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CRE Research
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Can Lodging Real Estate Fundamentals Support Continued Growth?

With Memorial Day behind us, the busy summer travel season has begun. AAA projected that 37.2 million Americans would travel over the holiday weekend, which represents a 10-year high and a 4.7% increase from Memorial Day weekend 2014. While travelers will benefit from lower fuel prices, the cost of lodging has increased, which bodes well for the real estate sector.

The single biggest factor affecting the lodging market is the stronger economy. During the recession, lodging was one of the hardest hit sectors. Since then, tourism and business travel have recovered and fueled increased room demand. Combined with a limited pipeline of new supply, the lodging sector has returned to good health.

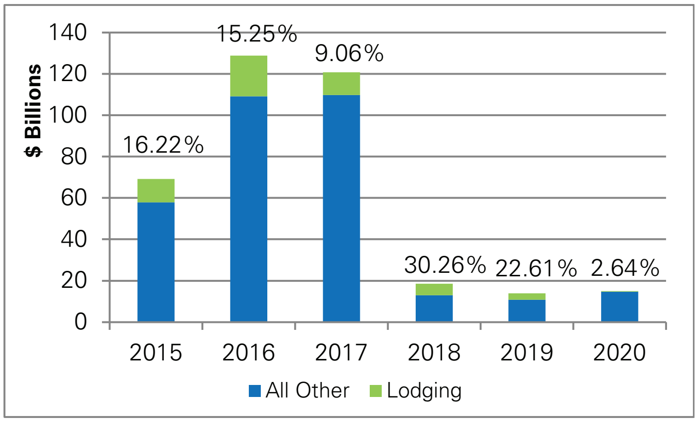
In a year-over-year comparison, hotel research firm STR, Inc. reported that first quarter US hotel occupancy increased 3.1% to 61.1%, the highest level ever recorded by the firm. The average daily rate rose 4.7% to $117.09 and revenue per available room (RevPAR) increased 8.0% to $71.56. Areas with the greatest growth include Phoenix, Tampa/St. Petersburg, and San Francisco/San Mateo.

Improving market fundamentals have prompted developers to increase building activity. STR's pipeline for hotels under construction increased 21.4% between April 2014 and 2015. The pipeline of new supply has attracted the attention of investors, especially in places like New York City.

The Wall of Maturing Loans

Availability of financing is key to keeping the market moving, and CMBS is an important source of funding. The pipeline of legacy CMBS loans set to mature will peak during the next several years. Trepp estimates that $11 billion in lodging sector CMBS loans will mature in 2015. That balance will grow to $19.6 billion in 2016 and drop to $10.9 billion in 2017. Many of these notes are 10-year loans that were originated at the height of the last cycle between 2005 and 2007. As a result, the total dollar amount of maturing lodging loans will drop significantly in 2018 and 2019, but lodging will still represent a larger proportion of total maturing CMBS loans in these years. (See Figure 1.)

Figure 1. Maturing Lodging Loans



Refinancing the maturing loans will be easier, as lodging CMBS delinquencies have fallen from a peak of almost 20% in late 2010 to 4.2% in April 2015. The fact that most of the loans maturing through 2017 are current should also improve borrowers' ability to refinance. The small number of lodging loans with appraisal reductions also illustrates the strength of the underlying market. (See Figure 2.)

The wall of maturities fluctuates from month to month, but peaks in June 2016 when the Kyo-ya Hotel Portfolio and Tharaldson Portfolio loans mature. Also maturing that month is a large loan on the InterContinental New York Times Square. Maturities spike again in late 2016, which is when the Inland Hospitality Portfolio and the Waikiki Beach Marriott Resort & Spa loans reach their maturity date. (See Figure 3.)

Historical loss trends provide an idea of what to expect as loans mature in the future. Around $30 billion in lodging sector loans were disposed in the last five years. Of this total, $23 billion did not experience a loss. Of the $7.1 billion that did report a loss, the combined losses totaled $3.2 billion. Losses averaged 45% on troubled loans but represented 10.6% of the total disposed loan amount. Because delinquencies are currently low, there will likely be fewer losses on the loans included in the coming wall of maturities than in the last five years, when real estate market fundamentals were weaker. (See Figure 4.)

CMBS Originations Increase

Healthy market fundamentals, low interest rates, and the impending wall of maturities have led to increased lending in the hotel sector. Despite prepayment penalties and other costs of paying off loans early, some borrowers are refinancing sooner to lock in low rates.

Lodging led all major property types in origination for the first five months of 2015. (See Figure 5.) The volume of newly issued lodging CMBS loans ballooned from $150.6 million in 2010 to $21.7 billion in 2014. First quarter 2015 CMBS loan originations were well ahead of the same period in 2014, which is another indicator of this year being a strong one for new lodging CMBS.

