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THE IMPACT OF INFRASTRUCTURE LISTING ON HOTEL INVESTMENTS

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The Impact of Infrastructure Listing on Hotel Investments

The inclusion of hotels with a development cost of over ₹200 crores and convention centres with a development cost of over ₹300 crores to the infrastructure lending list early October comes as a welcome step for an industry that has always been saddled with high interest rates, short repayment terms and consequently high debt service payments, all of which have been further exacerbated by the economic downturn. According to the Gazette issued by the Finance Ministry, the development cost thresholds include interest during construction but exclude land cost and lease charges.

While inclusion in the infrastructure list does not provide all the benefits that are available with attaining infrastructure status, we believe the hotel industry will now be eligible for the following benefits:

- Access to interest rates that are expected to be 100 to 200 basis points lower than current rates;
- Longer loan repayment period extending to 15 years;
- Higher debt to equity ratios, allowing developers to reduce equity outflow.

The Gazette also comes with the following caveats:

- Applicable with prospective effect from the date of notification
- Available for eligible prospects for three years from the date of notification

While the inclusion of hotels in the lending list is a welcome change, how much of a difference does it really make for industry stakeholders?

This article aims to illustrate the impact these terms have on the returns for a typical upscale hotel project and how it benefits both the investor and the bank.

To this end, we assumed the construction of a 300-room upscale hotel in Delhi at a cost of ₹80,00,000 per room (excluding land) and projected income and expenses for the proposed hotel for a ten-year period. We then arrived at Internal Rate of Return (IRR) for the project across two scenarios, one assuming traditional financing terms, and another assuming the new terms available as a result of the infrastructure listing.

Scenario A reflects the current situation and assumes a three-year construction tenure, a one-year moratorium, and a six-year loan repayment period at an interest rate of 13%. Scenario B assumes a three-year construction tenure, a one-year moratorium, and a 11-year repayment period at an interest rate of 11.25%.

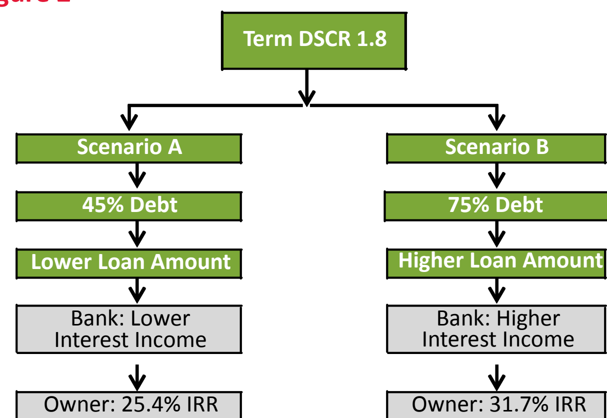
As shown in Figure 1, the investor would be able to fund only 40% of his construction cost with debt if banks require an average Debt Service Coverage Ratio (DSCR[1]) of 2 across the term, and 55% if banks will accept an average DCSR of 1.5. Given the expensive debt available to investors, it becomes very difficult, if not impossible, for a project to qualify for higher levels of debt while still meeting the bank's DSCR requirements. Thus, investors are forced to contribute more equity to the project, which has an adverse impact on their IRRs.

However, in the second scenario, the longer term and the lower interest rate allow the project to attain an average DSCR as high as 3.4, when the debt amount is 40% of the development cost. Also, the second scenario enables the bank to lend up to 75% of the development cost with an average DSCR of 1.8 through the term. In such a situation, the investor stands to attain an IRR of 25.8% at 40% debt and 31.7% at 75% debt.

Thus, in the second scenario, the investor benefits from being able to fund more of the project with debt while still dealing with manageable debt service payments, as evidenced by the DSCRs actually increasing. Banks will also derive greater comfort from the improved DSCRs even at higher levels of debt, which indicate the project's improved position to service debt across the payment term. The second scenario is also financially more lucrative for banks, as they would earn more interest income from the extended loan term.

