Public Involvement In Hotel Financing

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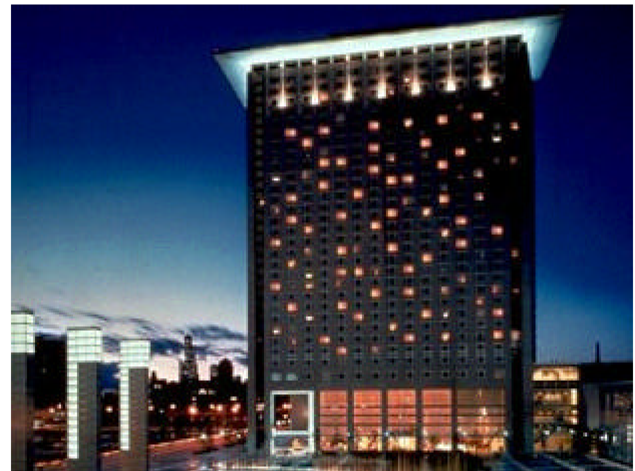
Public sector involvement in hotel projects is becoming increasingly common as the high cost of development and limitations on the availability of capital for new hotel investment limits the feasibility of conventional financing. The presence of a hotel property in a community may stimulate local economic activity by attracting new visitors and events as well as accommodating business travel in the region. As most communities desire the economic impact of group events and the spending of the visitors they attract, many are providing public subsidies to projects that are not feasible on a purely private basis.

Public involvement in hotel development may be divided into two general categories: 1) public/private partnerships, and 2) public financings. In a public/private partnership, the hotel is typically owned and developed by the private partner, and public involvement takes the form of a public subsidy or "bridging the gap" between the cost of constructing and financing a hotel project and the combination of equity and loans a private developer is able to secure for the project. In the category of public financing, the sponsoring municipality issues tax-exempt debt to cover the cost of constructing and financing the hotel project, accessing the municipal bond market rather than conventional sources of hotel debt and equity. The net operating revenues of the hotel are pledged as the first source of funds for the repayment of the bonds. A comparison of the two approaches to hotel financing is presented in the table on the following page.

Trends in Public/Private Partnerships

The amount of public support required to finance a hotel through a public/private partnership is dependent upon the gap between the capital cost of the project and the amount of debt and equity that can be raised in the capital markets.



McCormick Place Hyatt Hotel *– The financed in 1996 by the Metropolitan Pier and Exposition Authority in Chicago, Illinois with tax exempt debt using a public ownership model..*

The financial feasibility of a hotel depends on several factors, including: Estimated net operating income

- Construction cost
- Interest rate levels
- Availability of equity
- Seasonality and volatility of the local hotel market
- Other factors that affect the allocation of investment risk and return

