CMBS Research

Ballooning Supply Looms Over $3.68 Billion in CMBS Backed by Manhattan Hotels

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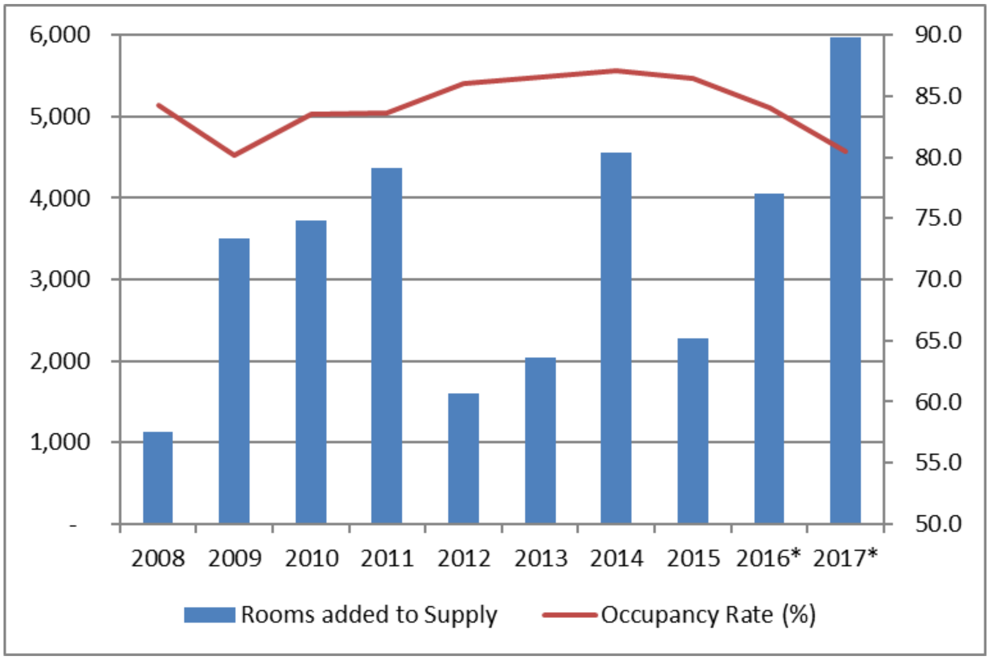
Overview

Morningstar Credit Ratings, LLC is concerned that the burgeoning hotel-room supply could increase risk for the $3.68 billion of fixed-rate loans backed by Manhattan hotels and packaged in commercial mortgage-backed securities that we monitor. Although Manhattan is one of the strongest markets in the U.S. for hospitality properties, we believe that demand growth could miss most industry experts' projections. While delinquent and specially serviced loans account for just 2.8% of these loans, Morningstar identified another 14 loans, with a combined balance of $730.9 million, with debt service coverage ratios, or DSCRs, below 1.2x, elevating default risk.

A Building Boom in Manhattan Hotels

Since 2009, Manhattan has experienced a construction boom that delivered 18,569 hotel rooms, an impressive 26.3% increase to existing supply, per data from STR, Inc. Projects underway will add another 10,019 rooms in 2016 through 2017, and another 10,000 to 15,000 rooms are anticipated in 2018 through 2020, per Morningstar's analysis of market data. The chart on the next page illustrates the historical and projected increase in supply, coupled with historical occupancy and Morningstar's occupancy projections.

Chart 1: Manhattan Hotel Occupancy Versus New Supply, Historical and Projected



*Future occupancy and supply projected by Morningstar Credit Ratings, LLC. Historical data per STR, Inc. and HVS.

As illustrated in Table 1, the known hotel development pipeline is segmented by neighborhood. Overall, the estimated new supply represents an impressive 15.2% increase relative to the existing 89,164 rooms in Manhattan. This tally of new hotels does not include projects in the early planning stages that we do not expect to hit the market until 2018 or later.

Table 1: Projected New Hotel Supply in Manhattan

Neighborhood	2016	2017	2018	Grand Total Rooms
Chelsea/Gramercy	463	615	740	1,818
Chinatown		229		229
Downtown	966	429		1,395
Financial District	61	779	618	1,458
Lower East Side	171		315	486
Midtown		114		114
Midtown East	96	230	775	1,101
Midtown South	496	1,880	452	2,828
Midtown West	965	896	638	2,499
Murray Hill	190	250		440
Soho	221			221
Times Square	66			66
Tribeca		171		171
Tribeca/Lower East Side		370		370
West Soho	361			361
Grand Total	4,056	5,963	3,538	13,557

Source: HVS. Manhattan Lodging Overview. 2016. Print.

