



Research Articles

## **CREDIT CRUNCH**

### **HOW CONCERNED SHOULD WE BE?**

In our opinion, the recent crisis in the world's financial markets has changed the rules of the game rather than putting an end to the game itself. A re-pricing of risk, with rising cost of capital, a curtailment of credit and a tightened underwriting climate, has been the most immediate consequence. We view this as a necessary correction that should help re-establish market stability.

Although it is still early days, consensus view is that the crisis will be limited to the financial markets and that it will not spread throughout the so called 'real economy'. The non-financial sector is in good shape and corporate fundamentals remain strong. If this financial malaise worsened and contaminated the underlying economy, the implications would be significant. Although the likelihood of a recession in the US has increased, the market is not discounting such a scenario for now.

From a hotel sector's perspective, the implications are being felt. Although prime assets should continue to attract investors' interest, secondary properties are expected to experience some pricing pressure. Private equity players, the industry's main source of investment over the last few years, certainly have new challenges to confront but also fresh opportunities to seize.

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## Executive summary

Risk perceived differently	The recent turmoil in the world's financial markets is a fact that has changed investors' attitude towards risk.
Why did the subprime market collapse?	The subprime mortgage debacle in the US came mainly as a result of rising interest rates coupled with pricing pressure in the real estate market and some moderation in economic growth. These are factors that we look at in this report. The heavy reliance of financial institutions on securitisation and other structured products contributed to the problem's rapid expansion both globally and into other market segments.
The financial crisis has not contaminated the real economy, for now	Still, fears of a global or US recession seem unfounded for now. Corporate fundamentals remain strong. The non-financial sector is in good shape, with corporations all over the world still reporting sound results. Additionally, and as the US Federal Reserve showed us only a few days ago, inflation remains under control and central banks have room to manoeuvre through easier monetary policies if the situation requires it.
A necessary re-adjustment	Until now, the most evident effect of the recent credit crunch has been a re-pricing of risk, not only in the subprime segment but also in the entire marketplace. In our view, far from being detrimental, this re-adjustment is a positive and even necessary step that should help bring balance to the marketplace.
Changing conditions in the lending market	Within the lending community, the effects of the crisis have been immediate. Loan-to-values (LTVs) have fallen, spreads have edged up, conditions have tightened and lending bureaucracy has increased.
Hotel trading remains strong	How has this impacted the hotel sector? There are different fronts to examine. From a trading perspective, the industry seems healthy enough. Although growth may be slowing down, RevPAR is still showing a positive performance on a global scale. Given the cyclicity of hotels, the sector should continue to perform well as long as the financial crisis does not contaminate the real economy.
Real estate asset prices should decrease by around 5-10%	In relation to pricing, the most immediate effect should be an increase in cap rates. On average, asset prices are expected to fall by 5% to 10% over the coming months in response to lower LTVs. Prime assets should prove more defensive, with secondary assets expected to take a harder hit. From an equity markets perspective, investors' reactions have already made an impact, as some hotel stocks' share prices having diminished significantly during the third quarter of this year.
Lower transaction	Additionally, deal flow should come down as the market waits for the situation to stabilise. Private equity groups, the hotel sector's main



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volumes expected short-term investors over the last few years, should be most affected due to their highly leveraged financing structures. However, we believe that the impact on such investors will differ depending on their various investment profiles and strategies.

## The subprime market

Subprime mortgages Subprime mortgages are home loans made to high credit risk borrowers. These have to bear higher financing costs compared with prime borrowers due to their higher likelihood of default.

Subprime accounts for 14% of all US mortgages... The market for subprime mortgages in the US has been growing at a significant rate over the last few years. According to the US Federal Reserve, in early 2007 subprime mortgages accounted for around 14% of all mortgages in the US.

...with ARMs accounting for two-thirds of subprime The subprime market emerged in the 1980's and expanded during the 1990's. However, it was not until 2006 that the main problems began. Holders of subprime mortgages with adjustable interest rates (adjustable-rate mortgages or ARMs) started to default. ARMs accounted for around two thirds of all subprime mortgages (9% of total market). The rate of default for these (or rate of serious delinquencies, which according to the Fed corresponds to "mortgages in foreclosure or with payments 90 days or more overdue") showed a significant increase in 2006, growing to about 12%. This level was around twice as high as that of mid 2005.