Comparison of Hotel Financing Approaches

Comparison of Hotel Financing Approaches

Issue	Public/Private Partnership	Public Financing
Ownership	A privately owned single purpose entity, typically a limited liability corporation ("LLC") holds title to the hotel. This owner is responsible for engaging the developer and operator.	A publicly controlled entity, that may be an agency of the sponsoring municipality or a not-for-profit corporation, holds title to the hotel. Through the ownership entity, the sponsoring municipality is responsible for engaging the hotel developer and operator. Various forms of non-profit ownership are possible under IRS rules, including a "63-20 corporation" under Section 115 of the IRS code or a 501(c)(3) under IRS Ruling 57-128.
Operations	A hotel management company is engaged to operate the hotel. It may be managed by a major hotel brand company (e.g. Marriott, Hilton, Hyatt or Starwood) or by a third party operator with a franchise agreement to brand the property. Compensation is typically based on a percentage of gross revenue, net operating income or both.	A hotel management company is engaged to operate the hotel under a Qualified Management Agreement ("QMA") that conforms to Internal Revenue Service regulations. The maximimun length of a QMA is 15 years, which is shorter than the term of operating agreements for privately owned hotels. Compensation to the operator must be on a fixed fee basis rather than as a percentage of revenue or net operating income. Most publicly financed hotel deals have been managed by a major hotel brand company. Franchise agreements are less common because hotel brands are reluctant to agree to fixed franchise fees as is required in a QMA.
Financing	Privately owned hotels are financed with a mix of debt and equity. In the current markets, lenders will only provide debt for 50% to 60% of the project cost, and equity investors must provide the balance of funding. Typically the developer obtains a variable rate construction loan which is later taken out with a permanent financing at the time hotel operations stabilize. Equity investment is obtained by selling stock in the LLC, and the development group may have a controlling interest in the LLC. In public/private partnerships a governmental entity may also provide an equity contribution to the project with little or no expectation of getting a cash return on that equity investment.	Publicly owned hotels are all debt financed through the issuance of municipal bonds. Some of the bonds may be "non-recourse." That is, the revenues of the project are the only source of payment and credit for the bondholders. To be rated as investment grade, debt service coverage on non-recourse debt must exceed 2.0 times debt service. Typically, net operating income is not sufficient to secure enough non-recourse debt to pay for the project. Consequently, the sponsoring municipality may provide credit enhancement. This usually involves some form of pledge to pay debt service in the event that hotel revenues are insufficient. The development team may be required to hold some subordinated debt, but this debt is typically less than 10% of the total financing.
Cost of Funds	Interest rate levels on permanent debt may range from 8% to 10% in the current financial markets. Private equity investors may require from 10% to 15% cash return on equity.	In today's financial markets, non-recourse debt carries interest rate levels of 7% to 7.5%. Interest rate levels on the credit enhanced debt depends on the credit of the sponsoring municipality. A AAA-rated municipality may achieve an interest rate level of 4.5 to 5.5%. Subordinated debt carries negotiated interest rate levels in the range of 9% to 12%. Consequently, the cost of funds for a publicly developed hotel are substantially less then from privately financed hotels.
Forms of public subsidies	Public subsidies may take the form of land contributions, infrastructure and parking development, tax abatements, tax turn backs, and cash subsidies.	As in public/private partnership deals, public subsidies may take the form of land contributions, infrastructure and parking development, tax abatements, tax turn-backs, and cash subsidies. In addition, credit enhancing debt is a form of local public subsidy. Typically one objective of of a public financing is to reduce the level of public equity contribution as compared to a public/private partnership.
Claim on income and the asset.	The investors in the LLC typically claim the residual project income from operations and the sale of the asset. Municipalities mass negotiate a share of project income in exchange for providing public subsidies. Developers often negotiate a "preferred return."	The sponsoring municipality owns the residual project income from operations and the sale of the asset.

Source: HVS

Public/private partnerships in hotel development are more frequently used in smaller projects in which a reasonable amount of public equity investment can make the difference between a feasible and infeasible project. For many smaller projects the potential benefit of new economic and fiscal impacts are modest and only justify a limited investment on the part of the sponsoring municipality. The recently approved project in Huntsville, Alabama is an example of a tertiary market in which city leaders chose to engage a private developer to construct a $40-million, 300-suite Embassy Suites Hotel adjacent to the convention center. The city offered to provide attached parking for the hotel, related infrastructure development, a favorable land lease and access to meeting space in the convention center to attract a hotel developer.

Omaha Hilton Hotel *– This 450-room property was the first to be financed after September 11, 2001. Its financing was supported by an appropriations pledge from the City.*

In other communities a public/private partnership is the only politically acceptable form of government support. Often other local hotel owners demand limits on government support of potentially competitive products. This is particularly true in stressed hotel markets and in situations where the proposed new property does not induce significant amounts of new demand. A recent example of this dynamic occurred in the Town of Normal, Illinois where local efforts to publicly finance a hotel and conference center were rejected in an advisory referendum. Consequently, the Town is proceeding with a privately owned project of a more modest scale and brand. In Naperville, Illinois, which is in suburban Chicago, hotel market stressed by the loss of transient hotel demand generators from the technology sector, government leaders choose to encourage full-service hotel and conference center development, but to limit public investment of only project related hotel taxes.

