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Events Impacting Lodging Capital Flow

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Events Impacting Lodging Capital Flow

Abstract
By reviewing events in the last quarter of the 20th century that have impacted the amount and type of lodging industry financing, the author analyzes these historical trends and major events to alert lodging industry investors, lenders, legislators, and hotel operators when similar events emerge in the future

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Events have impact on lodging industry finance

by A. J. Singh

By reviewing events in the last quarter of the 20th century that have impacted the amount and type of lodging industry financing, the author analyzes these historical trends and major events to alert lodging industry investors, lenders, legislators, and hotel operators when similar events emerge in the future.

As the lodging industry moves into the 21st century, it faces many uncertainties. These uncertainties are based on the underlying premise that the lodging industry is dependent upon financing for its growth and development. Various recent studies have tried to alleviate these uncertainties by predicting the extent and nature of capital availability to the lodging industry in the future.[1]

The last three decades of the 20th century (1970-1999) have witnessed three capital market cycles; the peaks represented capital availability to the lodging industry and the troughs signified periods when lenders and investors stopped supplying capital to the industry. At the end of each cycle the lodging industry emerged a little different from the previous decade.

The purpose of this study was to identify the critical events that influenced availability of capital to the U. S. lodging industry in this period and to discuss the structural changes to the lodging industry and lodging industry finance in each progressive decade. The study is historical research and relies upon secondary literature. Commenting on historical research, Baumgartner stated, "Using the historical approach, the researcher endeavors to record and understand events of the past. In turn, interpretations of recorded history hold to provide better understanding of the present and suggest possible future directions."[2]

The relationship between capital availability and room starts has been well documented. Figure 1 illustrates the close relationship between the availability of capital

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and room starts (one measure of lodging industry growth). For example, convenient access to capital through the mortgage REITs of the early 1970s pushed room starts in 1973 to 155,400. Conversely, in the early 1990s, as capital availability tightened, room starts declined. As capital availability increased in the second half of the 1990s, room starts also picked up.

Events have impact

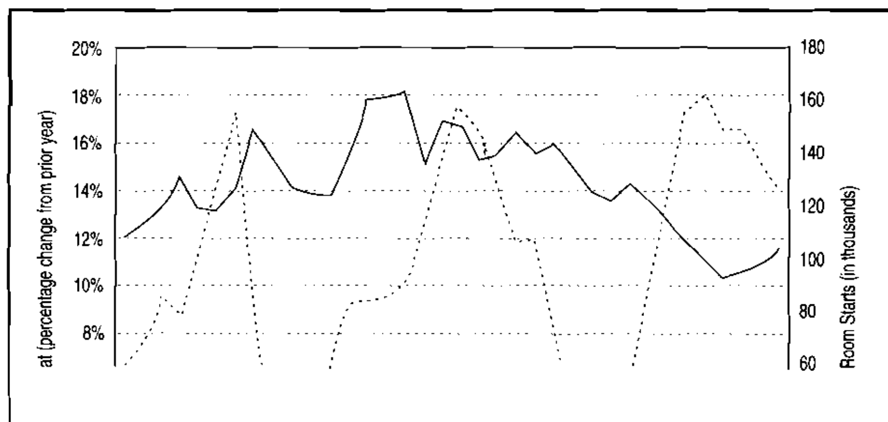
Over the past 30 years, many interrelated events have had an impact on the availability of capital to the lodging industry. Each event culminated in a critical event that directly impacted the increase or decrease of debt and equity capital to the lodging industry. A review of these critical events and their impact on the lodging industry is discussed in the context of the three decades.

1970s are boom time

• Critical event 1–REITs: During the late 1960s, as investors were not able to achieve adequate returns from stocks, they looked to real estate as a hedge against inflation. An efficient means of investing in real estate that developed during this period is known as the real estate investment trust (REIT). The REITs that financed the real estate boom of the early 1970s were mortgage REITs, as opposed to the equity REITs of the 1990s.