## The origin of the crisis

What happened? What caused such default ratios to escalate was not an isolated fact but, most likely, a combination of factors:

- Decelerating house prices.
- Increasing interest rates.
- Moderation in economic growth.

## Decelerating house prices

US residential market suffering The housing market in the US has suffered a severe downturn over the last few months, as the following facts would indicate:

- Sales of existing homes have gone down by more than 10% from the peak in 2005.
- During the same period, sales of new homes have dropped by 30%.
- Single-family housing starts have decreased by more than 30% since the beginning of 2006.
- The inventory of unsold new homes has increased to more than 7 months of sales. To put this in context, and according to the National Association of Realtors, months supply had averaged

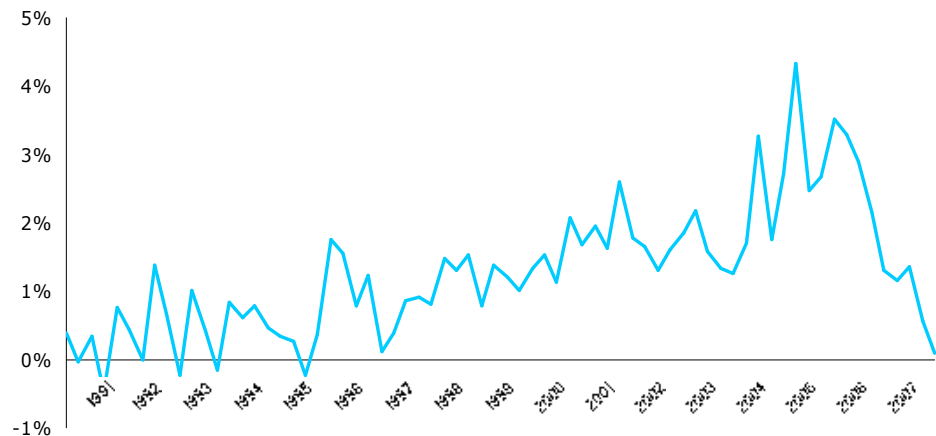


about 4 months during the boom years of 2001 to 2005.

On average, US house prices are still growing, although rate of growth has decreased dramatically

The immediate consequence of a weaker demand has been falling prices. From the beginning of 2000 until the end of 2005, house prices in the US increased at a CAGR of around 9%. Although still in positive territory, this rate of growth decreased dramatically in 2006 and 2007. Such deceleration has not had the same impact in all areas. While some are still holding up well (examples include Washington and the Southern states), others have recently recorded negative growth (i.e. falling house prices). This would be the case in places like Florida, California or New York.

**Chart 1: US House Price Index (1990–2007) (quarterly appreciation)**



Source: Office of Federal Housing Enterprise Oversight (OFHEO).  
Note: the graph shows the increase over the preceding quarter, not year-on-year.

### Increasing interest rates

Rising interest rates are partly to blame

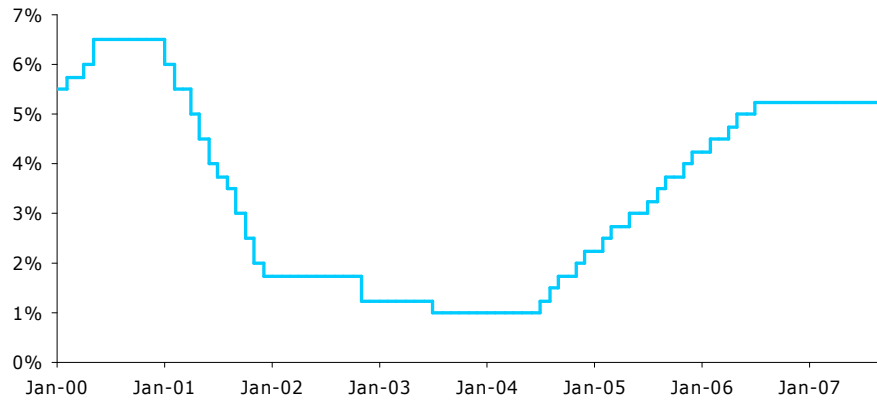
Interest rates have been on the rise, which has been a determining factor in the current financial crisis. We have looked at the evolution of interest rates in the US, Europe and the UK.

