

1-1-2004

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Recommended Citation

Singh, A.J. (2004) "Securitization of Lodging Real Estate Finance," *Hospitality Review*: Vol. 22: Iss. 1, Article 7.

Available at: <http://digitalcommons.fiu.edu/hospitalityreview/vol22/iss1/7>

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Abstract

In the early 1990s, the U.S. lodging industry witnessed a severe shortage of debt capital as traditional lenders exited the market. During this period hotel lending was revolutionized by the emergence of real estate debt securities. The author discusses key factors which have affected the growth and development of commercial mortgage backed securities and their changing role as a significant source of debt capital to the lodging industry.

Keywords

A.J. Singh, Finance

Securitization of lodging real estate finance

by A.J. Singh

In the early 1990s, the U.S. lodging industry witnessed a severe shortage of debt capital as traditional lenders exited the market. During this period hotel lending was revolutionized by the emergence of real estate debt securities. The author discusses key factors which have affected the growth and development of commercial mortgage backed securities and their changing role as a significant source of debt capital to the lodging industry.

An historical review of financing in the lodging industry indicates a cyclical pattern. During certain periods, capital has been readily available, while during other periods the industry has suffered from a dearth of capital.

In the 1980s, for example, excess capital availability resulted in a period of overbuilding, whereas the early 1990s were characterized by a financing drought. During the cyclical downturn and retrenchment of traditional lending sources, alternative sources of financing emerged to

partially fill in the credit gap and take advantage of the depressed values of hotel real estate. In particular, new debt instruments such as commercial mortgage backed securities (CMBS), collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs) emerged during this period as new investment vehicles which revolutionized the way in which commercial real estate is financed.

Today capital sources for mortgage debt are more than four times the size of equity markets, and as of September 2001, non-government CMBS issuance was at \$247.8 billion, constituting about 15 percent of the \$1.676 trillion debt market.¹ Undoubtedly, CMBS's have become a major source of capital for commercial real estate.

Historical approach taken

Given the importance of debt securities in financing commercial

real estate, the study was designed to comprehensively review and analyze the evolution of mortgage-backed securities which emerged in the 1990s to finance the lodging industry. During each phase of their evolution, the study will highlight specific factors and events which have shaped the innovative debt instruments and their market. Furthermore, the study discusses the outlook of the CMBS market and the impact of securitization on real estate finance.

This is historical research which relies upon secondary literature, including texts, relevant articles, research studies, and other significant documents from each of the periods studied. Commenting on historical research, Baumgartner states that "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."¹

Topic is not new

The need to create liquidity and a secondary market in commercial real estate is not new. Some of the early initiatives in this area included the "mortgage backed bonds of the 1920s, the real estate (mortgage) trusts of the early 1970s, the industrial revenue bonds and mortgage participations and the syndications of the 1980s."²

As interest rates skyrocketed in the late 1970s, capital flow to commercial and residential mort-

gages ceased because portfolio lenders viewed illiquid real estate loans unfavorably. To resolve this capital crisis, the federal government intervened by setting up federal government agencies such as the Federal National Mortgage Association (FNMA or Fannie Mae), Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac), and Government National Mortgage Association (GNMA or Ginnie Mae). They began purchasing mortgages from lenders such as banks and life insurance companies, and issued mortgage-backed securities to investors. Investors were mainly attracted to these securities because of the default guarantees provided by the government agencies.

The involvement of the federal government on such as large scale played a critical role by providing early momentum which helped establish the secondary mortgage market. In the 1970s this direct-sale program, as it was known, was further extended by the creation of mortgage-backed securities. "This was the beginning of one of the most important developments in real estate lending that has occurred since the invention of the mortgage itself—the securitization of mortgage debt."³

Commercial securities sold

The 1981 Economic Recovery Tax Act (ERTA) real estate tax incentives, declining interest rates, and deregulation of the savings and loan association created a conducive setting for the

development and sale of commercial securities. As capital flow increased for commercial real estate, a few insurance companies, banks, and savings and loans started to utilize commercial mortgage originators, albeit slowly. 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. By 1985, the total issuance of commercial mortgage securities was \$2.7 billion, growing to \$8.3 billion by 1991.