Mortgage REITs were essentially lenders, and in the early 1970s they were responsible for providing first and second mortgages, construction and development loans, and joint venture loans for hotel development. These REITs raised capital by selling shares to the public, issuing commercial paper, and borrowing from banks. It is estimated that between 1969 and 1972 the REIT industry sold

Figure 1
U.S. lodging industry room starts compared to availability of capital (1967-1999)



Source: *Pricewaterhouse Coopers, The WEFA Group. Adapted from* Global Lodging Almanac *by Bear Stearns (2000).*

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securities worth $1 billion to $2 billion each year.[3]

An advantage of these lending institutions over traditional lenders was that they were relatively unregulated. As the spread of rates at which they made their loans and their own cost of capital increased, their share prices showed dramatic increases in the early 1970s. The national stagflation (caused by simultaneous increase of both price level and unemployment rate) of 1974 destroyed the mortgage REITs because, as their cost of borrowing increased, they were unable to get adequate returns on their loans and, as the REITs became unprofitable, they were unable to attract investors to buy their shares. This problem was further exacerbated by the highly leveraged nature of the mortgage REITs; in some cases their debt-to-equity ratio was as high as 4:1.[4] From a peak of 200 REITs in 1974, their number was reduced to less than 100 by the end of the decade.[5]

In the early 1970s, mortgage REITs (and other lenders) kept developers supplied with capital for development. As a result, the supply of rooms showed a large increase during this period. In competition with these REITs, commercial banks, savings-and-loan associations, and other lending institutions made loans that exceeded prudent levels.

A study by Laventhol & Horwath, a premier lodging industry consulting firm, during this period summarizes the effects of overbuilding when the environment changed:[6]

> During 1973–1974, overbuilding in the hospitality field was aggravated by several unexpected factors. First, the energy crisis reduced travel. Second, developers were hit with staggering construction cost increases and cost overruns. Third, interest rates went up. With soaring costs crimping their profits, many developers had decided to wait for the widely-predicted lowering of long-term interest rates. Accordingly, many projects were undertaken without long-term mortgage commitments, and certain lenders flush with cash–notably REITs–did not discourage the practice. The Federal Reserve Board, however, in an attempt to dampen the country's rampant inflation, began to tighten the money supply and interest rates reacted appropriately (went up), catching builders with high-cost long-term financing, or–worse–none at all. Fourth, as the recession started to take hold, consumer confidence began to wither and demand for real estate projects of all sorts evaporated.

Because of this hostile environment, lenders became owners of non-performing lodging properties. Loan write-offs continued to increase. REITs started to fail due to their over-leveraged position. Besides REITs, other lenders also

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suffered losses on commercial real estate and hotel loans.

1980s show change

• Critical events 2, 3–Deregulation: Until the early 1980s, savings-and-loan institutions or S&Ls primarily financed housing through traditional mortgages at fixed interest rates for the duration of the loan. These long-term loans (30 years) were primarily funded by short-term deposits. Moreover, regulations at this time (based on Regulation Q: A regulation of the Federal Reserve for depository institutions) imposed interest-rate ceilings on these deposits. Under conditions of stable interest rates this is not a problem, but if interest rates rise above the interest rate on the mortgage loans, a negative spread results for the institution. This is what happened from 1979 to 1982 when the Federal Reserve radically changed its monetary policy by targeting bank reserves rather than interest rates in an attempt to lower the rate of inflation.[7] Due to this restrictive monetary policy, there was a surge in interest rates, with rates on T-bills rising to as high as 16 percent.

This increase in short-term rates and the cost of funds had two effects on S&Ls. First, as they were saddled with fixed-rate, long-term home mortgages, their earnings spread became negative, as their cost of funds was higher than what they were receiving from the interest on home mortgages. Second, due to Regulation Q, which restricted the interest rate they could pay on deposits, they were at a competitive disadvantage from the newly emerging money-market mutual funds, which paid a much higher market rate. The result of this was disintermediation or loss of depositors and hence erosion of their capital base.

In an attempt to counter this problem, Congress set into motion the deregulation of depository institutions by passing the Depository Institutions Deregulation and Monetary Control Act (DIDMCA, 1980) and Garn-St. Germain Act of 1982. These two acts expanded the deposit-taking and asset-investment powers of S&Ls. They were now able to offer deposits at higher rates of interest and make consumer and commercial loans through adjustable-rate mortgages.