Less than two weeks ago and for the first time in several years, the Fed cut rates by 50bp

In the US, the Fed fund rate reached a decade high of 6.5% in May 2000. Since then until summer 2003, rates were progressively cut and reached their lowest point in July 2003 (at 1%). After remaining flat for a whole year, in July 2004 rates escalated back up and reached 5.25% in July 2006. It was less than two weeks ago that the Fed decided to cut rates for the first time in several years. With inflation under control and in an attempt to counterbalance the effects of the financial crisis, rates were cut by 50bp and now stand at 4.75%.



**Chart 2: US Federal funds rate (Jan. 2000 to date)**

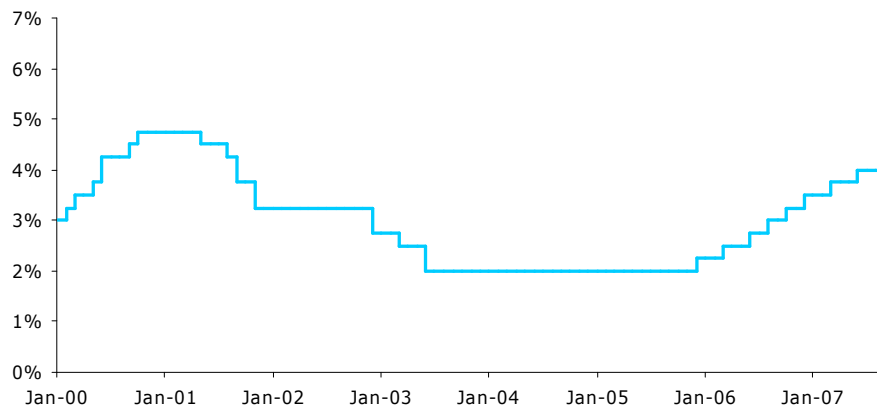


Source: US Federal Reserve.

Interest rates stand at 4% in Europe...

Although less volatile, the trend in Europe has been the same. Interest rates reached their high in October 2000 (4.75%), progressively declined to a low of 2.0% in June 2003 and started increasing back again in December 2005. They now stand at 4.0%.

**Chart 3: ECB key interest rates (Jan. 2000 to date)**



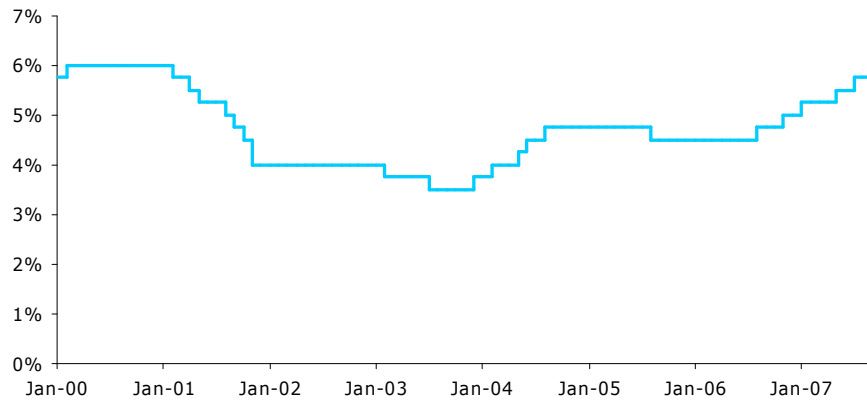
Source: European Central Bank.

...and at 5.75% in the UK

Interest rates in the UK went up to 6.0% in February 2000. They then showed a declining trend and hit their low in July 2003 (at 3.5%). The escalating movement began six months later. In July 2007, rates reached their current level (they now stand at 5.75%).