While the size of this capital market was relatively small in 1980, and growth rate very slow, significant developments during this period helped organize this emerging market for commercial real estate debt securities. First, investment banks such as Salomon Brothers, First Boston, Morgan Stanley, Drexel, and others began to take notice of this market and used their expertise in the residential secondary market to design similar issues for commercial securities. Second, as banks became involved in the sale of these securities they created multiple financial securities (products which they could sell) based on the risk/return appetite of the investors, called "tranches," which refers to the multiple risk classes in a commercial real estate loan pool; this further deepened the market for debt securities. Third, the creation of tranches required

the assignment of a risk rating to each class; as a result, Standard and Poor's began to assign risk ratings during this period. Thus began a period of formal analysis and evaluation, which provided investors with information and transparency about these new financial products.

Finally, the Tax Reform Act of 1986 ushered in a new era of securitization by creating Real Estate Mortgage Conduits (REMICS). This new structure facilitated the pooling and securitization of mortgages, broadened the appeal of the mortgage security to a wider group of investors, and gained preferred tax treatment for both issuers and investors.

1990s brings maturity

The Tax Reform Act of 1986 directly contributed to the development of the market for commercial mortgage backed securities (CMBS) in another significant way. The legislation made investment in commercial real estate less attractive by reversing tax and other accounting benefits accrued from previous legislation. Hotel and other commercial real estate projects initiated before the passage of the TRA were conceived as tax-sheltered vehicles which now became unprofitable and resulted in an overbuilt commercial real estate industry by 1989.⁴

As the industry collapsed under the burden of highly leveraged real estate assets, lenders foreclosed on numerous delinquent loans and were consequently

saddled with a large portfolio of non-performing loans. Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act in 1989 (FIRREA), which chartered the Resolution Trust Corporation to help liquidate the savings and loan loans and real estate owned properties. Investment banks were hired by the RTC to underwrite and dispose these non-performing loans. By 1993, the RTC had disposed of approximately \$14 billion in commercial real estate assets through the CMBS market.

A variety of factors made the CMBS product attractive to institutional investors and lenders during this period. Most traditional lenders facing recent losses from direct lending to commercial real estate were more comfortable with the liquidity of a real estate security. Furthermore, FIRREA imposed stricter lending regulations that required them to maintain higher loan loss reserves and provided traditional lenders, such as life insurance companies a reason to shift debt capital to CMBSs. The impact of these factors resulted in a dramatic growth in the issuance of CMBSs from 1990 to 1992 (See Table 1). The confluence of these factors resulted in a significant transformation of the secondary market for securitized debt in the early 1990s; as a result, by 1993 the total issuance of CMBSs increased to \$17.5 billion.

New period begins

Weak real estate markets and the RTC's need for an efficient loan exit strategy drove the CMBS loan pools in the early 1990s.⁵ By 1993, the original pools of non-performing loans dried up and issuers needed a fresh allotment of loan pools to sustain the emerging market for CMBSs. Therefore, beginning in 1993, securitization entered a new period called "conduit lending."

Working with correspondent mortgage lenders (the conduits), investment banks purchased mortgages expressly for creating debt securities for sale in the secondary market. From 1993-95, loan conduit lenders and investment bankers actively solicited and searched for mortgages and "manufactured" them into securities for sale in the secondary market. Their efforts sustained the CMBS market, which grew by 40 percent, for the next two years (See Table 1). Whereas CMBS was a "problem solving" tool in the early 1990s, it now became an "opportunity tool."⁶ The conduit market slowed down in 1995 as portfolio lenders such as life insurance companies returned to real estate capital markets, making direct commercial real estate loans, and competed directly with issuers of debt securities.

