

HOTEL CRISIS STRATEGIES

A client service of The Plasencia Group, Inc.

LOAN EXTENSIONS

There's a big effort under way to extend maturing hotel loans, but lenders should proceed with caution. Read on to learn more.

A number of our current consulting clients, most of them institutional lenders (CMBS special servicers, banks, and life insurance companies), are now having conversations with many of their borrowers who are seeking extensions on their current performing and non-performing hotel loans. Some would argue that extending a loan at current leverage levels may simply be prolonging the inevitable and actually exacerbating an already bad situation.

In a report just issued by a global investment bank, a sampling was taken of nearly 500 major hotel loans that are scheduled to mature between now and the end of 2012. Even if a generous 80% loan-to-value ratio were to be used (at today's depressed values), well over 50% of those maturing loans would not qualify for extensions since hotel cash flows are far from being able to service debt. Obviously, under the even more stringent underwriting terms now in place, few loan extensions are likely to be feasible.

“Brace for Impact”

Those were the three words of warning uttered by Captain Chesley Sullenberger of US Airways flight 1549, as he prepared his crew and passengers for a crash landing in New York City's Hudson River on January 15, 2009. Those same three words are most applicable today in the lodging sector.

We see marked evidence of continued substantial declines in 2009 in cash available to service debt as more and more hotels experience revenue erosion ranging from 12% to 30%. This may translate to bottom line declines in the 25% to 75% range. The losses are even more pronounced in the luxury and resort segments, especially in such properties outside the continental U.S.

So loan extensions may only be delaying the inescapable truth. Nevertheless, we expect that some loans will be extended and we offer a few words of caution to lenders and servicers contemplating loan extensions.

First and foremost, it is important to remember that a hotel is an operating business with cash crossing the front desk on a daily basis. There are no rent rolls, and unlike a tenant in an office building, a hotel's "tenants" come and go each and every day. Some hotels might be paying principal and interest now, but many are expected to default in the near future.

Look Before You Leap

The following questions should, at the very least, be considered by lenders as part of any loan extension.

- Is the borrower or manager being honest, sensible and completely committed to a recovery plan which maximizes the odds of the lender eventually being repaid? Is this even a realistic priority for the borrower, especially one with non-recourse debt?
- Is the borrower willing to pay down some of the principal as part of the extension plan? This is an opportunity for lenders to be aggressive.

LOAN EXTENSIONS *continued*

- What legal protections should be put in place to ensure that all available cash flow will be used to service debt?
- What considerations can the lender attain in exchange for the extension?
- What is the age and current physical condition of the property, and will the physical asset be properly preserved for the balance of the loan term?
- Are reserves for replacement being collected? What rights or assurances does the lender have with respect to those reserve funds in case of default or if they should be needed by the lender? Can a “cash trap” be established?
- Is the hotel in good standing with its brand, or does the brand require immediate operating and/or capital improvements?
- Is the property being managed in line with proper industry operating standards, or are service levels deteriorating along with revenues?
- Does the borrower/operator have other hotels and associated hotel loans in the same submarket, city or region? If so, what is the status of those loans? For example, if the borrower is fully liable for a debt facility associated with another hotel in the same submarket, the possibility may exist for business to be “pushed” in that direction.
- Has the borrower/operator conducted an analysis to determine if there will be a return of, and on, the capital necessary to get through the next two to three years (includes operating cash needs, debt service, brand capital requirements, etc.)?

We find that those lenders who are indeed granting extensions are being very honest with themselves about the possibility that they may ultimately end up as unintended owners, and we are often asked by our institutional clients about the ramifications of having to foreclose on hotel assets.

We'll address those points in a future article, but for now, suffice it to say that we frequently advise our clients to be wary of becoming a “forced owner,” especially if they have little or no prior experience owning a management-intensive operating business such as a hotel. It may be best to continue the relationship with the borrower/operator by creating a short-term forbearance agreement that provides for proper oversight and safeguards.

Any agreement should call for an updated and conservative operating forecast, making sure that all available cash flow is applied to debt service, while keeping current with payments for franchise fees and real estate taxes. This will give the lender time to evaluate the situation more fully. Accordingly, the lender could then decide to: (a) continue with the borrower under modified terms, (b) sell the note, or (c) proceed with a foreclosure.

The caveat to that advice, however, is that the lender should take a very aggressive posture if there is any inkling whatsoever that the borrower's actions are questionable or dishonest, or that the property's condition is deteriorating. Regardless of whether the lender has extended the loan or will soon become the *de facto* owner, bringing in experienced counsel and advisors to preserve and enhance the lender's position and the value of the hotel is always prudent.

During these difficult times, borrower and lender should increase their communication, combining trust with a critical, honest assessment of the asset's strengths and weaknesses. In this way, it may be possible to avoid an unpleasant outcome for both parties.

The Plasencia Group is prepared to actively work with lenders to evaluate current loans, and make recommendations on the best course of action. Please let us know if we may be of service to you.

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