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Alternative Financing to Help Close Hotel Deals

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Like other commercial real estate (CRE) sectors, the hospitality industry has seen a drop in deal volume. The very stubborn inflation level kept benchmark lending rates elevated for most of last year, and this trend is expected to continue this year. To make matters worse, lenders—particularly local and regional banks—are facing their own issues with maintaining sufficient liquidity to make loans, as well as managing CRE concentration and sub-performing loans in their books. The pool of active hospitality lenders is arguably much smaller today, and those who are still actively lending are very selective in adding new loans to their balance sheet.

While there is virtually nothing that a buyer or seller can do to influence the direction and level of borrowing rates, nor to change the lender's appetite to originate new hotel loans, there are other ways for buyers and sellers to close hotel deals in today's environment.

Firstly, we define acquisition as transfer of ownership interest in an asset from the seller to the buyer, whether wholly or partially. A CRE acquisition typically involves the use of external capital, either in the form of debt or equity, in addition to the buyer's own cash equity. Here are a few options to consider when you are using external capital or financing:

Debt Financing

The most common type of financing involves loans provided by financial institutions, such as banks, credit unions, life insurance companies, debt funds, CMBS originators, and other sources. For acquisitions, there are two main categories of loans: permanent and bridge loans.

A permanent loan is intended to provide long-term financing, typically ranging from five to ten years. Banks and CMBS originators are the largest providers of permanent loans for hotels. In addition to maintaining a target **loan-to-value** (LTV) level, these lenders rely heavily on actual, in-place cash flows in underwriting and determining the loan amount. The primary use of the loan proceeds is to pay for the purchase of the hotel, although some working capital and/or a minor **property improvement plan** (PIP) renovation may be funded by the loan.

For hotels that are yet to stabilize, either because they were recently opened or because they are scheduled to undergo a major renovation, rebranding, or repositioning, a bridge loan is more appropriate. A bridge loan is typically structured with a shorter term of one to three years (plus extension options). It is intended to provide interim financing before the hotel qualifies for a permanent loan. Bridge lenders consider the forecasted cash flows when underwriting these loans. Additionally, special attention is given to the owner's business plan for achieving the forecast and the owner's experience with executing similar plans.

Assumption of Existing Debt

In certain situations, a buyer can assume the existing debt on the to-be-acquired hotel. However, these situations usually only include a non-recourse loan where the original loan was made based on the real estate and not the sponsorship or loan guarantor. The advantage in taking over an existing debt is that it is likely to be priced lower than what the buyer can obtain today. The disadvantage is that the leverage level may be lower than what the buyer desires, as the existing debt's principal amount has been amortized over the years. It is also

Summary

Obtaining leverage through debt financing is key to achieving the desired equity return on a hotel acquisition. The reduced availability and prevailing high cost of traditional loans are forcing buyers to be creative and consider alternative strategies to seize an acquisition opportunity. This article presents a few of these alternatives.

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important to note that while the loan is non-recourse, the buyer will still have to undergo scrutiny by the lender and will have to demonstrate financial wherewithal that is similar to or better than the current borrower.

Seller Financing

Seller financing, as the name implies, is an arrangement whereby the current owner or seller accepts a cash down payment from buyer and carries the remainder of the purchase price as a loan by the seller to the buyer. This type of financing is meant to be a short-term, and the seller fully expects to be eventually paid out by a traditional loan from a bank or other lending institutions. Interest rates are negotiable and driven by the motivation of both parties to close the deal. This arrangement is typically made to accommodate a very short closing deadline or other circumstances preventing the buyer from obtaining a traditional loan before closing.

There are instances where seller financing can be combined with a new senior debt to achieve the buyer’s desired LTV level and minimize the amount of down payment required to close the deal. The seller financing is subordinate to the senior debt and is subject to the new lender’s approval.

Equity Recapitalization

When a whole transfer of ownership is not feasible, a buyer can participate in ownership and share the cash flow from the hotel operations through an equity recapitalization. Under this structure, the buyer acts as a new investor and pays for partial ownership of the asset. The seller stays in the deal as part owner. The buyer’s new equity could be **pari passu** (i.e., “of equal footing or claims”) with the seller, or it could be structured as preferred equity with preferential claim to operating cash flow and proceeds from a future sale of the asset. The existing debt also remains in place unless there is debt maturity.

In the hospitality industry, the new equity investor commonly requires equal rights to key decisions pertaining to the asset, including the sale, refinancing, selection of management company, and appointment of key staff members like the general manager or director of sales. At times, the new investor will bring its own management company to operate the hotel.

Conclusion

The reduced availability and higher cost of traditional loans has slowed hotel transaction activity and has limited buyers’ financing options to low LTV debt, which has put downward pressure on asset pricing and often resulted in rejected offers.

The options presented in this article may not be the final solution for securing external capital to finance a hotel acquisition. In fact, a few of them would be temporary, short-term solutions that would eventually be replaced by a traditional loan when the hotel lending market returns to normal. However, these alternatives can be used to close hotel deals when the traditional loan option is not available. Qualified members of the **HVS Brokerage & Advisory’s capital markets team** are available to help you investigate, structure, and execute these options.

About Emil Iskandar

Emil Iskandar, Senior Vice President of HVS Capital Markets, is responsible for the origination, structuring, and placement of debt and equity capital solutions. Prior to joining HVS, Emil was a Director at Marcus & Millichap, where he was responsible for securing debt and equity financing for full-, select-, and limited-service hotels, as well as resort hotels and golf courses nationwide. Earlier, he was a Vice President at HVS Capital Corp. He began his real estate career with Jones Lang Wootton Asia-Pacific. Throughout his career, Emil has worked with investors ranging from large multinational institutions to family offices. He has completed origination, structuring, and placement of debt and equity capital transactions across all facets of commercial, residential, lodging, and leisure properties. Contact Emil at 1-720-231-3927 or .