Making a strong case for banks, consider a 45% debt case in Scenario A and a 75% debt case in Scenario B, which have comparable DSCRs (Figure 2).

Figure 2



Source: HVS Research and Analysis

Figure 1

Scenario A	Internal Rate of Return	5-Year DSCR Average	Term DSCR
Unleveraged	23.8%	-	-
40% Debt	25.1%	1.9	2.0
45% Debt	25.4%	1.7	1.8
50% Debt	25.8%	1.6	1.6
55% Debt	26.2%	1.4	1.5

Scenario B	Internal Rate of Return	5-Year DSCR Average	Term DSCR
Unleveraged	23.4%	-	-
40% Debt	25.8%	2.7	3.4
60% Debt	28.3%	1.8	2.3
70% Debt	30.4%	1.6	2.0
75% Debt	31.7%	1.5	1.8

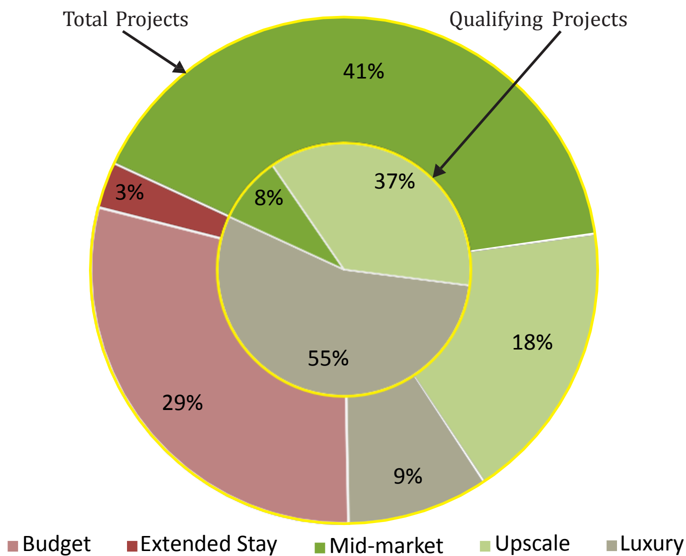
Source: HVS Research and Analysis

[1] DSCR= Net Income/Annual Debt Service

Hence as shown above, Scenario B is a win-win situation for both owners and banks.

While the policy announcement is a welcome step in the right direction, the minimum development cost thresholds imposed limit its benefits to only a small number of projects. HVS is currently tracking about 550 announced hotel projects across segments, with mid-market and budget hotels constituting 70% of the total pie (Figure 3).

Figure 3 Proposed Hotel Projects



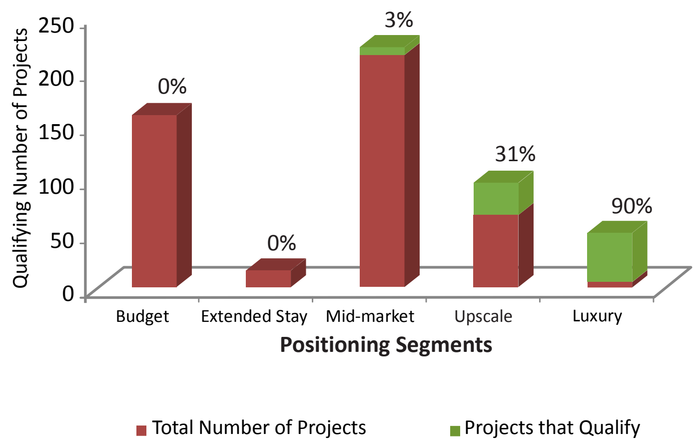
Source: HVS Research

Based on typical development costs for each segment and the actual proposed room count for each project, our research reveals that only 15% of the proposed hotel developments meet the minimum project cost requirements (inner pie). As shown in the inner pie in Figure 3, 92% of the qualifying projects fall in the luxury and upscale segment, with only 8% in the mid-market space.

