Hotel Mortgage Loan Workouts and Defaults

June 25, 2003 / By Michael T Sullivan

This is the first of a series of articles in which we will discuss current problems that some borrowers (and obviously their lenders) are having with hotel mortgage loans, along with ideas and strategies for possible resolution. To start, frequently asked questions include: how bad are things in the hospitality industry, especially regarding the conditions of hotel mortgage debt? Also, is this a "U" or "V" shaped downturn? As things have evolved over the last year or two, the downturn can probably be best described as an "L" shaped downturn. In most markets, Revenue per Available Room ("RevPAR") has deteriorated and, for the most part, remained fairly flat. On a positive note, however, improvements in the operating margins of the hotel industry have been well chronicled. Additionally, the current interest rate environment has been an added blessing for the industry, especially for borrowers of variable rate hotel mortgage debt. So the volume of hotel mortgage defaults and foreclosures has not been at the levels that had been expected. This does not mean that there have been no defaults or foreclosures. From the lenders' perspectives, particularly as it relates to their real estate debt portfolios, hospitality mortgages have been by far, the most troubling component. However, in most cases in which a lender has a reasonably balanced mortgage portfolio spread out over a variety of real estate asset classes, hospitality mortgages are usually relegated to a minority of the total. As such, even if default rates of hotel mortgages have climbed, such defaults only constitute a small percentage of lenders' portfolios. Due to this, few lenders seem to be worried about "going under" because of defaulted hotel mortgage debt. Therefore, improved operating margins, low prevailing interest rates, and a lack of general real estate malaise (affording lenders the opportunity to be somewhat understanding in handling defaults within their hotel mortgage debt portfolios) have combined to limit the number of defaults and subsequent foreclosures. Still, defaulted hotel mortgage debt (despite its percentage of an overall portfolio) represents a problem with which needs to be dealt. As stated above, since real estate mortgages portfolios are, in general, doing well, and the problems to date primarily involve hospitality, not many lenders are sufficiently staffed to manage these problem loans. In the early 1990s, when real estate defaults were rampant, workouts, foreclosures, and troubled asset management essentially became a "cottage industry," with numerous real estate professionals becoming active in the resolution of these problems. In response to this current lack of workout personnel, HVS has created a new and specialized division to handle this cycle's downturn: the HVS Special Hospitality Assets Group. Along with two major national law firms, we are currently providing a host of services to lenders and borrowers, working through and resolving their issues (please click here to view more information on the HVS Special Hospitality Assets Group). Essentially, a default in a hotel mortgage loan is a liquidity problem, or more precisely, is the result of a lack of liquidity. What exactly do we mean by the term liquidity? A lack of cash, cash flow, cash investment, and/or cash equity. In other words, a hotel that is the subject of a monetary default will often enter a downward spiral, and the various parties associated with the hotel (and/or its underlying debt) cannot or will not resolve the problem with cash. Of course, this problematic trend usually begins with a lack of liquidity at the property itself. The hotel is not generating enough bottom-line cash flow to fully service its monthly debt service requirements. This failure to meet debt service then extends this liquidity problem to the lender. However, the lender often takes the position that it has already invested as much money as it is going to into the project, and will not invest any additional capital. At such point, the lender is likely becoming concerned about the loan's repayment risk (specifically, as it relates to principal amounts), so the notion of any additional investment is probably a non-starter. Financial conditions of the borrower often mirror those existing at the property; when the property (or the hotel industry in general) is doing well, the borrower should be financially stable, at a minimum. Alternatively, when property operating conditions deteriorate, borrowers often suffer. This is particularly true for those borrowers that are heavily invested in the hotel industry. As such, more often than not, a borrower will not be in

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a position to provide much (if any) meaningful financial assistance to a troubled hotel property. By this point, the borrowers may have missed some scheduled payments (principal and/or interest). Sometimes, they will have asked for, and obtained, some level of temporary forbearance or other concession(s) from their lenders. Due to the apparent "L" shape of the industry's current downturn, however, sooner or later some action must take place. Examples include the borrower seeking more formalized and longer-term concession(s) from the lender, the lender beginning foreclosure proceedings, the borrower contemplating bankruptcy, or some other decisive plan of action. Such topics will be discussed in more depth in our upcoming segments.

About Michael T Sullivan

Michael T. Sullivan is Managing Director of HVS Capital Corp., joining HVS in June 2001. Previously, he served as Managing Director of Sonnenblick-Goldman, which he joined in 1974. During his career, he has been responsible for the financing and sale of more than 650 hospitality properties (hotels, resorts, golf courses, and shared ownership) and for completing, on average, roughly $1.0 billion per year in debt and equity transactions in hotels/resorts nationwide. In his current position, he oversees a staff of hospitality banking professionals, all of whom are involved in the origination and placement of debt and equity realty assignments, with a primary focus on the Lodging and Leisure Industry. Mr. Sullivan attended the University of Arizona, where he received a degree in accounting and marketing. He is a Certified Instructor for the National Apartment Association and a frequent speaker for the Colorado Apartment Association, BOMA, and other trade real estate groups.