S&P Global
Ratings

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Research Update:

Austin Convention Enterprises Senior Bond Rating Affirmed, Subordinated Bond Rating Lowered One Notch; Outlook Negative

July 21, 2020

Rating Action Overview

- S&P Global Ratings revised its base case and downside case assumptions for revenue per available room (RevPAR) for convention center hotels given the prolonged impact of the COVID-19 pandemic on the U.S. lodging industry. Under the revised base case, RevPAR will be lower than the 2019 level by 73% in 2020, 35% in 2021, 20% in 2022, and 10% in 2023 (see "U.S. Project Finance Conference Center Hotels Facing Unprecedented Operation Challenges," April 22, 2020 for previous scenarios). We expect RevPAR to return to its 2019 level by 2024 due to a gradual recovery from the pandemic-driven economic recession. Under the revised downside case, we expect an additional 10% decline of RevPAR against the 2019 level over the base case, and the hotel to return to its 2019 level by 2025, because of a possible slower and longer recovery for convention-related travel demand.
- Our downside analysis indicates that Austin Convention Enterprises Inc.'s (ACE) robust liquidity mitigates the cash flow shortfall risk to the senior bonds from the severe market conditions we are projecting. However, its subordinated debt is at risk of depleting all available liquidity in our downside case by 2022 given the extended recovery in the downside. As a result, we are affirming our 'BBB-' rating on ACE's senior debt and lowering our rating on its subordinated debt by one notch to 'BB-' from 'BB'. At the same time, we are removing the ratings from CreditWatch, where we had placed them with negative implications on March 23, 2020. We are placing negative outlook on the rating for both senior and subordinated debt.
- The negative outlook reflects the uncertainty of the hotel's performance given the possibility of a prolonged recovery from the weakening travel demand and fundamental shift in the lodging industry as the result of the extended impact of the COVID-19 pandemic on our economy recovery or the existing models of business travel and conventions, which could lead to a consistent and material decline in RevPAR beyond our downside-case assumption.

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Project Description And Key Credit Factors

ACE owns Hilton Austin, an 801-room, full-service hotel in downtown Austin, Texas, across from the Austin Convention Center. The hotel opened on Dec. 27, 2003, and operates in a 31-story tower (24 stories are occupied by the hotel), with about 98,800 square feet of meeting space (including pre-function space). Below the hotel is a 750-space parking garage, 600 of which the hotel operates.

Strengths

- Historically supported by high occupancy driven by convention center events and conferences given its prime location adjacent to Austin Convention Center.
- Managed by an experienced hotel management team from Hilton Worldwide.

Risks

- Uncertain recovery due to the COVID-19 pandemic.
- Fully exposed to hotel performance, which is highly sensitive to the competitive and cyclical local lodging market.
- Material dependence on liquidity balances during operational challenges.

Rating Action Rationale

ACE's liquidity profile reflects sufficient resilience under our revised downside stresses on the hotel's performance and throughout the path to recovery for the senior debt while its subordinated debt is at risk of depleting all available liquidity in our downside case before 2022 given the extended recovery in the downside. As a result, we affirmed our 'BBB-' ratings on the project's senior debt and lowered ratings on its subordinated debt by one notch to 'BB-' from 'BB'. We also removed the ratings from CreditWatch.

Unprecedented market conditions lead to revised S&P Global Ratings assumptions.

Since April of this year, the project witnessed unprecedented single-digit or very low double-digit RevPAR levels. In April and May, most of the guests staying at Hilton Austin were airline crew members while in June there were some transient leisure guests due to the less strict safer-at-home order in Austin. Nearly all conventions or events have been cancelled or significantly postponed for this year. We expect a slower and more gradual recovery in the hotel operation given the fact that convention center businesses would be the last to recover, following drive-to leisure and individual business travel. We believe the recovery would be highly dependent on how the community would deal with COVID-19 in the next 12 months, either by the availability of vaccine or further mandates imposed by the local government. Our updated forecast is based on the project's most recent performance and our latest corporate lodging forecast (see "U.S. Lodging, Leisure, And Gaming Sectors Face Rocky Road To Recovery", June 30, 2020) that anticipates a 40%-50% decline in RevPAR against its 2019 level in 2020 and 20% in 2021 for the

U.S. lodging market. In our view, given the nature of convention center business that drives the hotel's revenue, we expect the impact to be more severe for convention center hotels.

