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Public Involvement in Convention Center Hotel Financing*

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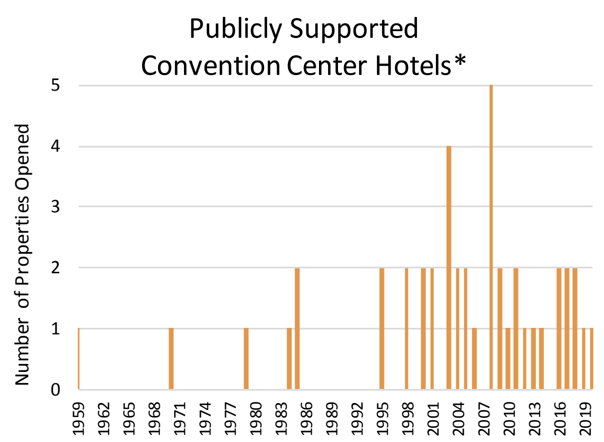
Public sector involvement in convention center hotel projects is common due to the high cost of development and lack of private capital for such investments. Event planners expect the presence of a hotel adjacent to a convention center. Consequently, proximate hotels are essential for many convention centers to remain competitive in the convention center industry. 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 can secure for the project. In the category of public financing, the sponsoring municipality issues taxable or 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

The figure on the right shows the frequency of publicly supported convention center hotels by year of opening date from 1959 to present to 2020. Three projects are currently under construction. HVS research found 44 hotel projects with 600 or more rooms that had substantial public-sector involvement in their financing.



*Includes hotels with 600 rooms or more.

The maturation of a highly competitive convention market has placed increasing pressure on cities to improve their appeal by adding hotel supply proximate to their convention venues. A change in tax law in 1996, which expanded the ability of governments to publicly finance hotels with municipal debt, also caused public sector investment in hotels to become more frequent.

Since 1959, the only hotel projects of 600 rooms or more outside of the gaming and resort industries that have been privately financed have occurred in New York City, Austin, and Seattle, where high

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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. The 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 engages the hotel developer and operator. Various forms of non-profit ownership are possible under internal revenue service ("IRS") rules.
Operations	The hotel may be managed by a hotel brand company (e.g. Marriott, Hilton, Hyatt, Intercontinental, Lowes). Or the hotel may be operated by a third party with a franchise agreement to brand the property. Compensation of the manager 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 IRS regulations. The maximum length of a QMA is 15 years, which is shorter than the typical 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 company.
Financing	Privately owned hotels are typically financed with a mix of debt and equity. In the current markets, lenders will lend 65% to 70% of the value of the project and equity investors or mezzanine lenders provide the balance of the funding. Typically the developer obtains a variable rate construction loan, which is later replaced with permanent financing when 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 obtaining a return on their equity investment.	Publicly owned hotels are debt financed through the issuance of municipal bonds and perhaps with some public equity contributions. Some of the bonds may be "non-recourse" which means that the revenues of the project are the only source of debt payment and credit. To be rated as investment grade, debt service coverage on non-recourse debt must exceed two times debt service. Typically, net operating income is not sufficient to secure enough non-recourse debt to finance the entire project. Consequently, the sponsoring municipality may provide credit enhancement. This usually involves a pledge to pay debt service if hotel revenues are insufficient.
Cost of Funds	Interest rates on permanent debt may range from 4.5% to 5% in the current financial markets. Private equity investors may require 15% to 20% return on equity due. These parameters vary depending on credit market conditions and the availability of capital for hotel investment.	In today's financial markets, non-recourse debt carries interest rates of 7 to 7.5%. The interest costs of credit enhanced debt depends on the sponsoring municipality's credit rating. An AAA-rated municipality may achieve interest rates of 4.0% to 5.0%. Subordinated debt carries negotiated interest rates in the range of 9% to 12%. Consequently, the costs of funds for a publicly financed hotel are substantially less than 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.	In addition to the public subsidies offered in the public/private partnerships, municipalities may credit enhance municipal debt, which is a form of public subsidy. One advantage of a public financing is to reduce the necessary amounts of contributed public equity as compared to a public/private partnership.
Forms of Public Subsidies	The investors in the LLC usually claim the residual project income from operations and the sale of the asset. Municipalities may negotiate a share of project income in exchange for providing public subsidies. Developers often negotiate a "preferred return," which gives the developer a first claim on income.	The sponsoring municipality owns the residual project income from operations and the sale of the asset.

occupancy and room rates can support development of a full-service hotel. All other developments have required some form of public support, either through public financing and ownership or a through a public/private partnership.

Share of Public Investment

The table on the right lists convention center hotel projects with more than 600 rooms that have received public sector support. This analysis covers the opening dates of hotels for the years 1959 through 2020.

Forty-two cities have participated in 44 convention center hotel projects with 600 or more hotel rooms. Twelve projects have been publicly financed. Where information was available, HVS estimated the share of public investment in public-private partnerships of these hotel projects. The estimated share of public investment has averaged 33% and ranged from approximately 10% to 65%.

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.

