that's what makes ADR important when working out the details of a loan deal.

Experts noted that while they expect lenders to continue to cautiously dissect deals, they also expect the loan deal pipeline to pick up some steam this year.

"I would say that there is a very active and well-functioning credit market that is both organized and available for borrowers, which wasn't the case for two or three years," O'Connor said.

--Editing by Jeremy Barker and Katherine Rautenberg.