What's Driving Development?

Manhattan has traditionally been under-supplied in hotel rooms, and as a major business capital and tourist destination, its hotel-room supply has seldom kept pace with demand. However, before diving into the demand side of the equation, we researched multiple drivers that have, in our opinion, spurred developers to keep building hotels, despite falling expected returns. Morningstar concluded that three factors are behind this building boom: public policy, capital market trends, and EB-5 funding.

1. Local businesses, labor unions, and government officials have welcomed the growth in New York City's tourism industry. This alignment of interests resulted in public policy that encouraged hotel development. For example, former mayor Michael Bloomberg announced in 2006 his goal of achieving "50 by 15," or 50 million tourists by 2015, and the city has since worked hard to attract both domestic and international tourists. According to NYC & Company, the city's official marketing and tourism organization, the city attracted a record 58.3 million tourists in 2015 and is expected to host approximately 59.7 million tourists in 2016.

2. The economics of development are driven by multiple factors, such as the cost and availability of financing, government permitting and approvals, and so-called hard costs, such as land, material, labor, and machinery. To be profitable,

however, a developer needs the market value of a project to exceed the cost of building it, and hence, rising asset values are helpful, if not essential, to making the investment profitable. Based on data from Real Capital Analytics Inc., the average price for Manhattan hotels sold in 2005 was approximately $482,000 per room for the trailing four quarters through the end of the first quarter of 2006, and that average price increased to $775,000 in 2015. This amounted to a cumulative 60.8% price increase over that time period, or 4.9% annually. RCA data indicates that capitalization rates declined to 4.9% in 2015 from approximately 7.7% in 2005. Rising asset values were primarily driven by falling capitalization rates, not from increasing asset cash flows. Given the outlook for more competition in Manhattan and lower rates for revenue per available room, or RevPAR, a key performance benchmark, we anticipate that capitalization rates will stabilize over the next 12 months and could increase over time.

3. Debt financing is the lifeblood of real estate development, and the most successful developers are creative at finding new, inexpensive sources of capital, which increasingly flows from foreign investors. Because of a lack of transparency, we were not able to confirm or quantify the various sources of foreign capital. Based on various public sources, however, we learned that the EB-5 program has funneled hundreds of millions of dollars into New York projects, of which the majority has been invested in developing hotel rooms. The EB-5 program allows investors, along with their family members, to receive a green card if they satisfy the requirements of the program, such as the following: invest a minimum of $500,000 in a commercial enterprise in the United States, specifically within a designated high unemployment zone or in certain rural areas; and create or preserve 10 full-time jobs for qualified U.S. workers. In fiscal year 2014, the U.S. issued 10,692 visas as a result of this program, of which 85.4% were for investors from China, according to the National Conference of State Legislatures.

Two of the largest hotel developers in New York City who use EB-5 funding are the Lam Group, led by John Lam, and the McSam Hotel Group, led by Sam Chang. Based on new supply data from NYC & Co., coupled with HVS' Manhattan Lodging Overview report, we determined that the Lam Group completed at least two Manhattan hotel projects (304 rooms) in 2015, and over the next three years, the company is expected to complete six projects (1,782 rooms). The McSam Hotel Group developed the world's tallest Holiday Inn, a 50-story, 492-room hotel that was completed in 2014, and a 271-room Holiday Inn at Times Square, which was finished in 2015. The McSam Hotel Group agreed to build five Marriott-franchised hotels over the next two years, including four properties in Manhattan that will comprise 948 rooms. The table on the next page includes nine projects for which EB-5 marketing materials were reviewed, so there is little doubt as to the source of financing, and eight projects from developers who are publicly associated with EB-5 platforms, for which

Morningstar was not able to confirm if EB-5 funding was used. Overall, the projects listed in Table 2 account for 27.9% of Manhattan's total projected growth of 15,828 rooms during the four years from 2015 through 2018, per Morningstar's analysis.