With a growing economy and low interest rates, there was a strong interest in real estate investments from 1996 to 1998. This period also saw strong growth and maturation of the CMBS market, with a cumulative growth of 183.5

Table 1
Total issuance of commercial mortgage backed securities
1984 to 2003 (August 29)

Year	Total Issuance (Billions)	Growth Percentage
1984	\$0.2	
1985	2.7	1250%
1986	1.1	(59.25)
1987	0.9	(18.2)
1988	1.2	33.0
1989	1.7	42.0
1990	4.8	182.3
1991	8.2	70.8
1992	14.0	70.7
1993	17.5	25.0
1994	20.2	15.4
1995	18.9	(6.0)
1996	29.7	57.1
1997	44.0	48.2
1998	78.4	78.2
1999	67.9	(13.4)
2000	61.0	(10.2)
2001	97.0	59.0
2002	94.9	(2.16)
2003 (Aug 29)	53.7	

Source: Commercial Mortgage Alert

percent from 1996 to 1998 (See Table 1). The CMBS market started to slow down after reaching a market peak in 1998 with a total issuance of \$78 billion. From 1996 to 2000, the lodging industry witnessed its strongest performance in terms of demand, revenue, and profitability growth, and growth through mergers and acquisitions. Consequently, during the period from 1997 to 1999 the percentage of hotel loans as a

component of securitized loans also increased, with a peak in 1998 of 12 percent (See Table 2).

Market in 2000 declines

The new millennium saw a relatively softer CMBS market in the United States. Total issuance that year was \$61 billion, as compared to \$67 billion in 1999, with total hotel issuance of \$4.7 billion as compared to \$6.7 billion in

Table 2
Issuance of hotel CMBS
1995-2002

Year	Total Hotel Issuance (Billions)	Hotel CMBS Percentage To Total Issuance
1995	\$0.0	0.0%
1996	.7	2.3
1997	.4	9.4
1998	9.7	12.3
1999	6.7	9.9
2000	4.7	7.7
2001	5.9	6.0
2002 (Q1)	.5	3.9

Source: Commercial Mortgage Alert

the previous year. A lack of properties in need of refinancing combined with rising interest rates were two factors which influenced the low CMBS volume in 2000. Specifically, as of August 2000, CMBSs backed with hotel and retail mortgages waned in popularity.⁷ Nevertheless, in the more recent environment of 2001-02, CMBSs preserved their status as a mature financing vehicle and an important source of debt capital for the commercial real estate industry.

Two issues have affected the current environment of the CMBS marketplace. First, the terrorist attacks on September 11, 2001, accelerated the already weakening economy and real estate markets. Second, while the "event crisis" generated by the attack affected all property types, the effect on certain property types, such as hotels, was much more catastrophic. These two

combined effects of the terrorist attacks resulted in a reduction of CMBS issues in 2002. The outlook in 2003 is more positive, with the issuance as of the first half of 2003 at \$41.22 billion as compared to \$31.74 billion for the same period last year, an increase of about 30 percent. Commercial mortgage backed securities spreads also continued to narrow, a further reflection of the shortage of new issues (See Table 3).

Downgrades expected

Most market analysts expect to see more downgrades versus upgrades as rating agencies take stock of the current environment and as delinquency rates on loans rise, resulting in loan defaults. Ninety percent of the participants responding to a *CMBS World* survey expected delinquency rate to rise. The most pessimistic projec-

Table 3
Commercial mortgage backed securities
trading spreads above 10-year treasury bonds (in basis points)
1998-2002

Class	1998	1999	2000	2001	2002
Returns of 10-year treasury bonds	4.87%	6.44%	5.11%	5.05%	3.81
CMBS trading spreads	1998	1999	2000	2001	2002
AAA	+140	+124	+147	+130	+93
AA	+165	+144	+162	+150	+107
A	+190	+164	+177	+175	+122
BBB	+270	+210	+235	+225	+183
BBB-	+350	+295	+280	+265	+224
BB	+575	+525	+525	+575	+450
B	+825	+800	+815	+1000	+950