Figure 2. Lodging Loan Delinquencies

Figure 3. Maturing Lodging Loan Status

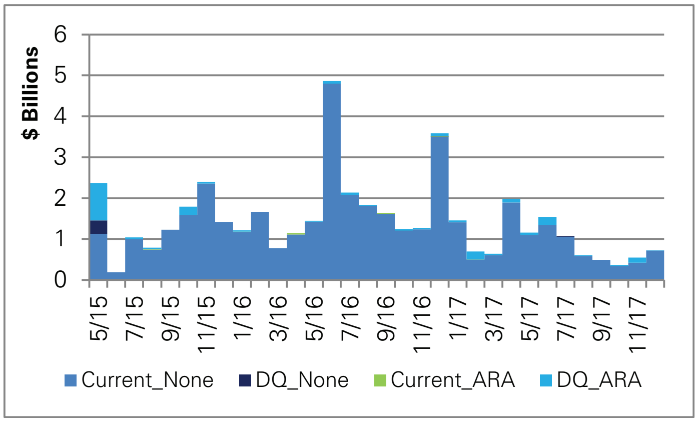


Figure 4. Lodging Loan Losses

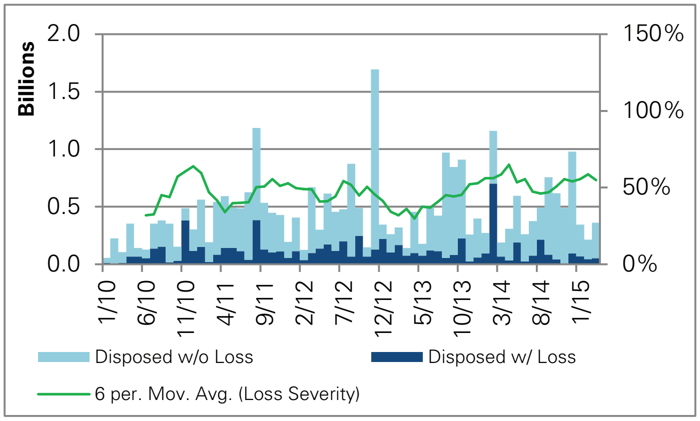


Figure 5. Origination by Major Property Type

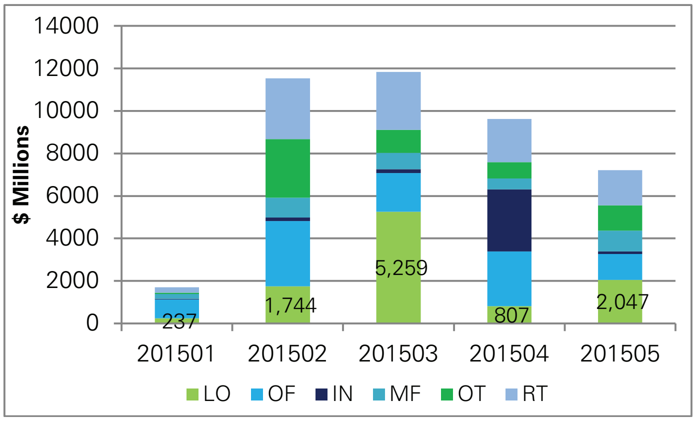


Figure 6. Lodging Loan Issuance by Deal Type

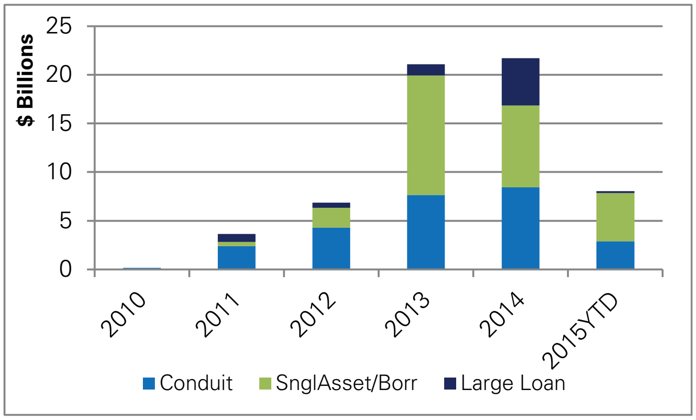
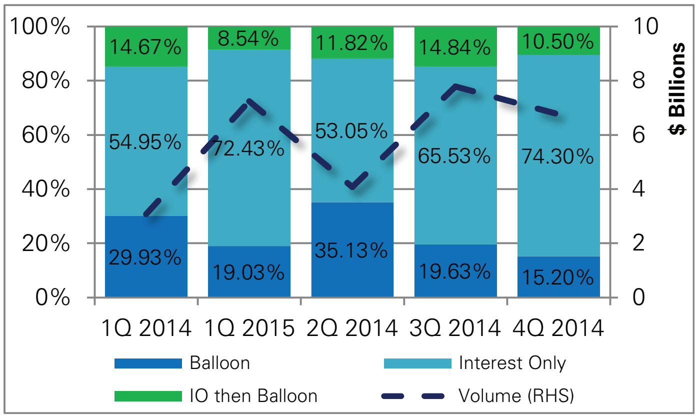


Figure 7. Lodging Loan Issuance by Amortization Type



The number of large borrowers seeking loans increased notably last year, the bulk of which were conduit or single asset borrowers. (See Figures 6 and 7.)

Outlook

Lodging CMBS will grow during the next several years as new loans are issued and maturing loans are refinanced. Nevertheless, the sector faces several challenges. Slower global growth and the strong dollar could affect foreign travel to the United States, resulting in less demand for hotel rooms and weakening lodging sector fundamentals. So far, the strength of the dollar does not appear to have affected international travel to the US. Increased traffic from China, where getting a visa has become easier, has offset a reduction in travel from Europe. However, the expectation is that the dollar is more likely to impact the lodging sector during the summer when business travelers give way to more discretionary tourist traffic.

New York City, which has experienced a small decrease in international visitors, appears to be the only exception to this trend. The city must contend with a significant influx of new hotel supply, which includes 63 hotels in the pipeline for 2015 and 2016, according to NYC & Company, the city's official tourism organization.

Lodging will move beyond the current growth phase of the real estate cycle in the next several years. If the US economy weakens and travel slows, lodging demand will fall, loan distress will increase, and loans could become more difficult to refinance. Higher interest rates will also affect borrowers' ability to refinance.

At present, healthy lodging fundamentals and low interest rates will work to the advantage of CMBS originators and borrowers that need to refinance maturing loans. The low level of delinquent loans will also make refinancing easier, which will contribute to the formation of new lodging CMBS. ■

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