Bridging the Gap on Hotel Financing with Aggressive Lending Parameters

July 8, 2005 / *By Josh Heiney*

As the national economy continues to rebound from the 2001 economic downturn, the hotel industry also follow this positive trend with impressive annual RevPAR growths, beginning in 2004. Despite the strong recovery, a hotel owner may have the need to complete a refinancing transaction, only to find out that net operating income has not yet returned to a sufficient level to service the necessary debt. However, hotel lenders have developed many aggressive bridge-financing programs in order to successfully underwrite the financing for hotels that are currently coming up short on proceeds, but have viable turn-around stories anticipated for the future. The question may arise: why can't the hotel owner wait to finance until the property has returned to its historical stabilized income level? The need to finance during this re-stabilization period can be attributed to many reasons that include maturing existing mortgage debt, locking-in attractive interest rate, or a franchise "PIP" and other capital requirements. The hotel owner may have an opportunity to extend the term of the existing loan so that the hotel has additional time to re-stabilize. However, there is little chance to extend the term if the loan has been securitized in a CMBS pool, if the property's performance is below par, or if the existing lender has earmarked the funds for other uses. Also, with current interest rates at a historical low, the borrower may be scrambling to rate lock as soon as possible. Lastly, the hotel may be reaching its 5 or 10-year renovation cycles, and unfortunately this cycle has arisen during a re-stabilization period, when the income is not at its peak level. However, in the current competitive hotel market, an owner cannot afford to hold off renovations and capital improvements, as many properties have recently completed extensive renovations in order to create a competitive advantage over their competitors. Interest-only financing, "interest rate bumps," and earn-out provisions are all techniques the capital markets are utilizing in order to "bridge the gap" until hotels reach a fully re-stabilized level. By providing interest-only financing during the initial years of the term, an owner has a more reasonable monthly payment that can provide the property with a sufficient debt service coverage ratio ("DSCR") while it continues to re-stabilize. Once the interest-only period expires, and the amortization schedule begins, the hotel has had an opportunity to reach its historical stabilized level of net operating income, therefore, continuing to to meet lender's DSCR. Lenders can also provide an "interest rate bump" to a hotel owner, which is another strategy that creates a sufficient level of DSCR during the re-stabilization period. The idea is that during the early years, when a hotel property is still in its re-stabilization period, the corresponding interest rate will be much lower, and as time passes, the interest rate will begin to grow. As the net operating income continues to grow, the hotel nears its stabilization period. During that same time, the interest rate will also be increasing so that the hotel is not overburdened during the early years, at the same time, giving the lender a risk adjusted return by the end of the term. An earn-out is another provision lenders utilize in order to bridge the gap to re-stabilization. If the owner has access to another source of funds that can be used temporarily to pay down the debt or to fund capital improvements, then they can go to market for a lower loan amount in order to lock-in an attractive rate. As the hotel begins to reach certain performance tests, such as a DSCR or LTV threshold, the lender begins to earn-out additional debt that would be used to repay the other temporary source of funds (which usually is more expensive than the senior loan). This is an effective technique that is used in order to lock-in an attractive interest rate and get the full loan amount to pay-off the existing debt and fund the necessary improvements. In the current debt market, a borrower has the opportunity to secure attractive loan terms due to the large availability of bridge financing in the market. However, the borrower also needs to be prepared to document and support the hotel's re-stabilization story. Lenders will request operating projections, historical operating statements, details on any PIP's or renovations, explanation of the local hotel market and economy, and many other supporting materials in order to get comfortable with the re-stabilization and upside potential.

Summary

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Comments

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Another factor to keep in mind is bridge financing, as the name implies, is designed to stay for a relatively short period of time. One of the lender’s chief concerns is how the loan will be paid off at the end of the term. Providing a clear exit strategy is of the utmost importance.