In North Carolina, legal barriers prevent the public ownership of hotels required for a tax-exempt municipal financing. Consequently the Charlotte headquarters hotel is privately owned and financed but the capital cost of public areas of the hotel (e.g. meeting and function space) were financed through a lease arrangement with the City. The project being planned in Raleigh, North Carolina would be financed using a similar structure.

Historical Trends in Publicly Financed Hotels

Most large, full-service hotel projects require extensive public support. Only three hotel properties of 700 rooms or more outside of the gaming and resort industries have been constructed without some form of public support since 1994. The table below shows the recent developments of hotel properties of 700 rooms or more and their method of financing.

Since 1994, the only hotel projects of 700 rooms or more outside of the gaming and resort industries that have been privately financed are in New York City, where high occupancy and room rates can support new development. All other developments have required some form of public support, either through public financing and ownership or a public/private partnership.

The table below lists recent hotel projects under development or completed and financed in whole or part through the issuance of municipal debt.

Recent Developments of Hotels with 700 or More Hotel Rooms

	Hotel Brand	No. of Rooms	Year of Opening
Public Financing			
Denver, CO	Hyatt	800	2005
Austin, TX	Hilton	800	2003
Houston, TX	Hilton	1,200	2003
St. Louis, MO	Renaissance	1,100	2003
Chicago, IL	Hyatt	800	1998
Public/Private Partnership			
Orlando, FL	Rosen Centre	1,408	1995
Jacksonville, FL	Adam's Mark	966	2001
Charlotte, NC	Westin	700	2003
Baltimore, MD	Marriott	750	2001
Philadelphia, PA	Marriott	1,408	1995
Private Financing			
New York, NY	Westin	863	2002
New York, NY	Ramada	1,005	1994
New York, NY	Hudson Hotel	802	2000

Source: Smith Travel Research/PiperJaffray

A change in tax law in 1996 first allowed the public financing of hotels with municipal debt. The first project completed under these new rules was the Hyatt at McCormick Place in Chicago. The Chicago project and the Sheraton in Sacramento were the first and only projects to be financed with all non-recourse debt. That is, the only source of payment and credit for the bond was the net operating income of the project. Less favorable credit markets, decreasing access to capital, and generally poorer performance of hotel markets since 2001, forced all subsequent projects to be credit enhanced. That is, the sponsoring municipality or another third party entity guarantees that at least a portion of the debt services will be paid if hotel net operating income is not sufficient.

The most frequently used source of credit enhancement is a pledge of a specific revenue stream such as non-project related hotel taxes to repay debt. Most municipalities seek to balance their level of financial risk with the market demands for a level of public financial commitment that makes the project feasible. Risk mitigation strategies include the following:

Publicly Financed Hotel Projects

City	Hotel Brand	No. of Rooms	Par Amount of Bonds (millions)	Year of Opening
Austin, TX	Hilton	800	$ 265.11	2003
Bay City, MI	Double Tree	160	15.50	2004
Cambridge, MD	Hyatt	400	134.17	2002
Charlotte, NC	Westin	700	16.00 [1]	2003
Chicago, IL	Hyatt	800	127.42	1998
Denver, CO	Hyatt	1,100	354.80	2005
Houston, TX	Hilton	1,200	310.00	2003
Miami Beach, FL	Loews	790	25.00	1998
Myrtle Beach, SC	Radisson	404	64.35	2003
Omaha, NE	Hilton	450	102.97	2004
Overland Park, KS	Sheraton	412	92.14	2002
Phoenix, AZ	Sheraton	1,000	350.00	2008
Sacramento, CA	Sheraton	500	92.80	2001
San Diego, CA	Hyatt	1,200	364.74	2003
Schaumburg, IL	Renaissance	500	239.32 [2]	2006
St. Louis, MO	Marriott	1,081	98.00 [3]	2003
Wayne County, MI	Westin	404	110.92	2002