For many institutions, deregulation made them safer and more diversified. However, for a significant number of S&Ls, whose earnings and shareholder capital were being depleted in traditional lines of business, it meant the opportunity to take more risks in an attempt to return to profitability. As a result, many S&Ls made high-risk loans—acquisition and development loans and construction loans on "location-oriented businesses" such as hotels, resorts, golf courses, and fast-food restaurants.[8]

At first the deregulated climate improved the profitability of the industry. However, in 1984, a regional economic crisis began to unfold in Texas as crude oil prices began to fall, which caused enormous declines in real estate values.

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This crisis spread to other parts of the nation. National delinquency rates on mortgages increased from 2.1 percent in 1983 to 5 percent in 1986.[9] Hindsight has shown that this loss of asset quality by the S&Ls was caused by the regulatory environment, which permitted them access to new areas in which they had no experience. The FSLIC (the insurer of S&Ls) accentuated this risk-taking behavior because it did not peg its insurance premium to the risk profile of the S&L, nor did it close down capital-depleted institutions.

Abundant capital from S&Ls, along with favorable accounting rules (allowing shorter depreciation periods) and tax incentives to invest in commercial real estate provided by ERTA (the Economic Recovery Tax Act of 1981), resulted in a massive hotel construction boom. The Tax Reform Act of 1986 (TRA) took away the previous benefits accorded by ERTA. As Arnold (1994) states:

> The passage of TRA had an instantaneous and devastating effect on the real estate industry. Construction for many types of real estate (including hotels) virtually halted. Default rates increased to record levels. In many cases, it became apparent that many thrift institutions, lacking experience in making real estate and construction loans, had accumulated portfolios with such a large percentage of bad loans that default was inevitable.

To rectify the situation, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in 1989. The two main tasks of this act were to once again regulate S&Ls (by establishing strict capital standards) and to establish the Resolution Trust Corporation (RTC), which was designed to take over failed S&Ls and dispose of their assets.

• **Critical event 4–Shelters:** Prior to the passage of the Tax Reform Act of 1986, real estate limited partnerships were a popular way to raise capital. This was primarily done through the process of syndication. In a syndicate, a group of investors pool their capital for investment in real estate.[10] Two primary types of syndicate structures were commonly used: a single-class syndicate, in which each investor receives a pro rata ownership interest in the syndicate for a one-time investment in cash, and a multi-class syndicate, in which investors own different classes of shares.

Prior to the passage of TRA, syndicate structures were set up mainly as a tax-sheltered way to invest in hotel real estate. The reversal of the tax advantages as a result of the Tax Reform Act of 1986 resulted in an increase in depreciation schedules from 18 years to 31.5 years, investment tax credit was repealed and passive investment losses could no longer shield earned income.[11] Hotel projects, which were initiated prior to the passage of the TRA, were conceived as tax-shel-

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tered vehicles. As such the reversal resulted in an excess inventory of unprofitable hotels as the 1980s came to a close.

The 1990s are overbuilt

- **Critical event 5–Excess:** Excess room inventory, the declining value of hotel real estate, the inability of hotels to meet debt service, the S&L debacle, and a national recession all combined to shut off funding for hotel projects in the early 1990s. In particular, traditional lenders such as commercial banks, life insurance companies, and S&Ls stopped lending on hotel projects. A survey of lenders in 1990 by Hospitality Valuation Services[12] indicated that only 33 percent of lenders would consider new hotel loans. The remaining lenders stated that new hotel loans were too risky. These lenders did not plan to return to hotel lending in the near future. This was a period when lenders were more concerned with disposing off the non-performing hotels that they were forced to acquire, or working with hotel owners to restructure their loans.

The investment climate during the early 1990s is reflected in an investment survey conducted by PKF Consulting during this period.[13] (See Table 1.) The survey indicates the increased risk of a hotel investment, which is reflected in higher interest rates, capitalization rates, debt coverage ratios, loan-to-value ratios, return requirements, and other investment and lending criteria. It should be noted that although by 1992 interest rates had come down, hotel loans were still difficult to obtain. Since capital was difficult to obtain, investors had to use more of their own equity to secure loans, which lowered loan-to-value ratios.