As a result, the table below outlines our revised base case and downside case assumptions for RevPAR:

Table 1

RevPAR Decline Versus 2019 Levels	2020	2021	2022	2023	2024
S&P Global Ratings base case	73%	35%	20%	10%	--
S&P Global Ratings downside case	83%	45%	30%	20%	10%

Our revised base case assumes nearly zero RevPAR until September 2020 and 50% lower than the 2019 level from October to December 2020. This is based on our assumption that the government would loosen up the restrictions on indoor gathering/business-related activities early in the fourth quarter of 2020 and the recovery would not happen immediately because people might still have concerns about being in large groups. We believe the shape of recovery is close to a U-shape, with a four-year recovery back to the 2019 level. A relatively slower recovery is outlined for convention center hotels, as smaller leisure-focused hotels or boutique hotels might recover sooner. After 2024, we have assumed a 2% increase year over year, consistent with our assumptions before pre-COVID-19.

The revised downside case assumes zero RevPAR until the end of 2020, which reflects the potential risks that the hotel might be still under great pressure with nearly no guests or suspended temporarily for the rest of the year. A possible scenario would be a sizable second wave that could make the virus battle longer than expected and lead to more restrictions from the local government. A 10% additional stress is also applied from 2021 to 2024 over our base case to reflect a longer U-shaped recovery with RevPAR resurfacing to the 2019 level by 2025.

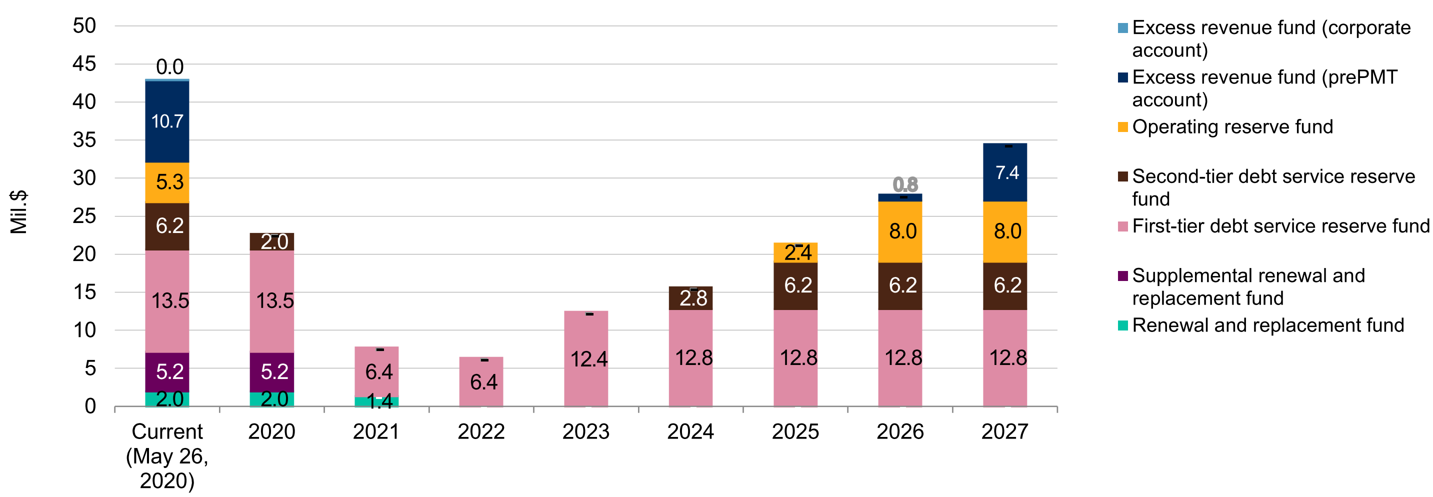
In addition, we discovered that hotel operating expenses become less elastic under the extreme operation environment when the hotel faces a material decline in RevPAR. Operating expenses are much stickier in such situations because the hotel is still responsible for paying a certain amount of room maintenance, utility, administration, marketing, and employee salary expenses. As a result, we forecast total operating expenses to be about $20 million under the base case and $18 million under the downside case in 2020, given the most severe decline on RevPAR assumed in this year. Our fixed expenses (including management fees, insurance, and the furniture fixtures and equipment (FF&E) reserve contribution) forecast is consistent with our assumption pre-COVID-19.

Sufficient liquidity cushion offsets cash flow shortfalls for senior debt but is not as robust for subordinated debt.