[1] *Privately financed with taxable debt but heavily subsidized through lease payments by the city. North Carolina state law does not allow public ownership.*
[2] *Bond issuance includes both a hotel and convention center.*
[3] *Empowerment zone development allows for private ownership and equity to be combined with the issuance of tax exempt municipal debt.*

- Reduction of the project size in terms of the number of rooms and function space that reduces overall capital costs.

- Structuring debt so that projected net operating income is substantially greater than debt service requirements. Debt service coverage ratios greater than 1.25 allow for the project to perform below expectation without requiring the sponsoring municipality to act on its pledge to pay debt service.

- Creating extraordinary debt service reserve funds that are available throughout the "ramp-up" period of the hotel (the first four to five years of operation) when the risk of failure is the greatest. Although large debt service reserve funds substantially increase the amount of debt issuance the carrying cost of this additional debt is free as the reserve funds can realize arbitrage earnings up to the amount of interest costs.

Overland Park Sheraton *– Financed in 2000, changing market circumstances required the City of Overland Park to provide credit enhancement by pledging city-wide hotel taxes to repay debt service.*

- Using project related taxes such as hotel, sales, and property taxes to pay debt service. To the extent that project revenues are new incremental revenues to the city that would not be realized without the project, their use entails no risk to the sponsoring municipality.

- Limiting the amount of debt service that is credit enhanced. The strength of the local hotel market and its history of volatility or stability determine the share of the debt service that may be non-recourse. Non-recourse debt (issued at reasonable interest rates) typically requires annual net operating income in excess of two times debt service. A sponsoring municipality may seek to maximize the amount of non-recourse debt. However, this strategy has the effect of reducing debt capacity because the interest rate levels on non-recourse debt are two-to-three-hundred basis points greater than credit enhanced municipal debt.

Facing debt capacity limitations and seeking to maintain control of the project in any unforeseen foreclosure situation, some municipalities have chosen to credit enhance the entire debt issuance. In Houston, the city issued revenue bonds supported by city-wide lodging taxes to support the development of their headquarters hotel and convention center expansion. In Schaumburg, Illinois the municipality issued general obligation debt to support its hotel and convention center development.

In addition to the hotel projects recently financed or constructed, many similar hotel projects are currently in various stages of discussion and planning throughout the country. In many cases the hotel flag, number of rooms, amount of meeting space and other such considerations has yet to be determined. The table below shows approximately 30 municipalities currently in various stages of consideration of a hotel property.

Cities Currently Considering Municipal Support for a Hotel

Cities	
Albany, NY	Lombard, IL
Albuquerque, NM	Los Angeles, CA
Bellevue, WA	Louisville, KY
Bloomington, MN	New Brunswick, NJ
Branson, MO	New Orleans, LA
Columbia, SC	New York City, NY
Columbus, OH	Osceola County, FL
Coralville, IA	Pine Hills, MA
Dallas, TX	Salem, OR
Detroit, MI	San Antonio, TX
Erie, PA	Syracuse, NY
Flagstaff, AZ	Virginia Beach, VA
Fort Worth, TX	Washington, DC
Fort Wayne, IN	West Palm Beach, FL
Lancaster, PA	

In many cases cited above, the specifics of the proposed hotel's financing have yet to be agreed upon. Of the cities that elect to move forward and

develop a hotel, some may opt for a public/private partnership or public financing.