The true nature of the real estate "credit crunch" during 1992–1993 is summed up in a research newsletter by Grubb & Ellis, a real estate advisory firm: "The truth seems to be that the crisis in real estate finance, where it exists, is not a crisis born of a shortage of loan funds. Instead it is one of confidence, on the part of both lenders and buyers, in the integrity of investment real estate in a severely overbuilt market."[14]

- **Critical event 6–Alternatives:** From 1990 to 1993, when traditional hotel financing sources curtailed their lending in the overbuilt commercial real estate market, alternative sources of financing emerged to partially fill in the gap and also take advantage of the depressed values of hotel real estate. Finance companies, charging very high rates of interest, were the main providers of capital. These companies were called "lenders of last resort" primarily because of their high financing costs. They were appropriate when funds needed were for existing properties with appreciation potential.

A review of the Crittenden Report on Real Estate Financing from 1990-1993 revealed some of the early finance companies involved with hotel lending were G.E. Capital, Heller Financial, Security Pacific, Barclays American

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Table 1
Investment criteria
(1986–1992)

	1986	1988	1990	1992
Overall cap rate	10.90%	11.10%	10.20%	11.90%
Discount rate (IRR)	13.80%	14.60%	15.0%	16.0%
Holding period (yrs)	9.3	8.8	9.6	8.4
Debt coverage ratio	1.30	1.30	1.30	1.60
Income growth rate	4.00%	4.40%	4.80%	3.80%
Expense growth rate	4.30%	4.30%	4.70%	3.60%
Interest rate	10.1%	11.6%	11.5%	8.9%
Loan to value	72.5%	73.6%	69.0%	67.4%

Source: *PKF Consulting*

and Money Store, PMC Capital, ITT Small Business Finance and Westinghouse.[15] Some of these companies, specifically the Money Store, PMC capital and ITT Small Business Finance, worked closely with the Small Business Administration as providers of SBA guaranteed commercial mortgages. While foreign commercial banks were more willing than domestic banks to provide financing to the hotel industry, even they were beginning to reduce their exposure to the industry.[16]

However, three new sources of financing emerged during this period:

- opportunity funds
- evolution of the secondary mortgage market, the securitization of commercial real estate, including hotels, and the creation of new financing structures (CMBSs, CMOs, and REMICs)
- equity real estate investment trusts (equity REITs)

Opportunity funds defined

Opportunity funds are still loosely defined in the hotel real estate industry. However, Richard G. Carlson, of Deloitte & Touche, a consulting firm, defines them as "a source of capital that has a contrarian investment focus on under-performing properties and loans."[17] Investment banks are the source of most of these funds, but in some cases the source of these funds may be a company with an opportunistic focus. These entities acquire under-performing hotel properties or other forms of real estate and loans, with the purpose of turning around the investments through repositioning, restructuring, or updating, and then waiting for the market to improve. The long-term objective of these funds is to buy properties at rock bottom prices or at times when capital is scarce, hold the investments for a few years, and then sell them at much higher prices, thus reaping huge profits on the assets.

Many opportunity funds

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started in 1990 when the Resolution Trust Corporation was disposing of the real estate assets of failed S&Ls. The majority of their early acquisitions occurred during the period from 1990–1992, generally considered to be the bottom of the real estate cycle. Investors in these funds may include institutions, such as pension funds, or high-net-worth individuals. The high yields (20 to 25 percent) and the passive nature of the investment were the primary motivations for investors in these funds. Some examples of opportunistic investing that went directly to the hotel industry can be seen in Table 2.

Generally speaking, opportunity funds are not currently very active as a funding source in the hotel industry. Those that still exist have been transformed into some form of acquisition fund, because as the prices of hotel real estate continue to rise, the opportunities to purchase at deep discounts have been reduced.

Markets are broadened

A major change in the way that commercial real estate in general and hotel real estate in particular is being currently financed is the linkage of the originators of mortgage loans with the broader capital markets. Colloquially this is also referred to the linkage of "Main

Table 2
Opportunistic investments in the hotel industry

Year	Investor	Acquisition	Value
1992	Ashford Financial and Fisher Family	143 hotels from RTC	$380 million (57 percent discount)
1993	Colony Capital, Hilton Hotels and Pan Global	Hyatt Regency Waikoloa (1,241 room resort)	$55 million (85 percent discount)
1993	KSL Recreation (Created by Kohlberg, Kravis and Roberts, the LBO firm)	La Quinta Resort and PGA West	$276.4 million (57 percent discount)
1993	Morgan Stanley Real Estate Fund	Carmel Valley Resort and Doral Telluride Resort & Spa. Red Roof Inns	N/A
1994	Ashford Financial, Fisher Family and George Soros	14 Howard Johnsons and three full-service hotels	N/A
1994	Interstone Partners (JV between Interstate Hotels and Blackstone Group)	3 full-service hotels	N/A
1994	Starwood Capital	Interests in 8000 rooms	N/A