Chart 4: Bank of England official bank rate (Jan. 2000 to date)



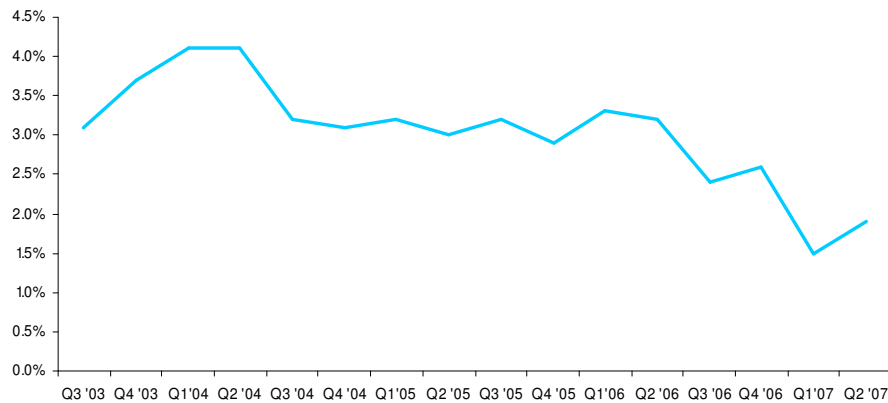
Source: Bank of England.

US GDP growth has been decreasing since 2004

### Moderation in economic growth

Decelerating house prices together with higher interest rates were clear detonators of the subprime mortgage crisis. However, it is also worth mentioning that this all happened in the context of slower economic growth in the US. GDP increased from the lows of 2001 up until mid 2004. Since then, and as the chart below shows, GDP growth has been steadily declining.

Chart 5: US real GDP growth (year-on-year quarterly growth)



Source: Bureau of Economic Analysis - US Department of Commerce.

Securitisation caused risk to spread widely

### Transfer of risk through securitisation

When mortgage holders increasingly defaulted on their home loans, panic spread. Over the last few years, new market dynamics have allowed financial intermediaries to pool mortgages from traditional lenders and sell the right to future cash flows as structured securities. Institutions' heavy reliance on securitisation contributed to the rapid expansion of the crisis.



A liquidity crunch that got to the interbank market

Structured products offered a wide range of maturities and risk levels in order to meet different investors' criteria. The spread offered by financial intermediaries to these new investors would be, on average, lower than the spread received from mortgage lenders. This provided financial intermediaries with access to a new source of cost-free liquidity. Thus, mortgage credit risk was quickly spread throughout a very large number of institutions. Highly leveraged hedge funds were seriously affected, with some being forced to liquidate assets in order to raise cash. The interbank market was eventually impacted, with institutions being suddenly wary about lending to each other.

Confidence was lost

Concerns about where losses are and how much they amount to are likely to haunt investors for a while. The role of rating agencies has been questioned, leading to a widespread loss of confidence. The combination of high leverage ratios together with dispersion of positions (geographically and by type of institution) and complex structures created an entanglement difficult to solve in the very short term.

## The consequences

The underlying economy has not been impacted so far...

So far, the implications of the current crisis have not impacted the underlying economy, which seems resilient. The effect of the financial market dislocation might not have been large enough to have a significant impact on economic outcomes. As the Global Economics Research Team at UBS indicates, "Testing the pulse of the world economy will be a priority for investors in the weeks ahead as the macroeconomic and earnings fallout from the recent market turmoil is assessed".

... partly thanks to easing policies

Benign monetary policies by the world's major central banks (mostly through liquidity injections and an easing of interest rates in the case of the Fed) have helped to stop, at least for now, the contagious effect.

Investors operate under the assumption that the crisis will remain financial

Currently, consensus is that the market is discounting a strictly financial crisis. Although the likelihood of a recession in the US has increased, investors are not forecasting such a scenario. The fact that the crisis will be constrained to the financial markets and that it will not spread throughout other sectors is assumed and taken as the base case.

Risk premiums are being evaluated

Under that hypothesis, the most immediate effect is a re-pricing of risk not only in the subprime mortgage segment but also in the overall debt markets. The lending community has already reacted to this by adopting a more conservative approach. This translates into the following main points:

- Lower LTVs.



