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Owners, put Libor on your radar

(The views and opinions expressed in this blog are strictly those of the author.)

Headwinds are a regular topic of conversation in our asset management practice, as we work to alert our investors to changes coming down the pike and to strategize on opportunities to mitigate risk.

While many of the factors we monitor are directly related to operations – and , frankly are more interesting to write and read about – we also stay in tune with market indicators to provide owners with visibility on other issues that could potentially impact investment returns. One such indicator that is back on our radar of late is Libor (the London interbank offered rate) … admittedly, not exactly a sexy topic, but the pace of recent growth is notable.

For instance, since January, the one-month Libor rate has increased roughly 50 basis points approximating 2%, the highest level since 2008. Market experts assure us that the recent rise is not attributed to the same conditions that sent Libor soaring in 2008, which sparked fear of a threatened banking system worldwide. It does, however, suggest tightening financial conditions, and what we find most concerning is the pace at which this growth is occurring and the disconnect in many Libor forecasting tools.

As a standard practice, we typically download an updated Libor forecast a couple of times a year to spot-check cash flow forecasts to market conditions, and for the past several years, the change has not been significant forecast to forecast. However, this is not the case in 2018. Within the past six months,

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changes to the December 2018 forecasted rate has increased significantly. To put it in perspective, the difference in annual debt service based on forecasted Libor between January and June equates to just under US$900,000 on a US$100 million loan. While we knew that rates were rising, we did not know, as I suspect others may find surprising, that the expected pace of growth has been steadily picking up.

As illustrated in the example above, the implications of an unexpected increase can be material. Some of the questions owners with floating commercial loan rates should be asking include, was is the actual increase and do I have enough cash to cover it? It’s challenging to pull an extra million out of even the best of hotel operations in a given year. Will I still pass my debt covenants?

Debt yield tests will not be impacted, but DSCR most certainly will. Likewise, investors planning to acquire or develop new assets should revisit interest rate assumptions to be sure project returns reflect current market conditions. Owners may also benefit from exploring refinancing options at this time.

And, if nothing else, make sure you update your rate forecast monthly for cash planning purposes. Rates today may no longer be reliable for future planning, even in the short term.