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CPACE STRATEGY FOR AVOIDING LOAN LOSS RESERVES AND PRESERVING EQUITY CAPITAL

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A **recently published** article by several of my colleagues at HVS forecasts the expected pattern of decline, and the subsequent recovery, in the market value of hotels in the United States under “best case,” “most likely case,” and “worst case” scenarios. And while they further acknowledge a variety of factors that will also influence the ultimate value impact realized by a hotel under each of these scenarios, the decline in asset value under the “most likely” scenario is expected to average 26% in 2020, with 2019 market values not being fully recovered until 2023, at which time they are anticipated to surpass 100% of the 2019 market value.

While this forecast of decline in market value will have a significant and undesirable impact on the equity capital stack, the more immediate and serious problem for many hotels will be the insufficient level of EBITDA Less Replacement Reserve, otherwise known as the net operating income (NOI), available to pay debt service over the next one to two years as the hotel effectively works to restart business from a minimal occupancy level and faces a recovery timeframe that will depend on multiple external factors in a post-COVID-19 world, including the availability of a vaccine, vacation preferences, the level of business travel, and the propensity of groups to resume frequent gatherings.

The timeframe to ramp up occupancy and ADR levels to produce EBITDA Less Replacement Reserve capable of satisfying current debt obligations will pose serious challenges to lenders which, in turn, may further threaten the short- to mid-term survival of the equity capital stack. Although the CARES Act did provide some narrow and temporary relief to covered financial institutions for certain accounting standards relative to loan-loss reserves and their ability to delay the adverse effects of said standards for two years, and to subsequently phase loan-loss-reserve increases over three years, lenders will ultimately have to deal with losses and their balance-sheet impacts.

What realistic choices does a bank have in handling anything from short-term loan modifications through major troubled debt restructuring without ultimately dealing with the adverse effects related thereto? And, as an alternative, does a lender really want to fight through a foreclosure process and likely Chapter 11 counter filings by the borrower?

Clearly, in all cases, the “recovery plan” will need to acknowledge the decline in value and the decline in NOI. There is no “managed solution” for increasing the market value of the asset, as the recovery of value will be entirely in the hands of time and external market forces.

However, there is a managed solution for injecting new cash into the hotel operation without the source of the cash seeking to extract major considerations from the equity stack, or seriously threatening the position of the senior lender.

Currently, 36 states and the District of Columbia (D.C.) have passed laws enabling CPACE programs; twenty (20) of these states and D.C. have active CPACE programs. At the writing of this article, eight (8) of these states had accepted “look-back” program modifications, as described below, with up to a total of eighteen (18) states considering the look-back modifications on a case-by-case basis. The look-back modifications create an opportunity for CPACE providers to inject cash into a completed hotel development that is less than two or three years old. The state of Florida, where I focus my practice, is one of the states in the above subset of eight states, thus, actively providing the opportunity for hotel assets in Florida to avail themselves of the “recovery plan” strategy discussed in this article.

While the CPACE program has historically been utilized as part of the capital stack in new construction, the look-back program modifications allow CPACE providers to obtain these program funds for newly constructed hotels that have been open for a 24-month, and sometimes a 36-month, period. Typically, approximately 25% of the total dollar amount of expended hard and soft costs can be obtained in CPACE funding. Note that this funding is centered on expended costs, and not market value, another key to a creative recovery plan solution.

CPACE funding is repaid as an annual voluntary lien assessment within the real property tax bill. Borrowers can

work with CPACE providers on the amortization period with terms up to 25 years. Current program interest rates are between 5% and 6%, which makes this very inexpensive money compared to preferred equity or mezzanine debt. The funding is non-recourse, as it is attached to the asset, and assumable by a subsequent purchaser of the hotel.

Total CPACE provider and program fees are a bit higher than a typical real estate loan funding, but most of the fees are rolled into the total funding amount. And given the solution this money source can provide for a hotel that fits the above criteria, the slightly higher fee costs become irrelevant, especially when amortized over 25 years.