- Widened credit spreads.
- Restrictions by deal size, with fewer mega-deals.
- Tightening conditions and more rigorous covenants. Increase in lending bureaucracy.

## Lower LTVs

LTVs expected to fall by 10pp...

It is reasonable to assume that LTVs will fall by around 10pp (percentage points). To this respect, the market believes that highly leveraged transactions (LTVs of 90% or over) will now be extremely difficult to close if the current situation persists. Very highly leveraged buyers are bound to be more seriously affected by the recent market turmoil. Difficult conditions may force certain players to bring down their leverage ratios to more reasonable levels (LTVs in the order of 70-75%).

## Higher financing costs

...while spreads go up

The amount by which financing spreads have widened varies according to the risk of the underlying asset. For high quality assets, spreads have increased by around 50bp. However, certain higher risk products have seen spreads escalate by more than 150bp, although the correction that we saw during the summer months has somewhat receded.

## Restrictions by deal size

<€200M transactions better placed

The market expects mega-deals to be the most affected by the crisis. Transactions under the €100-200million hurdle are expected to better weather the storm.

## Tightening conditions and increase in bureaucracy

Stricter lending conditions

As the residential subprime bubble burst, institutions began demanding increased underwriting discipline. Document requests have intensified as lenders are more inquisitive.

We believe that lending standards for borrowers, which have been tightened over the last few weeks, are unlikely to go back to the relaxed standards we have seen in the recent past.

## The impact of the crisis on the hotel sector

How will hotels be affected?

We have looked at the preliminary impact of the recent credit crunch on the hotel industry. Our view is outlined below.

## Demand still strong

RevPAR growth still shows a healthy trend

From a hotel sector perspective, trading remains robust. RevPAR growth is still positive in all major geographical areas. Although the rate of growth is slowing down, occupancy and room rates still show a positive performance. Demand continues to grow satisfactorily. Given the strong correlation between the hotel industry's performance and



GDP growth, the sector should continue to do well as long as the financial crisis does not spread throughout the real economy.

Impact on supply beneficial

### **Benign supply**

As construction and other costs continue to rise, new room supply remains under control. Higher costs and extended construction periods are holding back uncontrolled development. As several hotel projects are called off due to tightening financing conditions, the supply side of the equation provides a base for support in the long term. This is one of the most positive outcomes that hotel investors can infer from the current crisis.

Cap rates should increase and bring asset prices down by around 5-10%

### **Lower asset prices**

Lower LTVs will probably bring capitalisation rates up. As investors are forced to rely less on the cheaper debt-financing to fund their acquisitions (as opposed to the more expensive equity), prices should escalate. Investors may be less ready to pay higher prices due to less abundant and more expensive third party financing. This, in turn, translates into lower prices for hotel and other real estate asset classes. We believe that valuations are expected to fall by around 5-10% over the coming months. This, however, is expected to affect mainly secondary and tertiary assets. Prime assets in strategic locations should prove more defensive ahead of a possible downturn.

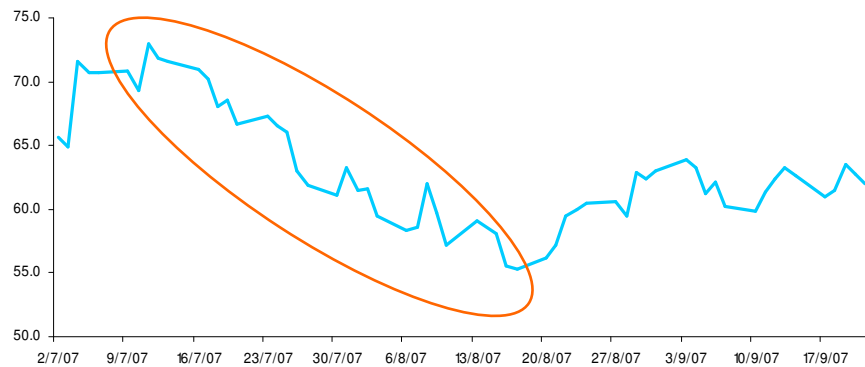
Hotel stocks have underperformed the market during Q3 2007

