Top 4 Hotel Financing Obstacles And How to Get Around Them

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Do you have upcoming hotel financing needs? Whether you are in the market for a simple refinance or acquisition financing, a discounted-payoff (DPO) financing or a PIP-induced recapitalization, the same rules apply.

The hotel loan market has been on a good run for the last twelve months with competition among lenders heating to a point not seen since prior to the financial crisis. Lenders are beginning to focus increasingly on areas outside of pricing and leverage in order to preserve loan profitability and keep mortgage leverage below the aesthetically pleasing 70% loan-to-value level.

SIMPLY PUT, WHAT THIS MEANS FOR HOTEL LOAN BORROWERS IS THAT LENDERS ARE WILLING TO LISTEN TO YOUR STORY, NOW MORE THAN EVER, TO WIN AND CLOSE YOUR BUSINESS.

The following list identifies the top 4 hotel financing obstacles and advice on how to approach them:

#1 - NOI UNDERWRITING ADJUSTMENTS

Unfortunately, the borrower's NOI doesn't aways look like a lender's NOI. Lenders implement a series of underwriting adjustments to determine an "underwritten" NOI. Below are the most common adjustments:

- Occupancy Adjustment – Lenders are reluctant to underwrite occupancy levels above 75%. There are certain markets, particularly those with high barriers-to-entry (New York City), where this rule may not apply or carry a higher threshold. The reason for the threshold is because hotels operating at or above 75% occupancy are typically in markets that have latent demand which may lead to future new supply and pressure on market-wide occupancy.

  It is in an owner's best interest to push ADR in lieu of occupancy prior to a financing. Lenders will not adjust ADR upward to offset a downward occupancy adjustment, so be prepared to do that yourself. Lenders will correspondingly drop variable expenses associated with the lower underwritten occupancy to help offset the downward adjustment.

- FM&M (Franchise, Marketing and Management) Adjustment – Some lenders will underwrite a minimum FM&M expense as a percentage of revenue. For full-service hotels, the minimum is approximately 12.0% and for limited/select-service product, the minimum is approximately 14.5%. Included in the FM&M calculation is the management fee which most lenders will underwrite at a minimum of 3.0%.

  The FM&M adjustment typically comes into play on owner-operated and un-flagged hotels. A case can be made to waive the adjustment if the historical FM&M expense has been consistent over the years, the hotel is performing near the top of its competitive set and there is no new supply anticipated in the market.

- FF&E (Furniture, Fixtures & Equipment) Adjustment – The standard FF&E adjustment made by lenders today is 4.0% of revenue. Lower adjustments can be made for new or recently renovated hotels. There is a difference between underwritten FF&E and the amount of actual FF&E reserve that will be collected by the lender. It is often easier to negotiate a lower actual FF&E collection than it is to negotiate down the underwritten FF&E for the purposes of loan sizing and pricing.
  Presenting and explaining a detailed schedule of recent capital improvements is important ammunition to

Summary

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#2 – RECESSIONARY BATTLE SCARS

It has become commonplace for borrowers to have at least one, or multiple, instances of default, workout, foreclosure or bankruptcy as a result of the most recent recession. Prior to the recession, most lenders would avoid such borrowers. Nowadays, if lenders took that same stance, there wouldn't be a whole lot of qualified borrowers.

The foremost question that arises when underwriting the above situation is whether or not the sponsor "played nice" in such times of distress. It is our job to help craft an explanation in a manner that is easily digestible and viewed favorably in the eyes of a lender. Almost every financing we have worked on post-financial crisis included one or more of these stories. We have been successful, without exception, at telling that story and getting credit approval.

#3 –LOAN TERM FRANCHISE EXPIRATIONS

With an exception for recently constructed hotels, it is often difficult to execute franchise agreements with term in excess of ten years. This poses a problem when seeking five or ten-year permanent financing. Lenders are reluctant to take on the risk that their collateral will be down-flagged or become un-flagged during the term of the loan or at the time of maturity.

A cash flow sweep structure can solve this problem. The sweep is triggered by a non-renewal of the franchise agreement prior to the franchise expiration. The sweep is a temporary mechanism, with all swept cash returned to the borrower once the franchise agreement is renewed and there are sufficient funds available to pay for an associated PIP.

#4 – PREPAYMENT PENALTIES

Prepayment penalties typically come in the form of yield maintenance or defeasance. Prepayment penalties make it more difficult to take advantage of cap rate declines, as the penalties become more costly as interest rates decline. Below are the most effective ways to mitigate prepayment penalties:

- • Loan Assumability – A loan assumption option allows the borrower to sell the hotel encumbered by its existing debt. Although slightly lower leverage and a higher than market loan interest rate may detract from a hotel's value, it is less costly than paying a prepayment penalty to sell a hotel unencumbered. This is almost always true, as yield maintenance and defeasance penalties are discounted at the risk-free rate (U.S. Treasury Rates), whereas a loan interest rate includes additional spread above treasury rates.
- In a rising interest rate environment, a loan assumption will add value to an encumbered sale by allowing a new buyer to take advantage of a lower than market interest rate for the remainder of the existing loan term.
- Additional Debt – Lenders are beginning to allow for the ability to add additional debt post-closing, usually in the form of mezzanine financing. In an encumbered sale scenario, as discussed above, this allows a new buyer to assume the senior financing and "right-size" the loan by adding additional debt at closing. This minimizes or eliminates the discount to market value a seller would otherwise have to accept, particularly in a declining interest rate environment.
- Lengthening the "Open Period" – Most non-recourse hotel loans include a 90-day period at the end of the loan term with which loans can prepaid without penalty. Lenders have the ability to price in longer open periods, with the cost varying amongst lenders. A borrower can think of this structure as having a loan with a shorter term and built-in, prepaid extension options.

The author, Brian Holstein, is a Senior Vice President at HVS Capital Corp. Mr. Holstein is primarily responsible for the origination and placement of debt financings and investment sales. Prior to joining HVS Capital, Mr. Holstein closed more than $1 billion in commercial real estate loans and underwrote more than $20 billion of loans while working at a direct lending institution. Mr. Holstein's experience as a commercial real estate banker gives him a unique perspective on loan underwriting, pricing, structuring and closing.

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