***Source**: Robert G. Harp*[18]

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Street with Wall Street." This linkage started with the development of a secondary market for real estate. Until the 1970s, when a bank or another financial institution originated a loan, it was held on its balance sheet until the loan was paid off. The secondary market in real estate began when lenders in a particular geographical area, who had more available capital than demand for it, bought mortgages from lenders in geographical areas that had a shortage of capital. This secondary market received further impetus when the RTC in the early 1990s acquired failed S&Ls and banks and sold off nonperforming mortgages.

"Securitization" is a process by which an asset, such as a mortgage, is standardized into individual units, such as shares. An investor in these shares is a partial owner of a large pool of mortgages. The direct-sale program started to revolutionize mortgage lending by letting the mortgage originator remove mortgages off its books and sell them to another party. However, the creation of securities carried the revolution to greater heights by converting the mortgage instrument into a packaged product, which could then be sold in an organized market just like a stock or bond.

The securitization of real estate is part of the new advances in finance called "financial engineering," which John Finnerty says "involves the design, the development, and the implementation of innovative financial instruments and processes, and the formulation of creative solutions to problems in finance."[19]

The key words in the definition include creative and innovative. This type of creativity was first seen in the creation of products such as the swap, zero coupons bonds, junk bonds, and—in the case of the securitization of real estate—the first mortgage-backed securities. Starting with the first plain vanilla CMBS or commercial mortgage-backed securities, these instruments evolved into more sophisticated forms such as CMOs or Collateralized Mortgage Obligations, and REMICs or Real Estate Mortgage Investment Conduits. While similar in concept, each of these securities was designed to suit different investors and structured to improve tax efficiency.

REITs re-emerge

The securitization of real estate was one of the solutions to the problem of scarcity of capital for commercial real estate, in general, and hotels, in particular, during the early 1990s. Selling debt securities (CMBSs and CMOs) to the broader public market increased the flow of capital to the lodging industry. On the equity side, another solution to the scarcity of capital during this period was offered by the reemergence of real estate investment trusts (REITs).

The equity REITs of the 1990s were different from the mortgage REITs of the 1970s, however. While both mortgage REITs and equity REITs sold shares to individuals

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and institutions, the former were akin to banks because they used the funds to make loans, while equity REITs are akin to corporations because they are investment vehicles that use the funds to acquire or construct hotels.

The New York Institute of Finance (1988) states:

> A REIT may be a corporation, business trust, or association primarily developed to own or finance real estate. As with most corporations, a board of directors or trustees elected by shareholders sets policy and arranges the day-to-day operation of the REIT by professional managers or advisors. Persons with real estate experience, such as real estate brokers or mortgage bankers, organize many REITs. They may also be organized by commercial banks or insurance companies."[20]

Once legally organized, an equity REIT begins its existence by issuing shares of stocks. To purchase properties, equity REITs sell securities to institutional investors, issue commercial paper, and borrow from banks. Traditional equity REIT investments include the purchase of office buildings, apartments, shopping centers, warehouses, and hotels. REIT shares trade on the major stock exchanges. This provides liquidity to the holders of REIT shares.

Besides being a type of mutual fund for purchasing real estate and being organized like a corporation, REITS are also intended to be a tax "conduit" or pass-through, according to section 856-60 of the Internal Revenue Code. This means that REITs are exempt from corporate income tax as long as they distribute 95 percent of their income to their stockholders.

REITs as they are known today emerged in the early 1990s. Kimco Realty, a regional-mall REIT, was the pioneer in the field with its public offering in November 1991. In fact, the asset class that led the emergence of equity REITs was regional malls. As the operating performance of hotels improved, they became the next target for REITs.[21]

RFS Hotel Investors was the first of the modern hotel industry REITs, with its initial public offering in August 1993. Jameson Inns, Equity Inns, Winston Hotels, Felcor Suites, and Innkeepers USA followed in 1994, and Starwood Lodging Trust in 1995. Arnold states that the resurgence of equity REITs in the 1990s can be traced to three primary motivations:[22]

- As the traditional financing sources such as banks, S&Ls, and insurance companies stopped funding commercial real estate (including hotels), a vacuum was created. As a result, real estate developers, managers, and owners saw REITs as a means to raise capital and finance growth.
- The demand for REITs also came from institutional investors such as mutual funds and pension funds. These investors wanted to continue investing in real estate but needed an exit strategy. Securitization and investment in REIT

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shares provided the ideal solution.