### **Weaker equity markets**

From a stock market perspective, the story is no different. Last July, the share price performance of various hotel groups weakened considerably, as the charts below show. We have looked at the performance for the last 3 months of hotel groups like Accor and InterContinental Hotels Group in Europe and Marriott International, Starwood and Host Hotels & Resorts in the US. The data reflects investors' concerns over the crisis. During the third quarter of this year, Accor and Host's share price fell by around 5%. IHG and Starwood were more seriously hit, recording share price declines of 23% and 12% respectively. Marriott International's share price recovered during August and September, with an increase of 2% for the quarter. On a relative basis, all five stocks underperformed the market during the same period.

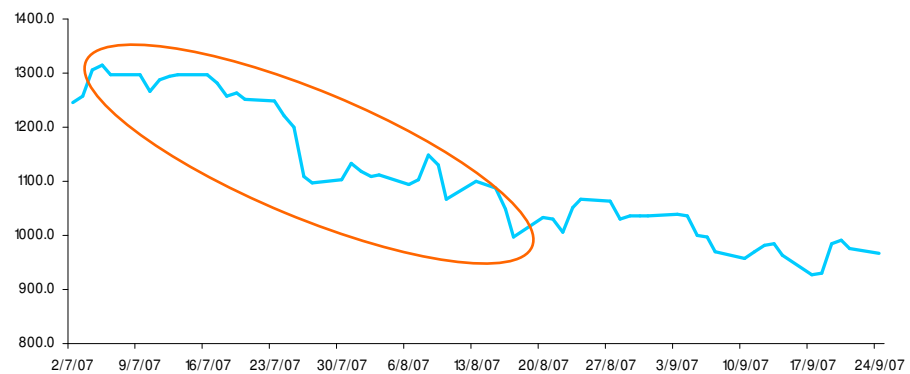


**Chart 6: Accor share price performance (last 3 months) (in €)**



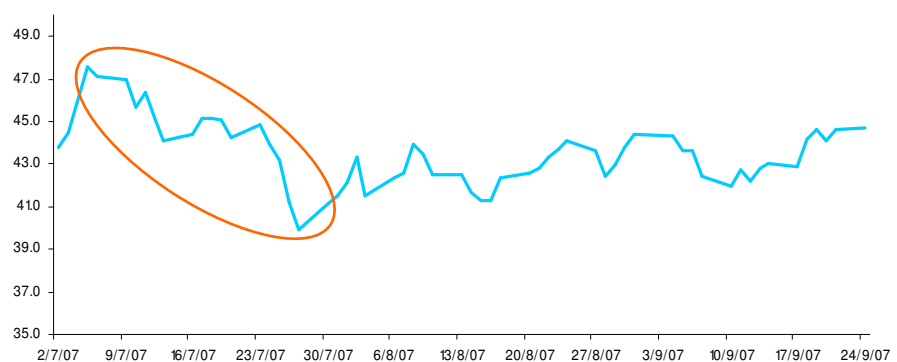
Source: Bloomberg and Meridia Capital.

**Chart 7: IHG share price performance (last 3 months) (in GBP p)**



Source: Bloomberg and Meridia Capital.

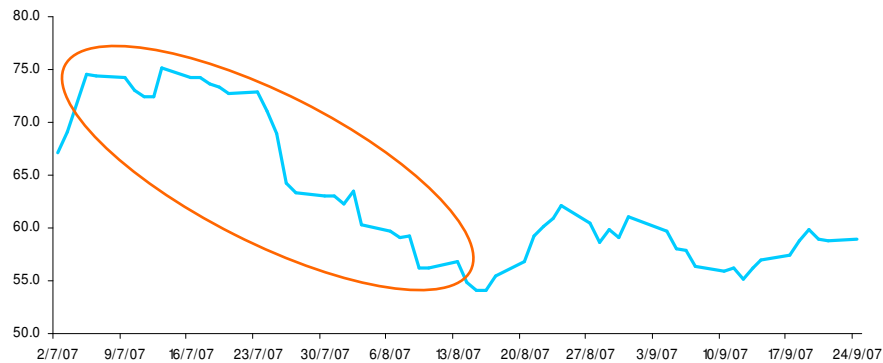
**Chart 8: Marriott International share price performance (last 3 months) (in US\$)**



Source: Bloomberg and Meridia Capital.