Oklahoma City Omni *– This 600-room property which is slated to open in 2020 is being financed through a public/private partnership.*

Convention Center Hotel Projects

City	Hotel Brand	Opening Year	Number Rooms
Public/Private Partnerships			
National Harbour	Gaylord Hotels	2008	2000
Dallas	Sheraton	1959	1842
Grapevine	Gaylord Hotels	2004	1811
Atlanta	Marriott Marquis	1985	1663
Aurora	Gaylord Hotels	2018	1507
Orlando	Independent	1995	1408
Philadelphia	Marriott	1995	1408
New Orleans	Hyatt Regency	2011	1193
San Diego	Hilton	2008	1190
Washington	Marriott Marquis	2014	1175
Indianapolis	JW Marriott	2011	1005
San Antonio	Grand Hyatt	2008	1003
Houston	Marriott Marquis	2016	1000
Kansas City	Marriott	1985	983
Jacksonville	Hyatt Regency	2001	966
St Louis	Marriott	2003	917
Los Angeles	JW Marriott	2010	878
Boston	Westin	1984	803
Nashville	Omni	2013	800
Boston	Westin	2006	793
Miami Beach	Loews	1998	790
Baltimore	Marriott	2008	750
Tampa	Marriott	2000	719
Charlotte	Westin	2003	700
Pittsburg	Westin	2000	618
Louisville	Marriott	2005	616
Indianapolis	Marriott	2001	615
Fort Worth	Omni	2009	614
Louisville	Omni	2018	612
Miami	Hyatt Regency	1979	612
Oklahoma City	Omni	2020	600
Portland	Hyatt Regency	2019	600
Publicly Financed Hotels			
Chicago	Hyatt Regency	1998	1258
Chicago	Marriott Marquis	2017	1205
Houston	Hilton	2003	1200
Denver	Hyatt Regency	2005	1100
Dallas	Omni	2012	1001
Phoenix	Sheraton	2008	1000
Austin	Hilton	2003	800
Baltimore	Hilton	2009	757
Birmingham	Sheraton	1970	757
Cleveland	Hilton	2016	600
Omaha	Hilton	2004	600

Public/private partnerships in hotel development are more frequently used for projects in which a reasonable amount of public equity investment can make the difference between a feasible and infeasible project.

The financial feasibility of a hotel depends on several factors, including:

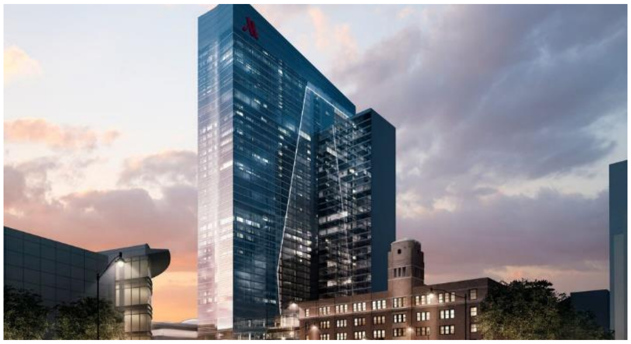
- construction costs,
- estimated net operating income of the hotel,
- interest rate levels,
- availability of equity,
- seasonality and volatility of the local hotel market, and
- other factors that affect the allocation of investment risk and return.

For the recently approved project in Oklahoma City, city leaders chose to engage a private developer to construct a $235.5-million, 600-room Omni Hotel adjacent to the new convention center. The city will contribute $85.4 million capital (36% of the total) by issuing debt to be repaid with revenues from a tax increment financing district and other sources.

Publicly Financed Hotels

The first publicly financed hotel project completed under current IRS 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 where the only source of debt repayment payment and credit for the bonds was the net operating income of the projects.

Less favorable credit markets, decreasing access to capital, and uneven 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 service will be paid if hotel net operating income is not sufficient. After the 2008 Great Recession and the disappearance of mono-line insurers, third-party guarantees became unavailable. Local governments assumed increasing amounts of risk in publicly financed projects or turned to public/private partnerships that shifted risks to the private sector.



***Marriott Marquis Chicago** – opened in September of 2017 and was financed by the Metropolitan Pier and Exposition Authority in Chicago with tax exempt debt using a public ownership model.*

In public financings, the public sector raises 100% of the capital through debt issuance. The primary advantages of public financings are lower costs of capital and the benefits of retaining ownership and control over of the hotel asset. In public/private partnerships, credit enhancement offered by local governments can provide the security required to borrow in the capital markets.

In most cases, the public sector also benefits from room block commitment agreements, which require the convention hotel manager to commit a large share of their room inventory to convention center events at reasonable rates.

But, these financial advantages require the assumption of more risk—primarily the risk of an underperforming project that does not generate sufficient revenues to repay debt and provide for capital replacement costs.

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:

- 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.

- 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, the use of new project revenues entails no financial risk to the sponsoring municipality.

Houston Americas-Hilton*– Opened in 2003, this 1200-room property was financed with revenue bonds, the repayment of which was supported with hotel net income, parking garage revenue, and city-wide lodging taxes.*

- 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 more than 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 may be substantially more 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.

Even though many of these projects opened prior to or during the 2008 Great Recession, only one project, the St. Louis Renaissance project (subsequently renamed the Marriott St. Louis Grand) defaulted on its debt. Other projects such as the Sheraton Hotel in Phoenix faced dual challenges of the recession and event planner boycotts brought on by passage of unpopular State legislation. None-the-less, guarantees of debt repayment by the city allowed the Phoenix Sheraton and other projects facing challenging economic conditions to continue to successfully operate and avoid default.

Conclusion

Public agencies may choose from a wide variety of options to provide public support for a convention center hotel project. This support can come in the form of bond financing, the donation or favorable leasing 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.

Reviews of headquarters hotel projects conducted by HVS and other consulting companies have shown that the new hotels generate new room night demand in their communities. But, hotels often require three to four years to become fully absorbed by the local market. During this transitional period before the new hotel reaches stabilization, the occupancy rates and average daily room rates of existing hotel properties may decline. 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. In some cities, the number of meetings and conventions and total attendance experienced a significant increase in the first year following the opening of 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.

As in any competitive industry, continuous product improvement is necessary to maintain market share. Assessment of the impact of a headquarters hotel on convention center demand should consider the alternative scenario of the lack of such development, which may result in the loss of convention business.

Correction: A previous version of this article listed the Fairmont Hotel in Austin as a publicly financed hotel. The Fairmont was privately financed.

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