Hotel development costs vary considerably by positioning, with a majority of luxury hotel projects having development costs higher than ₹200 crore, conversely all budget hotels have project costs below the threshold (Figure 4).

Figure 5 shows how many projects qualify in each segment and the news is unfortunately not good for budget and mid-market hotels, since the minimum ₹200 crore project cost requirement excludes the entire budget segment and many mid-market hotels, which typically have lower construction costs. Thus, while the greatest supply-demand gap lies in the budget and mid-market segments, these projects will see no benefits from hotels being part of the infrastructure lending list.

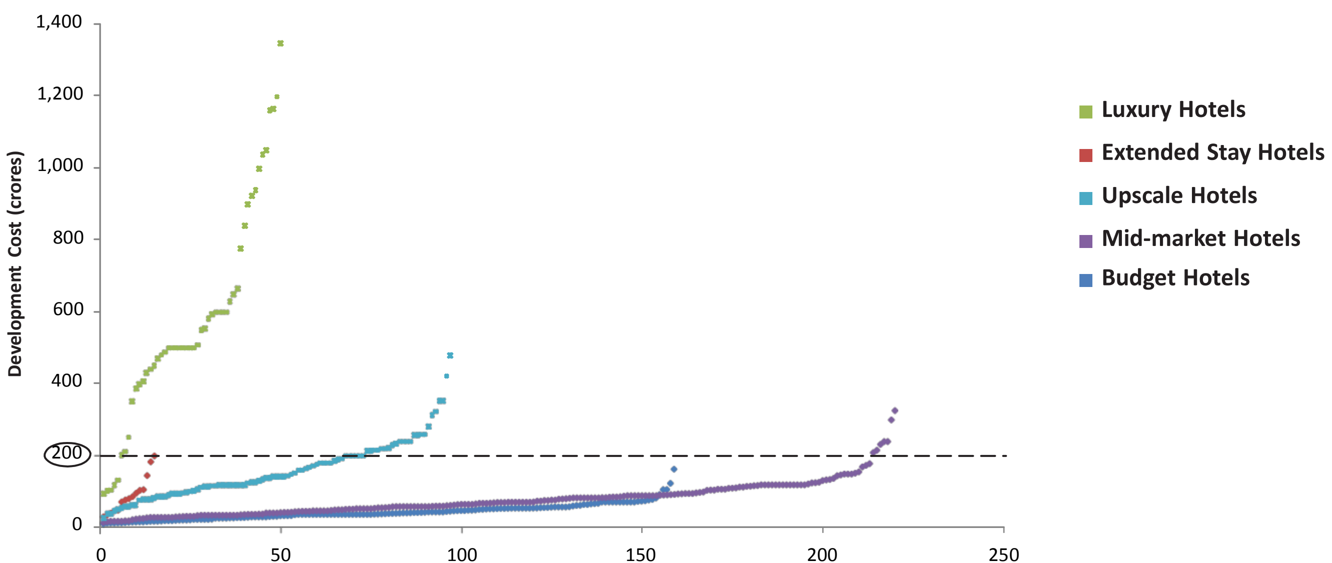
Figure 5 Qualifying Projects by Positioning