Source: Morgan Stanley Dean Witter

tions were 5 percent with optimistic estimates being 1.22 percent.⁸ Compared to 1.6 percent in 2000 and .67 percent in 1999, this is a monumental increase. Examples of recent downgrades by rating agencies Moody's and Fitch's default projections outlined in Tables 4 and Table 5 illustrate the current mood of CMBS analysts. The downgrades in Table 4 were loans collateralized by five upscale Hilton hotels, a segment which was most impacted by the recent down-

turn in travel. Interestingly, recent survey results reveal that CMBS market participants were more concerned about limited service hotels versus full-service hotels with regard to loan originations and inclusion in CMBS loan pools.⁹

While the short term forecast for the lodging industry is pessimistic, industry analysts are more confident of growth and recovery in 2003. In a recent interview, Jacques Brand, managing director with Deutsche Bank,

Table 4
Moody's downgrade of HHPT 2000-HLT
March 14, 2002

Class	To	From	Notches
C	Aa3	Aa2	1
D	A3	A1	2
E	Baa1	A2	2
F	Baa3	A3	3

Source: Moody's, Merrill Lynch

stated, "There is virtually no hotel supply coming online in the late 2002 and certainly not any in 2003. Therefore, with virtually no new supply and with demand historically growing with GDP, the industry should be poised for growth in 2003. As the U.S. comes out of this economic downturn over the next year, I expect the lodging sector to fare extremely well."¹⁰

The results of Table 5 indicate an overall increase in expected defaults and delinquencies in the CMBS portfolio. Not surprisingly, hotels are expected to default at a higher rate than the core properties (4.0 percent versus .60 percent). The expectation of increasing defaults in the hotel sector partly explains the reason why CMBS originations and issuances are low this year. In a recent interview, Arthur Adler of Jones Lang LaSalle Hotels said that lenders are having difficulty underwriting the hotel industry based on the uncertainty in their future performance as an aftermath of September 11.¹¹

Analysts at rating agencies such as Moody's and Fitch are being

extremely cautious and conservative in including hotels in the loan pool and rating hotel mortgages. Moody's believes that it might take a year or more for travel patterns and lodging demand to reach normalized levels. Additionally, in their opinion, recovery will not be uniform but based on the market segment and location.¹²

Conservatism is present

In a similar vein, Fitch plans to take a very conservative approach in underwriting hotel assets by reducing the 12-month trailing REVPAR by 20 percent. Furthermore, their analysis will inflate fixed and variable expenses in light of recent increases in costs. In particular, the cost for insurance for commercial properties has risen since September 11. Hotels in particular expect these costs to increase from 15 to 50 percent, depending on the line of coverage. Referring to insurance costs, Tony Rodolakis, vice president of risk management for Starwood Hotels & Resorts, recently stated, "The biggest increases are on the prop-

Table 5
Default/delinquency rate outlook
2000 vs. 2002

Property Type	2000 Default Rate	September 2001 Delinquency Rate	2002 Default Rate	2002 Delinquency Rate
Core*	0.40%	0.80%	0.60%	1.55%
Hotels	1.50	2.50	4.0	7.50
Healthcare	3.50	9.50	3.50	13.88

*Core properties (office, retail, multi-family and industrial)

Source: JP Morgan and Fitch

erty side. We are in the midst of renewing now and anticipate a 50 percent increase."¹⁴

Losses less severe

While CMBS issuances are expected to pick up in the second half of 2002, the outlook for the balance of 2002 is lower than 2001 levels. This is the combined result of rising delinquency rates, concern over the health of the hotel, health care, and retail sectors, potential for increasing interest rates, decline in loan maturities, and the threat of new terrorist activities. Overall, the CMBS issuances and secondary market volume should remain healthy throughout the year, responding to events as they unfold in an orderly manner.¹⁵