Table 2: Manhattan Hotels Financed by EB-5 Developers

Property Name	Neighborhood	Opening (Year)	Rooms	Developer	Description
Fairfield Inn & Suites by Marriott	Downtown	2015	176	Lam Generation/Rinaldi	32-story tower at South Street Seaport
Aloft Hotel Financial District	Downtown	2015	128	Lam Group	18-story tower at 49 Ann Street
*Holiday Inn Times Square	Midtown	2015	271	McSam Hotel Group	585 8th Ave at 38th Street
		Subtotal 2015:	**575**		
Four Seasons Hotel New York Downtown	Downtown	2016	185	Silverstein	82-story tower. EB-5 provided $250 million
*Four Points by Sheraton	Downtown	2016	261	Lam Group	30-story tower at 6 Platt Street (aka 217 Pearl Street)
*Marriott Fairfield Inn	Midtown	2016	230	McSam Hotel Group	17-story tower at 538 West 58th St (Hell's Kitchen)
*Fairfield Inn & Suites by Marriott	Midtown	2016	112	McSam Hotel Group	7-story development at 326 W. 44th Street
*TownePlace Suites by Marriott	Downtown	2016	200	McSam Hotel Group	26-story tower at 100 Greenwich Street
		Subtotal 2016:	**988**		
Courtyard & Residence Inn by Marriott	Downtown	2017	320	Lam Group	40-story "two-pack" at 213 -215 Pearl Street
Renaissance Hotel	Midtown South	2017	330	Lam Group	39-story tower at 112 West 25th St. EB-5 provided $40 million.
Courtyard by Marriott Convention Center	Midtown	2017	385	David Marx/MRC	At the Javits Center
*Boutique Hotel Project	Midtown	2017	109	David Marx/MRC	42-44 W. 29th Street
*Marriott Fairfield Inn/ SpringHill Suites	Midtown	2017	406	McSam Hotel Group	Officially "Unnamed" project at 334 W. 36th Street
*Aloft Hotel Midtown	Midtown	2017	200	Lam Group	44 W. 30th Street
		Subtotal 2017:	**1,750**		
Virgin Hotel	Midtown	2018	463	Lam Group	38-story tower at 1205 Broadway. EB-5 provided $100 million.
Harlem Victoria Mixed Use	Harlem	2018	208	Lam Group	Mixed-use (hotel, apartments, retail, theater).
Aloft Convention Center	Midtown	2018	438	David Marx/MRC	39-story tower at 37th Street and 11th Ave. (Hudson Yards)
		Subtotal 2018:	**1,109**		
		Total 2015-2018:	**4,422**		

* EB-5 funding not confirmed; MRC - Manhattan Regional Center. Sources: NYC & Co. (nycandcompany.org), Lamnyceb5.com, ny-eb5.com, and silversteinrc.com.

Demand Growth Has Slowed

During the past six years, demand for Manhattan hotel rooms has been bolstered by a strong domestic economy, robust hiring, international travelers, particularly from China, and the city's attractiveness as a tourist destination. Following a 3.2% decrease in 2009, the number of visitors to New York City has grown at an annual rate of at least 3% during the past six years. Nonetheless, the growth rate of domestic and international visitors has decelerated. Specifically, the year-over-year increase in domestic visitors fell to 3.4% in 2015 from 4.0% in 2014, and for international visitors dropped to 2.5% from 4.3%, per data from NYC & Co. City employment dipped to 2.0% growth in 2015 from 3.3% the prior year, according to the New York State Department of Labor. Most concerning is the slowdown in demand for Manhattan hotel rooms, based on data from STR. As indicated in Table 3, the 2015 growth rate in occupied room nights, which is the best indicator of demand, dropped below 2% for the first time since 2009.

Table 3: Demand Driver Trends – Visitors (Tourism), Employment, and GDP

Year	Domestic NYC Visitors Per Year (Millions)	International NYC Visitors Per Year (Millions)	Total NYC Visitors Per Year (Millions)	Total Visitors Growth Rate (%)	NYC Metro Total Employment Growth Rate (%)	US GDP Real Growth Rate (%)	Occupied Room Nights Growth Rate (%)
2007	37.1	8.8	46.0	—	0.90	1.8	—
2008	37.6	9.5	47.1	2.4	(0.6)	(0.3)	0.7
2009	37.0	8.6	45.6	(3.2)	(3.0)	(2.8)	0.1
2010	39.0	9.8	48.8	7.0	0.8	2.5	9.6
2011	40.3	10.6	50.9	4.3	1.4	1.6	6.0
2012	41.8	10.9	52.7	3.5	1.8	2.2	5.0
2013	42.8	11.5	54.3	3.0	2.6	1.5	3.3
2014	44.5	12.0	56.5	4.1	3.3	2.4	6.2
2015	46.0	12.3	58.3	3.2	2.0	2.4	1.7