Overall, the project benefits from its strong liquidity deposits in various accounts, including senior and subordinated debt service reserve accounts (DSRA), operating reserve account, senior and subordinated FF&E reserves, and excess revenue fund accounts. The total amount of liquidity was about $50 million as of May 26, 2020 (including about $6 million in the senior debt service account and $1.3 million in the subordinated debt service account). For the senior debt, the current level of liquidity would provide sufficient resilience under our revised downside case throughout the recovery period and beyond 2025. However, we expect that the senior DSRA would be drawn in 2021 by about 50%, and not fully refunded to the required amount of about $13 million until 2024 in the downside. While this potential draw shows some weakness, we believe it remains in line with our 'BBB-' rating expectation given our sensitivity analysis on additional RevPAR declines. For the subordinated debt, given the subordinated nature of this debt tranche, which is highly subject to liquidity available to the subordinated debt obligation (not including senior DSRA) and the residual cash after senior debt services and replenishment of senior DSRA, we expect the liquidity position could only support two years and likely be fully depleted in 2022 under our revised downside case. Therefore, the liquidity profile for the subordinated debt tranche is closer to the 'b+' level under our downside assessment.

Chart 1

Liquidity Position 2020-2027



Environmental, social, and governance (ESG) factors relevant to the rating action

- Health and safety

Outlook

The negative outlook reflects the uncertainty of the hotel performance due to the possibility of prolonged recovery from the weakening travel demand and fundamental shift in the lodging industry with regard to the existing models of business travel and conventions, which could lead to a consistent and material decline in RevPAR beyond our downside case assumption.

Downside scenario

We could lower the senior debt ratings if RevPAR declined 20% or more over our downside RevPAR assumption each year from 2020 –2024, which exhausts the project's liquidity before 2024 in our downside case. We could lower the subordinated debt ratings if there were a significant RevPAR drop of more than 30% below our downside RevPAR assumption in 2021, leading to full depletion of liquidity available to subordinated debt by 2022. Factors that could trigger the downgrade include a new round of government shelter-in-place mandates due to a material second wave of COVID-19 in U.S. in 2021, a faster transition of the convention business model to virtual reality conferences over the next two years, and a longer-than-expected economic recession after post-COVID-19.

Upside scenario

We could revise the outlook to stable if the hotel's performance returns to pre-COVID-19 levels, with a DSCR of 2.1-2.5x. This could happen if the speed of recovery in the convention business-related travel outperformed our expectation in the next two years.

Base Case

Assumptions

- Please refer to Table 1 for the revised base-case RevPAR assumptions for 2020-2024. We assume RevPAR will revert to its 2019 level by 2024. Post-2024, we assumed a 2% increase year over year, consistent of our assumption pre-COVID-19.
- Operating margin: 48.1% from 2021 onward.
- FF&E reserve contribution: 6% of total operating revenue.

Key metrics

Senior debt:

- Minimum DSCR: negative 0.41x (2020)
- Average DSCR: 2.06x

Subordinated debt:

- Minimum DSCR (consolidated): negative 0.27x (2020)
- Average DSCR (consolidated): 1.48x

Downside Case

Assumptions

- Please refer to Table 1 for the revised downside-case RevPAR assumptions for 2020-2025. We assume RevPAR will revert to its 2019 level by 2025. In addition, we assume the growth to be 50 basis point lower than our base case in the last 10 years.

- Operating margin: 10% reduction of operating margins over remaining asset's useful life.
- Fixed costs: 0.5% increase over base case.
- FF&E reserve contribution: 5% increase over base case in the last 10 years.

Key metrics

Senior debt:

- We expect the liquidity resiliency for the senior debt to be sufficient to mitigate any cash flow shortfall risk anticipated under our downside scenario throughout the recovery and beyond 2025, which is in line with our expectation of the 'BBB-' rating for the senior debt.

Subordinated debt:

- The liquidity resiliency for the subordinated debt is not as robust as it is for the senior debt, since liquidity available to subordinated debt tranche is likely to be fully exhausted by 2022 under our downside case. It is closer to our expectation of the 'b+' level under the downside assessment.

Peer Comparisons

The peers include Denver Convention Center Hotel Authority (DCCHA) and Baltimore Hotel Corporation (BHC). All peers are similar to the project with adjacent convention centers being primary business drivers of performance.

Though Austin's lodging market has shown stronger performance in the past few years, the unprecedented impact of COVID-19 on Austin's lodging demand and the absence of the tax support (unlike DCCHA and BHC) positioned the project to be fully exposed to this significant trough of market. However, offsetting this risk by a strong liquidity position accumulated from previous years by its unique closed-loop cash flow waterfall, the project's senior debt credit profile would be still in line within investment grade.

The closed-loop cash flow waterfall is the key advantage of the project relative to peers. At the end of the waterfall, all cash available, after a $2 million distribution to the City of Austin, will be deposited into an excess revenue fund that can be deposited into the supplemental FF&E reserve account or bond prepaid account, at management's discretion. The trapped cash provides support to both senior and subordinated debt. Compared with its peers, the senior debt ratings on the project are commensurate with the 'BBB-' level. However, relative to other 'B' rated projects, the trapped cash demonstrates additional resiliency for its subordinated debt. Therefore, we assign a one notch uplift of comparable ratings analysis (CRA) to the subordinated debt.