Schaumburg Illinois- *A model of the Renaissance Hotel currently under construction which is financed with the support of the general obligation of the City rather than reliance on a project revenues.*

Rating Agency Trends

Many recent public hotel transactions have been insured by third-party municipal bond insurers such as Ambac and Excel Capital Assurance Inc. These insurers are paid a premium to wrap the entire transaction with a surety policy that guarantees bond holders repayment of debt in the event that project revenues and other publicly pledged sources of repayment are not available. While insurance premiums are substantial, they have the effect of dramatically lowering interest rate levels thereby lowering the overall cost of funds.

Among other conditions, municipal bond insurers require that the transaction be rated at a minimum investment grade by Standard & Poor's, Moody's Investor Service, or other agencies that rate municipal debt. These rating agencies typically have standardized criteria to determine whether the transaction qualifies for an investment grade rating. As the issuance of municipal bonds for publicly owned hotels is a relatively recent phenomena, the rating criteria for hotel transactions and the application of the criteria have evolved and become more stringent over the past few years. The failure of the St. Louis Renaissance project to produce sufficient revenues to pay debt service has had a particularly important influence on how agencies rate transactions. Currently, the most salient requirements are as follows:

1) Pro forma revenues available to pay debt service on non-recourse debt must be more than two times projected debt service.

2) Project completion must be guaranteed by a third party that will be required to pay liquidated damages in the amount of annual debt service of the projects if not built by the scheduled completion date. These guarantees are typically provided by the developer or builder.

3) Similarly, the timely opening of the hotel after completion must be guaranteed by the operator or developer. This requirement necessitates careful negotiation of the terms of the hand-off of the hotel from the construction group to the operator.

4) Most recently, Moody's Investor Service is requiring a "ramp-up" guarantee. That is, the repayment of debt service must be guaranteed during the first few years of operation of the hotel before it reaches a stabilized level of rate and occupancy. The amount and length of the ramp-up guarantee varies with the perceived strengths or weaknesses of the local market. The ramp-up guarantee may be in the form of a letter of credit that supports an extraordinary debt service reserve fund.

Conclusion

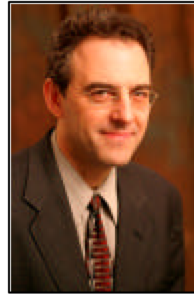
Public agencies may choose from a wide variety of options when opting to provide public support for a headquarters hotel project. This support can come in the form of bond financing, the donation of land or infrastructure, empowerment zone development,

and other methods of support discussed herein. Whatever forms the public support may take, public officials often try to provide a level of support that is commensurate with the expected economic impacts the proposed project is expected to generate in the local community.

A recent review of headquarters hotel projects conducted by HVS International has shown that the new hotels generate new room night demand in their communities, however hotels often requires three to four years to become fully absorbed by the local market. During this transitional period before the new hotel reaches stabilization, the occupancy levels and average daily rates ("ADR") of existing hotel properties are expected to decline somewhat. As the new hotel reaches stabilization and generates additional room night demand, the occupancy levels and ADR of competitive hotel properties are expected to return to normal levels.

The impact of these hotels on convention center activity in the cities HVS has studied is less conclusive. For example, the number of meetings and conventions and total attendance experienced a significant increase in the first year following the opening of the some hotels. In other cities, convention center sales staff indicate that the number of leads – indicators of potential future business – have increased following the opening of a headquarters hotel. Given that many event planners operate on multiple-year planning horizons, the full effect of a headquarters hotel on convention center activity might not be realized until several years following the hotel's opening. Further observation and analysis will be necessary to determine the impact of these headquarters hotel properties.

ABOUT THE AUTHOR



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Since 1980, HVS International ("HVS") – the leading global hospitality consulting organization – has provided financial and valuation consulting services for over 8,000 hotels in all 50 states and more than 60 foreign countries. With 20 offices in 10 countries and more than 200 consultants worldwide, we offer one of the most comprehensive knowledge bases in the industry. Last year, HVS International completed more than 1,500 appraisals, feasibility studies, and consulting engagements. HVS International is respected worldwide by developers, underwriters, operators, and investors

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