Sources: NYC & Co., Reis Inc., STR, HVS and New York State Department of Labor

The strong U.S. dollar is an impediment for international visitors to the United States, but it may also be a symptom of economic weakness in those countries where the currencies have struggled. Per NYC & Co., foreign visitors to New York City primarily come from 10 countries, which comprise 60.3% of total international visitors. The top 10 includes four countries, or 18.9% by visitor count, that are in the eurozone. The next six largest sources of foreign visitors include the United Kingdom (9.8%), Canada (8.9%), Brazil (7.7%), China (6.2%), Australia (5.3%), and Mexico (3.5%). Because of the decline in commodity prices, the Canadian dollar, Brazilian real, Australian dollar, and Mexican peso were hit particularly hard. From year-end 2012 through May 3, 2016, those currencies' values relative to the U.S. dollar declined by 21.8%, 42.5%, 27.9%, and 26.8%, respectively. On a weighted average, the basket of seven currencies for these 10 countries has declined by 16.6% versus the U.S. dollar over the same time period, per data from Bloomberg.

Hotel Fundamentals: Past, Present, and Future

As illustrated in Table 4, the supply of hotel rooms in Manhattan grew with the demand from domestic and international visitors, while the pricing, as measured by average daily rate, slowly continued to increase. However, in 2015, both the ADR and occupancy rates for Manhattan hotels fell. In our view, the decline in RevPAR is a direct result of supply growth exceeding demand growth, particularly in 2015.

Over the next two years, Morningstar projects that occupancy will fall to 80.5%, while ADR will slip 4.4% to $275, resulting in a 10.9% decline in RevPAR over the two-year period. These projections are based on our assumption that demand growth will slow to less than 3%. For 2016 and 2017, consulting firm HVS Global Hospitality is projecting annual demand growth of 5.0% and 4.7%, occupancy of 85.6% and 85.2%, and ADR of $285.58 and $287.86, as published in HVS' Manhattan Lodging Overview, dated February 2016.

Table 4: Manhattan Hotel Trends[1] and Projections

Year	Supply (Rooms)	Supply Change (%)	Occupancy Rate (%)	Average Daily Rate ($)	RevPAR ($)	RevPAR Change (%)	Total NYC Visitors Per Year (Millions)	Total Visitors Change (%)
2007	65,960	—	85.2	297.58	253.45	—	46.0	—
2008	67,097	1.7	84.3	306.35	258.27	1.9	47.1	2.4
2009	70,595	5.2	80.2	236.96	190.10	-26.4	45.6	(3.2)
2010	74,324	5.3	83.5	256.40	214.09	12.6	48.8	7.0
2011	78,694	5.9	83.6	270.63	226.14	5.6	50.9	4.3
2012	80,296	2.0	86.0	277.52	238.56	5.5	52.7	3.5
2013	82,334	2.5	86.6	285.87	247.60	3.8	54.3	3.0
2014	86,893	5.5	87.1	291.83	254.32	2.7	56.5	4.1
2015	89,164	2.6	86.4	287.59	248.51	-2.3	58.3	3.2
2016*	93,220	4.5	84.0	280.00	235.20	-5.4	59.8	2.5
2017*	99,183	6.4	80.5	275.00	221.45	-5.8	61.0	2.0

* Projections by Morningstar Credit Ratings, LLC

[1]HVS. Manhattan Lodging Overview. February 2016. Print.

Morningstar made certain assumptions in projecting that occupancy will decline to 80.5% in 2017. The numerator (demand), which is occupied room nights, was calculated by increasing the total number of occupied room nights from 2015 levels by 1.6% in 2016 and 2.0% in 2017; these growth projections are based on the slowdown that we saw in 2015 and headwinds that will hurt demand, in our opinion, over the next two years. The denominator (supply) was calculated by adding 4,056 rooms to inventory in 2016, and another 5,963 in 2017, which is supported by data on known projects under construction. Morningstar's projection for ADR is based on the assumption that 2015's ADR decline will accelerate into 2016 as new competition forces hotel operators to cut prices more sharply. We have only one-quarter of 2016 data to judge these projections against, during which STR reported that ADR declined by 3.1% year-over-year, occupancy in the quarter increased, to 77.4% from 75.9%, and RevPAR declined by a modest 1.2%.