Most importantly, other recent program modifications within this grouping of states enables CPACE providers to allow for the deferral of the payment of the first two years of the special assessment. This provision is central to a creative recovery plan solution, as it enables the existing senior lender to avoid accounting for loan losses and enables the preservation of the existing equity capital stack.

Here is an example of how our advisory services are working with a prominent CPACE provider to create a workable recovery plan for both our hotel owner and hotel lender clients.

In this example, the asset is a new-build hotel that opened on January 1, 2019, before the advent of COVID-19, and was on track to refinance out the construction loan at the end of June 2020. However, refinancing is no longer an option. The hotel has had minimal business since the beginning of March and is hopeful that business will begin returning sometime in June. Hotel ownership expects EBITDA Less Reserve Replacement in 2020 and 2021 to be insufficient to pay interest on the existing construction loan.

Hotel ownership anticipates a gradual ramp up in occupancy over the next three years, with the hotel achieving a stabilized level of occupancy and operations in 2023 at a 73% occupancy and a \$140 ADR. The revised annual occupancy forecast for 2020 is 50%, with occupancy in 2021 and 2022 forecast at 67% and 71%, respectively. In 2023, when the hotel has achieved a stabilized occupancy of 73% at a \$140 ADR, total revenues are forecast at \$5,388,000 with EBITDA Less Reserve Replacement forecast at \$1,616,500.

Below is a recap of the development capital stack.

Development Capital Stack

One-Year-Old, New-Build Hotel		130 rooms
Opened January 1, 2019		
First Year of Operations: 2019		
Total Turn-Key Cost (\$150K/room)	\$ 19,500,000	
Land Value (\$15,400/room)	2,000,000	
Total Hard & Soft Costs (\$134,600/room)	\$ 17,500,000	
Original Development Capital Stack	\$ 19,500,000	100%
Existing Construction Loan (70%)	\$ 13,650,000	70%
Equity Capital (30%)	\$ 5,850,000	30%
Construction Loan		
Interest Only at 5%		
Term Expires 18 Months after Completion		
Loan Due	6/30/2020	
Annual Interest	\$ 682,500	

Source: HVS

Hotel ownership cannot afford annual interest payment for the next two years.
Hotel ownership cannot take out construction loan with refinancing given the minimal NOI at mid year 2020.

A comparison of the market-value estimates for this hotel, both pre and post COVID-19, appear below.

Pre- and Post-COVID-19 Value Estimates

Appraised Values: Pre COVID-19		
Market Value at Completion (4/2019)	\$	20,500,000
Stabilized Market Value (4/2021)	\$	22,000,000
Revised Value Estimates: Post COVID-19		
Current 2020 Market Value	\$	15,170,000 (74% of 2019 value)
	\$	116,692 per room
Allocation of Current 2020 Capital Stack Values	\$	15,170,000 100%
Construction Loan	\$	13,650,000 90%
Equity Capital	\$	1,520,000 10%
Forecast Market Value at YE 2021	\$	17,630,000 (86% of 2019 value)
Forecast Market Value at YE 2022	\$	19,680,000 (96% of 2019 value)
Forecast Stabilized Market Value at YE 2023	\$	21,000,000 (102% of 2019 value)

Source: HVS

In this example, the pattern of the value decline and recovery is consistent with the HVS “most likely scenario” for a hotel in the United States. Relative to this example, before COVID-19, the construction loan represented 70% of the total capital stack of \$19.5 million and 66.5% of the estimated (pre-COVID-19) market value of \$20.5 million at the opening of the hotel. Now, the current construction loan balance represents 90% of the value of the asset; note that the equity capital stack has now been compressed to a tenuous 10% of the total asset value.

If the lender chooses to add two years of accrued interest to the existing loan balance and extend the loan through mid-year 2022, with the expectation that hotel ownership will be able to refinance out the construction loan balance mid-year 2022, the lender will have a loan balance of \$15,015,000 at that time against an estimated asset value of \$18,655,000 (mid-point of YE 2021 and YE 2022 value estimates), or an LTV ratio of 80.5%.