• The Tax Reform Act of 1986 took away the tax shelter advantages of investing in commercial real estate, including hotels. At the same time, the tax shelter partnerships and syndicates that were formed prior to the passage of the act were no longer the ideal business format for investing in real estate. Furthermore, there was an excess inventory of real estate, resulting in unprofitable operations and the eventual decline in the value of real estate, including hotels, by the early 1990s. During this period, many investors wanted to purchase hotels and other real estate because of these reduced values. Since traditional capital sources were not available, and the previously used limited-partnership formats were not suitable for raising capital, REITs became the vehicle of choice for raising capital to make real estate purchases. In fact, many of the early hotel REITs got their start by buying hotels in this overbuilt environment at 50 cents on the dollar.

Three forms of REITs exist

There are typically three forms of REIT structures. In the traditional structure, the REIT owns the real estate (hotels, apartments, and office buildings), and these are then leased to a lessee, who arranges management and franchise agreements. A paired-share REIT pairs a REIT with a C-Corp (public corporation). This combined company is then traded as one. This integrated structure is advantageous to investors because the REIT leases the hotel properties to the C-Corp, which then is the operating company and the franchisor; this structure avoids what is termed in the industry "leakage," meaning loss of income due to the management contract and franchise agreement, which otherwise are typically given to another company.

As a result of the IRS Restructuring Bill passed by the U. S. Congress in August 1998, paired share REITs will not enjoy the tax advantages associated with their unique structure for future acquisitions. In anticipation of this announcement, Starwood Lodging, the largest lodging equity REIT, gave up its paired share status and converted to a tax paying C-Corp.[23]

The third type of REIT, similar to a paired-share REIT, is known as a paper-clip REIT. The main difference between the two is that paired-share REITs trade the shares in the REIT and the C-Corp as one integrated share, while a paper-clip REIT trades the shares in the REIT and the C-Corp separately; however, the REIT and the C-Corp have common management control.

From 1994 to 1998, REITs dominated the lodging industry as owners of hotel properties and companies. The superior performance of their stock and the tax advantages enjoyed by their structure attracted public capital to fuel their growth. Table 3 outlines the lodging REITs and their acquisitions in 1997. Paine Webber reported that REIT stocks were down by about 19 percent in the

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first seven months of 1998.[24] The direct impact of declining stock values for lodging REITs made it difficult for them to find financing to fuel their growth during this period. This trend continued until the end of 1999, in which year REITs provided a total return of –16.5 percent.

However, REITs rebounded in 2000 when total returns from January to September have been over 36 percent.[25] While the total number of REITs is about the same, (as of the August 2000 there were 16 hotel REITs),[26] the total inventory of rooms they control and overall market capitalization has considerably reduced since the their peak in 1997. As of September 11, 2000, lodging REIT market capitalization was approximately $8 billion.[27]

In December 1999, the REIT Modernization Act was signed into law. As REITs have evolved over the years into service-related real estate owners, the new act will allow them to create subsidiaries, which can provide value added services to their lessees, hitherto disallowed. Furthermore, the new act is expected to reduce some of the tax disadvantages of the present REIT structure.[28] The new law goes into effect in 2001.

Events impact capital

In the past 30 years various interrelated critical events in the external environment impacted the availability of capital to the lodging industry. In the 1970s inadequate stock returns coupled with high inflation led to the creation of the Mortgage REIT. Monetary policies enacted in the early 1980s to combat inflation led to interest rate increases, which in turn resulted in a competitive disadvantage for depository institutions. To rectify the situation, deregulation acts were passed which increased the scope of lending activities for savings and loan institutions. Lacking experience and proper

Table 3
Biggest REIT deals of 1997

Acquirer	Target	Amount in $millions
Starwood Lodging	ITT Corp	$17,000.
Patriot American	Interstate Hotels	2,100.
Starwood Lodging	Westin Hotels	1,570.
Patriot American	Wyndham Hotel Corp	1,100.
Patriot American	Carnival Hotel and Resorts	485.
Starwood Lodging	HEI Hotels	327.
Patriot American	WHG Resorts & Casinos	300.
Patriot American	California Jockey Club	238.
Patriot American	Grand Heritage Hotels	22.