Source: HVS Research

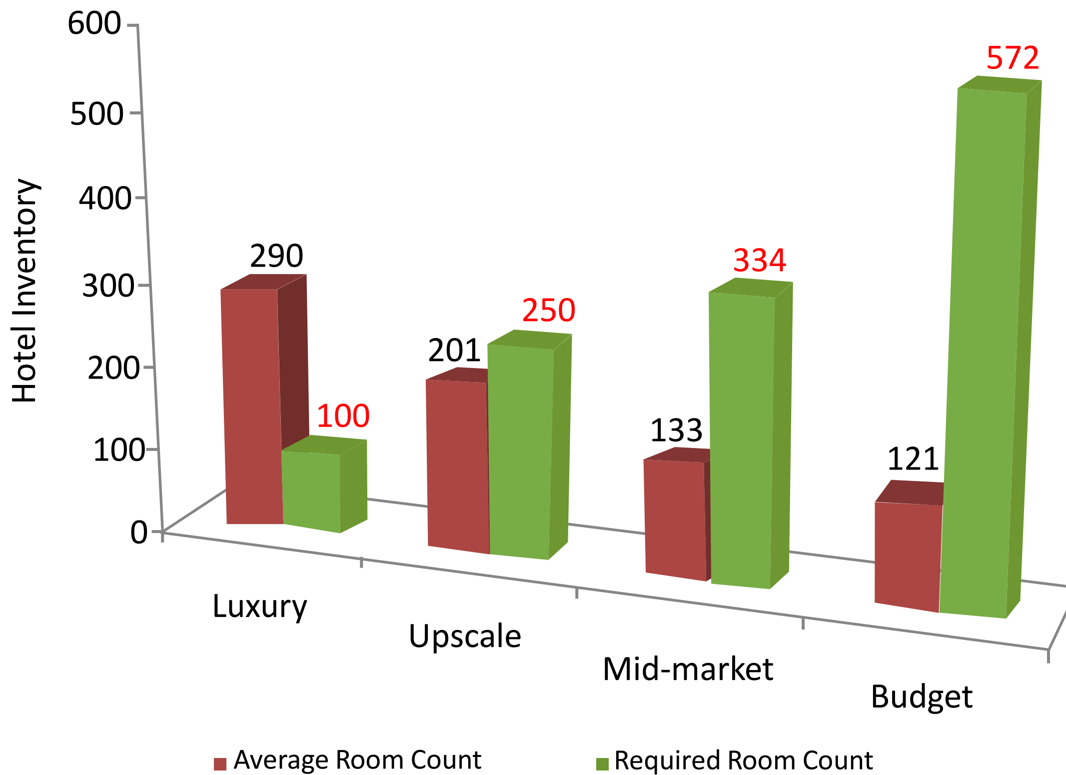
Figure 6 presents the minimum number of rooms that would be required by positioning for a project to qualify for the infrastructure list benefits, given the minimum project cost threshold of ₹200 crores and a per room development cost of ₹35 lakhs for budget hotels, ₹60 lakhs for mid-market hotels, ₹80 lakhs for upscale hotels and ₹2 crores for luxury hotels. As is clear from this analysis, the minimum inventory required in the budget and mid-market segment far exceed the nationwide average size of proposed hotels.

Figure 4 Development Cost by Positioning



Source: HVS Research

Figure 6 Room Count to Qualify



Source: HVS Research

Given the Tourism Ministry's 12th Plan (2012-2017) goal of augmenting the current inventory by an addition of 180,000 classified guest rooms and raise domestic and international tourist arrivals and therefore increase the tourism sector's contribution to GDP, it is our view that the current provisions under infrastructure listing are insufficient.

For this measure to be truly inclusive and effective, we recommend the following changes:

- **Reduce the development cost threshold to ₹50 crores**
- **Provide the benefits to all existing hotels and allow them to switch over to the new loan terms**
- **Provide the benefits to hotels that are currently under construction**
- **Eliminate arbitrary time limits, such as the currently mandated three-year period, and ensure that all benefits are permanently available**

The hospitality sector plays a significant role in increasing foreign tourist arrivals into the country and in creating employment, thereby making a meaningful economic contribution to the country. Given the importance of this sector, we believe that a comprehensive policy that addresses the needs of the various stakeholders is critical and long overdue. It is our hope that the government will take proactive steps in this regard to encourage further investment into the sector and enhance the fiscal position of what is indisputably an essential part of infrastructure in India.

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About the Authors

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