Rating Score Snapshot

Operation Phase Stand-Alone Credit Profile (SACP; Senior Debt)

- Operations phase business assessment: 9 (1 = best to 12 = worst)
- Preliminary SACP: bbb-
- Downside impact on preliminary SACP: None

- Liquidity: Neutral
- Adjusted preliminary operations phase SACP: bbb-
- Comparative analysis aassessment: None
- Counterparty assessment limitation: None
- Operations phase SACP: bbb-

Modifiers (Senior Debt)

- Parent linkage: Delinked
- Structural protection: Neutral
- Extraordinary government: None
- Sovereign rating limits: None
- Full credit guarantees: None
- Senior debt issue rating: BBB-

Operation phase SACP (Subordinated Debt)

- Operations phase business assessment: 9 (1 = best to 12 = worst)
- Preliminary SACP: b+
- Downside impact on preliminary SACP: None
- Liquidity: Neutral
- Adjusted preliminary operations phase SACP: b+
- Comparative analysis assessment: +1 Notch
- Counterparty assessment limitation: None
- Operations phase SACP: bb-

Modifiers (Subordinated Debt)

- Parent linkage: Delinked
- Structural protection: Neutral
- Extraordinary government: None
- Sovereign rating limits: None
- Full credit guarantees: None
- Senior debt issue rating: BB-

Operations phase SACP

- Due to the relatively higher operating complexity for large-scale convention center hotels, we assign an asset class operation stability assessment of '2' (on a scale from '1' as least volatile cash flows to '10' as the most volatile). The concession terms are typical, and we make no adjustments for other risk attributes or performance standards. The project is also not exposed to resource or raw material risk, achieving a performance risk score of '2'. The market risk assessment remains '4' given the project's full exposure to the cyclical and competitive lodging market. With no further adjustment, the project's operations phase business assessment is '9'.

- We rate the senior and subordinated debt to the liquidity resiliency under our downside case. We expect the liquidity resiliency for the senior debt to be sufficient to mitigate any cash flow shortfall risk anticipated under our downside scenario throughout the recovery and beyond 2025, which is in line with our expectation of the 'BBB-' rating for the senior debt. With no further adjustment, the operations phase SACP for senior debt is 'bbb-'.
- The liquidity resiliency for the subordinated debt is not as resilient as for the senior debt, since we expect liquidity available to the subordinated debt tranche to be fully exhausted by 2021 under our downside case. It is closer to our expectation of the 'b+' level under the downside assessment. With a one-notch uplift of CRA, the operations phase SACP for subordinated debt is 'bb-'.

Operations counterparties

The hotel is operated by Hilton Management LLC (an affiliate of Hilton Worldwide Holdings Inc.), which is assumed to be replaceable. The project funds are held by U.S Bank N.A. The creditworthiness of these counterparties does not constrain the project.

Liquidity

We view the project's liquidity as neutral to the ratings. As of May 26, 2020, the debt service reserve was funded at $13.5 million for the first-tier bonds and $6.2 million for the second-tier bonds. The project also has $5.3 million operating reserve fund and $10.7 million excess revenue fund. For its FF&E, the project has a senior and supplemental FF&E reserves with a combined balance of $7.2 million.

Related Criteria

- Criteria | Structured Finance | General: Counterparty Risk Framework: Methodology And Assumptions, March 8, 2019
- Criteria | Corporates | Project Finance: Project Finance Framework Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Key Credit Factors For Social Infrastructure, Accommodation, And Entertainment Project Financings, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Operations Methodology, Sept. 16, 2014
- Criteria | Corporates | Project Finance: Project Finance Transaction Structure Methodology, Sept. 16, 2014
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | Project Finance: Project Finance Construction And Operations Counterparty Methodology, Dec. 20, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- U.S. Lodging, Leisure, And Gaming Sectors Face Rocky Road To Recovery, June 30, 2020
- U.S. Project Finance Conference Center Hotels Facing Unprecedented Operation Challenges, April 22, 2020

Ratings List

Issue-Level Ratings Lowered; CreditWatch/Outlook Action

	To	From
Austin Convention Enterprises Inc.		
Subordinated	BB-/Negative	BB/Watch Neg
Issue-Level Ratings Affirmed; CreditWatch/Outlook Action		
Austin Convention Enterprises Inc.		
Senior Secured	BBB-/Negative	BBB-/Watch Neg