Source: *Coopers & Lybrand*

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credit checks, unrestricted capital flowed to the lodging industry. In conjunction with capital availability, favorable real estate taxation laws provided further incentive to invest in hotel real estate. This potent mixture resulted in a hotel construction bubble, which burst at the end of the 1980s; the "needle" in this case was the removal of real estate tax incentives, passage of the Tax Reform Act of 1986, and a general recession engulfing the nation. As a result the lodging industry was clearly overbuilt going into the 1990s.

The 1990s were a time of tremendous change with regard to financing the lodging industry. In many ways changes in the past decade were a response to events of the 1980s. The decade began with a period of capital scarcity due to excesses of the 1980s. In response to this shortage, investment banks created financially-engineered products which included the various debt securities using mortgage as a collateral. In addition, equity capital was available with the emergence of the REIT.

Finance is redesigned

In the 21st century, the interrelated events and lessons learned in the past three decades have restructured capital sources and have redesigned lodging industry finance in many ways.

Formerly, capital sources to the lodging industry were primarily private; now both public (issuance of debt and equity securities) and private (direct investment in hotel real estate or commercial mortgage) sources of capital are available to the industry. As the availability of public capital from both debt and equity slowed down in 1999, so did the room starts. It is interesting to note, however, that when the public capital markets started to decline in 1998, it presented opportunities to the traditional lenders (commercial banks and life insurance companies) who stepped forward to fill the vacuum. This is an interesting change from financing earlier in the decade at which time traditional lenders stopped financing the lodging industry and public capital markets filled the vacuum.

In this current financing environment, where capital is available from both public and private sources, the financing environment may be described as one of conservative competition between the various sources of capital. This is reflected in the changes in the lending terms. While interest rates have declined from the mid-1990s, as compared to the 1980s, lenders are conservative in terms of their debt coverage ratio and loan to value ratios, which are more stringent as compared to the 1980s.

With the introduction of securitization of debt and equity, hotel real estate investments do not carry the same amount of risk. Instead of investing in bricks and mortar, which are not liquid, investors have a more liquid investment with a better exit option. The ultimate impact of these creative instruments was to bring flexibility to real

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estate investing, which makes investing in real estate appeal to a wider range of investors.

With the introduction of securitization, a new organization—the rating agency— entered the hotel-financing arena in the 1990s. One of the main reasons for the over-building of the 1980s was a breakdown in loan quality by the banks and thrifts. As each competed to make loans and earn up-front fees, their lending criteria began to be less strict, which resulted in poor-quality loans. The rating agencies are expected to prevent an excess flow of capital to the lodging industry as they evaluate a potential issuer's credit quality (default risk) and assign a rating based on the issuer's business and market sector (hotel, regional mall, warehouse), management asset quality, and other financial measures such as profitability, size, and leverage.[29] Therefore, it is expected that the securitization process and the role of the rating agencies will keep capital flows in check.

Financing of the hotel industry changed from being merely mortgage lending to what is called "credit-based financing." In this lending environment, loans are more akin to corporate loans, in which the borrower is treated as a business. "Credit-based financing takes into account not just the value, cash flow, and risk profile of a single property, but rather the borrower's overall credit, based on an evaluation of all the borrower's assets and operations."[30]

The profile of equity investors in the 1990s has changed from those in the 1980s. While limited partnerships and syndication were the dominant source of equity capital in the 1980s, the 1990s started with opportunity and acquisition funds buying depressed hotel real estate; from the mid-to-late 1990s, hotel companies and REITs became the major source of equity capital. Today there are 29 public hotel companies (C-Corps) and 15 equity REITs that raise capital through the issuance of equity and debt. While this activity slowed down in 1999, it still remains at much higher levels than in the 1970s and 1980s.

As the financial services industry continues to consolidate and the last vestiges of the Glass-Steagall act of 1933 continue to be dismantled, the financial services industry will have more flexibility in their decision to lend and invest in the lodging industry. This is expected to positively impact capital flow to the lodging industry.

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