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## State of the Hotel Capital Markets Where did my lender go? What is going on?

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My, how quickly things have changed in the real estate capital markets. The hyper liquidity and amazing investor froth, of both debt and equity providers, which propelled real estate values to almost unimaginable levels in the United States (and elsewhere) over the last 24 months has come to an abrupt halt. What happened and what does this mean? The answer to the first question is fairly straightforward. The increasing default rate of US residential mortgages (primarily) and the realization by buyers of these debt instruments of how illiquid they were and difficult to value on a mark-to-market basis (the so-called sub-prime mortgage crisis) woke up investors of securitized debt of all kinds worldwide to the fact that risk indeed existed and most concluded that they were not being compensated adequately for that risk. This re-evaluation of risk by debt providers began in the spring and reached a crescendo in early August when the CMBS, CDO, CLO and major loan syndication markets basically shutdown, leaving originators of loans intended to be sold off in these markets literally holding the bag.

To put this issue into context with respect to real estate, CMBS (Commercial Mortgage Backed Securities) issuances accounted for approximately 75% of all debt placed on real estate between 2005 to mid-2007. During 2006 and year-to-date 2007, CMBS issuances exceeded \$200 billion; in 2000 these issuances were less than \$50 billion and virtually didn't exist prior to 1990. This astounding growth and the fees that could be earned related to it, resulted in declining underwriting standards, ever more-borrower friendly loan pricing and terms, higher loan proceeds relative and, in our view, resulted in lenders often becoming an equity partner of the borrower but not getting paid for it.

So, what does this mean? This is a little hard to say at this point, as the debt market continues to seek its equilibrium. The transaction market has slowed markedly as a wide swath of the debt market is sitting on the sidelines. Balance sheet lenders, particularly life insurance companies and some credit companies, that had been non-competitive for the last 2+ years are taking advantage of market conditions but have finite debt funds and could well be satiated prior to year-end. What can be said with a high degree of certainty is that hotel loan underwriting standards, pricing, proceeds and terms will not be as favorable. Loan-to-value of 65%, or thereabouts, for senior debt will likely be the norm/maximum as compared to 80%-90% on very aggressive valuations this past spring. Interest rate spreads are anywhere from 150 - 250 basis points above the corresponding benchmark depending on the quality of the property, location, market and cash flow, where as in the spring, interest rate spreads in some cases were below 100 basis points.

Loan-to-value will be more conservatively determined, primarily based on current year cash flow and debt service coverage including an amortization factor will return resulting in materially lower proceeds than the recent past. And, last but not least, no more so-called "covenant lite" loans, real

covenants will return.

The back-up in the debt markets has impacted real estate values negatively, the converse of the value run-up the last 2-3 years. The question is how much and for how long? If you are in the market attempting to sell today, we believe values have adjusted around 10% from earlier this year. There are a wide range of opinions on how long the debt dislocation that presently exists will continue and what will happen to hotel values over the next 12 or so months. Many people believe the debt markets will "normalize" at the beginning of the year as the \$50 billion+ of CMBS overhang is dealt with, and originators have realized substantial losses in the values they will realize for these loans once they're sold, and new debt allocations for balance sheet lenders are determined. There are likely to be bigger debt allocations and more balance sheet lenders in 2008 in an attempt to take advantage of the changed market conditions.

We believe the debt market recovery will be gradual and the more "conservative" approach to lending will hold. So, unless equity providers, which remain plentiful, are willing to accept lower returns on larger equity investments relative to the recent past, which we think unlikely, values must adjust. That is, unless property cash flows rise a sufficient amount to offset the increased cost of debt.

Values for U. S. hotels, even with a 10% near-term correction remain robust. Interest rates remain near historic lows and cap rates for hotels, accordingly, while somewhat higher than earlier in the year, remain quite low (7% +/- on reasonable 2007 forecast). Supply/demand fundamentals also appear to be holding up and one of the results of the "credit crunch" will be a more extended/gradual ramp up of new supply. Supply will also continue to be restrained somewhat by the continuing escalation of development costs, although land costs are moderating somewhat. REVPAR (room revenue per available room) through August 2007 has increased 5.8% nationally as compared to the same period in 2006. While lower than the 7+% of the last three calendar years, this rate of REVPAR growth, with most of it being driven by ADR (average daily rate), is quite healthy and appears sustainable, at least in those markets where new supply remains controlled. New supply will challenge suburban markets (mostly) in Orlando, Phoenix, San Diego and D.C. in the next 12-24 months. The Boston market has had and will continue to have a steady stream of new hotel openings in urban locations, but appears poised to absorb this increase in supply reasonably well.

The biggest risk, as we see it, is on the demand side. The US economy is in its sixth year of recovery/expansion, so we are most likely closer to the end than the beginning of this business cycle. There has been a lot of public angst among economists and other pundits that the sub-prime crisis, credit crunch in general and decline in home sales and values would cause a national recession. While certainly possible, we think a recession will not likely occur in the short term due to rising corporate profits and manufacturing activity, helped significantly by the weak US\$, strength of the technology sector(s) and resilience of the American consumer, helped by high employment levels and strong wage gains. We do believe the US is in for a marked decline in the rate of growth which may feel like recessionary conditions in markets with tremendous over supply of housing (Miami and elsewhere in Fla., San Diego, the LA Inland Empire and Phoenix, in particular) and Detroit. Interestingly, hotel demand has actually increased its rate of growth over the last six months (April-September 2007) as compared to the nine months preceding this period (July 2006 - March 2007). August 2007 actually experienced the highest level of demand growth in almost two years. This is contrary to how hotel demand typically acts with a recession pending.

We view the debt market correction as healthy, albeit a short-term disincentive to recapitalize. If you

have a well-positioned, competitive hotel in a market where looming supply additions are not an issue, then our advice is to make sure management is focused on "blocking-and-tackling", drive revenue and cash flow and a "rebound" in value should be achievable. The debt markets could correct more quickly than anticipated, which could assist value creation. Don't despair, but be careful and prudent.

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