Key results from *CMBS World's* recent survey further strengthen this expected outlook. Survey participants indicated that losses will be less severe than the last recession, with more than 56 percent of the participants believing that the CMBS market will survive the economic downturn and actually emerge stronger; another 33 percent believe that it will survive but remain the same. As testimony to the purported market discipline imposed by the securitization process, two thirds of the respondents indicated that underwriting on deals would be tougher, with a strong consensus on this question among investment bankers, investors, originators, and rating agencies.¹⁶

Finally, as the CMBS market continues to evolve, three events

will affect the future development of the secondary market. First, since November 2000, new ERISA (Employment Retirement Income Security Act) legislation has allowed pension fund managers to invest in CMBS tranches rated BBB or higher. With this change, the eligible securities for investment increased by about 25 percent, which in turn may increase the capital flow into the CMBS market. Second, recent analyst research has identified a strong correlation between the movement of CMBS spreads and spreads of similar maturity interest swaps. Using this information, a portfolio manager could "reduce interest rate risk on warehoused loans by building hedge positions as the warehouse portfolio grows, then unwind the hedge upon issuing the CMBS securities collateralized by the loans."

Finally, the biggest issue in today's market is the lack of buyers for the lowest CMBS tranches, termed as "B-piece buyers." Since there are very few firms which purchase these lowest rated and highest risk tranches, they exert a strong influence on the process of securitization. They have a strong voice in determining which loans are included in the securitized pools, and can demand the removal of loans which they feel are too risky. In effect, their actions raise the quality of tranches they purchase and increase the overall quality of the security issue. In the future, the extent to which the CMBS issuers are successful in retaining and attracting more firms

to absorb these lower-rated tranches, the secondary market will remain flat, grow, or decline.¹⁷

As the 21st century progresses, the interrelated events and lessons learned in the past decades have restructured capital sources and redesigned lodging industry finance in many ways. With the introduction of new sources of finance, the lodging industry is no longer dependent solely on the traditional lending sources such as commercial banks and life insurance companies. Securitization created a new financing vehicle by introducing a public source of capital. With the creation of new and alternate sources of financing and resultant increase in competition within the capital markets, borrowers may benefit by a reduction in the cost of capital. While competition may favorably impact the cost of capital for borrowers, they are now faced with more stringent underwriting terms with the introduction of rating agencies that critically analyze and rate securities based on the quality of the mortgage collateral. This, however, is beneficial to the industry as a whole by introducing market discipline, which should prevent the overbuilding excesses of the 1980s.¹⁸

Base is broadened

With the introduction of tradable securities, the investor base for commercial real estate has broadened. Previously, capital sources for the industry were restricted to those who were knowledgeable

about a particular property type, such as hotels. With the introduction of securities backed by a diversified asset base and rated to suit the risk tolerance of investors, knowledge of hotel industry dynamics is not a prerequisite for investment.

As real estate and public markets become more integrated, capital market factors exogenous to the property markets have an impact on the flow of capital to real estate. For example, the Asian currency crisis disrupted fixed-income markets and triggered widening CMBS spreads in the fall of 1997. None of these events had anything to do with local property market dynamics.¹⁹ Conversely, however, positive global market factors will result in increased capital flow to real estate.

When hotel borrowers are not able to meet their payments, they were previously accustomed to dealing with their neighborhood banker who worked with them based on past relationships. However, with securitization, pooling and servicing agreements transfer the administration of delinquent loans to special servicers who then will decide in favor of a workout or foreclosure, purely on the merits of the case.

After receiving their early impetus in the 1970s with the involvement of the federal government in providing liquidity to the residential capital markets, the secondary mortgage markets continued to grow through the 1980s with the involvement of

investment banks that engineered specific investment bonds to suit the commercial investor. As traditional lending sources reduced significantly, the CMBS markets grew rapidly and matured in the 1990s. While the growth in issuance of CMBS offerings has slowed in the past few years, they are recognized as a significant financing vehicle comprising 15 percent of the market for debt capital.

The increased competition, which this new source of financing brought to the capital markets, has resulted in lower financing costs for hotels, while exposing them to changes exogenous to the hotel property markets, as well as to more merit-based foreclosure risks.

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