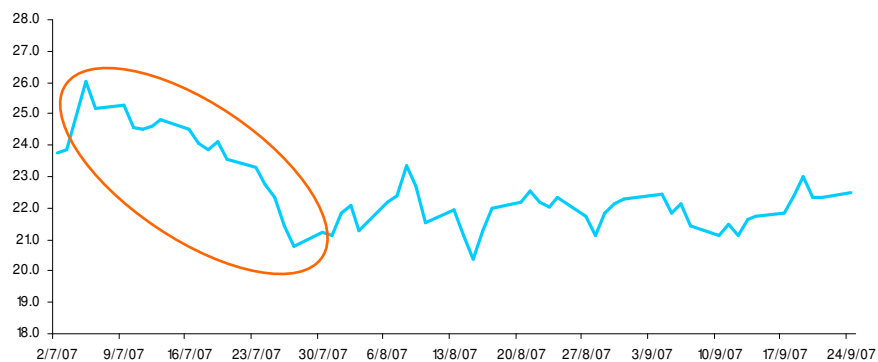


**Chart 9: Starwood Hotels & Resorts share price performance (last 3 months) (in US\$)**



Source: Bloomberg and Meridia Capital.

**Chart 10: Host Hotels & Resorts share price performance (last 3 months) (in US\$)**



Source: Bloomberg and Meridia Capital.

## Lower deal flow

Transaction volumes have fallen

Most investors are currently in a "wait and see" situation. This has led to a cooling-off period in the M&A arena. Although not dramatically, transaction volumes have dried up slightly.

Some hotel deals are being postponed

Over recent weeks, hotel sector participants have seen some deals postponed. Given the current market uncertainty, vendors seem reluctant to make any decisions. The sale of their assets or portfolios is being delayed, as they wait for the market to stabilise. Examples of this would include the disposal of various hotels by The Royal Bank of Scotland (a reported GBP1.1 billion transaction), as well as the proposed sale of the Malmaison and Hotel du Vin portfolios (which are expected to achieve a value close to GBP700 million).

## The hotel investor's perspective

Over the last two to three years, private equity funds have been the



main investors in hotels. Unquestionably, their high interest in hotels coupled with their high leverage ratios have contributed to a rise in hotel asset prices.

Impact on private equity unlikely to be homogeneous

The recent financial crisis and the implications that it has already had in lending conditions should directly impact private equity groups. However, the consequences will be felt differently according to the various players' profiles and investment preferences. The recent market turmoil has revived hotel investors' preference for quality. Aspects like sound branding, proactive asset management as well as focus and specialisation should prove to be sought-after qualities.

Flight to quality

### **Brand equity**

The financial community has emphasised the importance of having branded projects with quality sponsors. Prime assets are expected to prove more defensive ahead of a downturn, as apposed to secondary and tertiary properties.

Sound asset management skills, a priority

### **Skilled asset management**

The ability to control the hotel's operations and be able to extract high value from them becomes even more relevant under the current circumstances. As First American Realty Associates, LLC point out, "We are entering that time in the hotel business cycle when experience and prior planning distinguish the winners from the losers".

Market putting a premium on specialisation and focus

### **Specialisation**

Specialisation and a focused business model are proving to be an advantage amongst lending institutions. Specialised investors, albeit more exposed to risk through lower diversification, are regarded as more rigorous players.

Hotels should continue to attract investors' interest

### **Final thoughts**

We believe it is important to highlight the fact that there is still plenty of cash in the market for hotel investment. There seems to be enough equity out there to partially take the place of missing debt. Private equity groups might be less ready to finance hotel deals, but the market has certainly not dried up. We believe that hotels will continue to be regarded as a good asset class. In our view, the interest that the sector generated over the last few years amongst various investor groups is not transitory. Rather, it is likely to stay.



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