CMBS Exposure to Manhattan Hotels

Morningstar has observed pockets of weakness in the $3.68 billion of CMBS loans backed by Manhattan hotels. Based on Morningstar data as of April 2016, we found just one defaulted loan, the $33.1 million Shoreham Hotel loan (0.9% of all fixed-rate Manhattan hotel loans), securitized in CSMC 2007-C1. Morningstar forecasts an $11.7 million loss on the loan if it is liquidated. One other loan with the special servicer is the $70.0 million Best Western President (1.9% of all fixed-rate Manhattan hotel loans), a reperforming loan in CSMC 2006-C5 that was previously modified and was current as of the April remittance report. However, the property generates negative operating cash flow, and the borrower is seeking another modification. Morningstar's value suggests a $10.2 million loss if the loan is liquidated.

In addition to the two specially serviced loans, Morningstar identified 14 loans that totaled $730.9 million (19.9% of the total Manhattan exposure) with DSCRs less than 1.2x, and thus, have increased default risk. Approximately half of these loans were securitized in 2006 or 2007, and the other half were securitized in 2012 or later. To shed light on the individual loans with low DSCRs, we compared each loan's latest net cash flow with the issuer's underwritten NCF at issuance. Table 5 below does not include all 14 loans, because we had insufficient data on some, particularly for the smaller loans.
Our concern is somewhat mitigated by the lower interest rates prevailing in the market. For instance, the Residence Inn Times Square loan has a coupon rate of 6.15%. If the borrower elected to refinance the loan today at an interest rate of 5%, the 2015 net cash flow DSCR would increase to 1.58x from 1.03x on an amortizing basis. In June 2016, the loan enters its open period where the borrower may repay the loan without penalty. The Courtyard by Marriott - Times Square would have a hypothetical amortizing DSCR of 1.45x assuming a 5% interest rate and a 30-year amortization schedule.

Table 5: Manhattan Hotel Loans With Low DSCRs

Deal (Short Name)	Loan (Property)	Current Loan Balance ($)	Hotel Size (Rooms)	Loan Balance per Room ($)	NCF DSCR (x)	Debt Yield (%)	NCF change versus Issuance (%)	Comments
MLCFC 2007-5	Hotel Gansevoort	111,809,340	187	597,911	0.99	8.6	-33.3	
CSMC 2006-C5	The Mansfield Hotel	18,891,353	124	152,350	(0.12)	0.0	-100.0	NCF DSCR based on nine months of data.
JPMCC 2006-CIBC17	Residence Inn Times Square	118,982,963	357	333,286	1.03	10.2	-20.3	
CGCMT2012-GC8, GSMS 2012-GCJ9	Gansevoort Park Avenue	136,165,025	249	546,847	1.11	7.5	-36.4	
COMM 2014-UBS3	Sixty LES	62,250,000	141	441,489	0.88	4.7	-52.3	Renovations may have hurt the performance.
JPMCC 2007-CIBC18	Courtyard by Marriott Times Sq. South	70,544,029	244	289,115	0.98	9.4	-21.4	
COMM 2013-CCRE12	The MAve Hotel	21,261,224	72	295,295	0.70	4.9	-50.2	NCF DSCR based on nine months of data.
WFCM 2015-C28	Flatiron Hotel	22,500,000	64	351,563	0.36	1.8	-85.1	Water leak contributed to NCF decline.
COMM 2015-CCRE22	Hotel Giraffe	38,036,421	72	528,284	1.16	7.0	-27.6	NCF DSCR based on nine months of data.
MLCFC 2006-4	Hampton Inn South Street	17,357,652	65	267,041	0.66	5.5	-49.8	
LBUBS 2006-C4	Courtyard Marriott Fifth Ave.	48,080,145	185	259,893	1.05	8.5	-19.0	Paid off in May
	Total/Average	665,878,152	1,760	378,340	0.95	7.6	-35.4	

Sources: Morningstar DealView® reports and investor reporting from multiple servicers. Unless otherwise indicated in the comments, DSCRs reflect the most recent 12 months of reported net cash flow.

With 10,000 new hotel rooms likely to become available in the next two years, many in Midtown, Morningstar expects that demand won't keep pace with the burgeoning supply. As a result, we believe that key hotel performance benchmarks, including occupancy, ADR, and RevPAR, could dip this year and next. Consequently, we can expect the cash flow of many Manhattan hotels in CMBS to drop over the next two years. While hotels with net cash flow just above their debt service have elevated risk of default, we note that Manhattan hotel loans have historically not defaulted in large numbers.