Below is a recap of the recovery plan using a CPACE funding strategy.

CPACE Funding Strategy	
Total Hard & Soft Costs	\$ 17,500,000
Above Costs Eligible for CPACE Funding @ 25%	\$ 4,375,000
Use of CPACE Funds	
Provider & Program Fees	\$ 262,500
Reduction of Construction Loan Balance	\$ 2,000,000
Debt Service Reserve for Construction Lender for 2 Years on Reduced Loan Balance at 5% Interest	\$ 1,165,000
Working Capital for Hotel	\$ 947,500
Total	\$ 4,375,000
Annual CPACE Voluntary Lien Assessment	
Based on 5.5% Interest/25-Year Amortization	\$ 326,153

Source: HVS

In this example, the CPACE funds are primarily used to provide the construction lender with a \$2-million paydown of the existing loan balance and two years of interest reserved on the new loan balance of \$11,650,000. Given that the CPACE voluntary lien assessments are deferred for the first two years after the initial CPACE funding, the construction lender is never really “primed” by this new assessment, as the hotel will be much better positioned to refinance out the construction loan before any of the CPACE voluntary lien-assessment payments are due.

Now, with a CPACE funding strategy, instead of ultimately accounting for a loan loss reserve, the construction lender has significantly improved its position and eliminated payment risk, as shown in the comparative table below.

Lender Position: With & Without CPACE Funding Strategy

Lender Position at Mid-Year 2022 without CPACE Strategy

Initial Loan Balance in 2020	\$	13,650,000
Plus Accrued Interest over 2 Years	\$	1,365,000
Balance at Mid-Year 2022	\$	15,015,000

LTV Ratio on Mid-Year 2022 Value Estimate **80%**

Risk of Borrower Ability to Fully Refinance	
Lender Loan Balance Mid-Year 2022	Above Average to High

Lender Position at Mid-Year 2022 with CPACE Strategy

Initial Loan Balance in 2020	\$	13,650,000
Accrued Interest (<i>none, as it was reserved</i>)		0
Balance at Mid-Year 2022 (with paydown)	\$	11,650,000

LTV Ratio on Mid-Year 2022 Value Estimate **62%**

Risk of Borrower Ability to Fully Refinance	
Lender Loan Balance Mid-Year 2022	Average to Below Average

Source: HVS

Hotel ownership also benefits from the CPACE funding strategy. It now has a cooperative and happy lender, and it receives approximately \$950,000 in working capital to help the hotel operation pay bills as it works through a multi-year occupancy recovery. When the hotel stabilizes its operation in 2023, EBITDA Less Replacement

Reserve is forecast at \$1,616,500 (a 30% margin). The initial CPACE voluntary lien assessment, which is paid in arrears, will be due in early 2023 and will reduce EBITDA Less Replacement Reserve to \$1,290,000.

By buying the time needed for the market to recover and for the value of the hotel to increase accordingly, the CPACE funding strategy enabled the equity capital stack, which was at a tenuous 10% in 2020 (and could have easily been threatened by the senior lender), to survive and enjoy the recovery of its value.

In summary, for those hotels located in the states that offer the above program modifications, HVS advisory services can facilitate CPACE funding options to provide a win-win strategy for debt and equity stakeholders that need to modify existing loans.





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About the Author



Kathy Conroy, MAI, is a Senior Managing Director in the HVS Miami office and is also the firm's Practice Leader of Shared Ownership Consulting. Kathy has been an active participant in the hotel and shared ownership industry for more than 30 years. Since joining HVS in 1998, she has completed thousands of real-estate valuation and consulting

assignments with a focus on hotels, motels, resorts, condo hotels, timeshare, fractional and private residence club projects, and hospitality-driven mixed-use real estate for clients throughout the world. She has appraised properties in over 30 U.S. states and 30 countries. Furthermore, Kathy is a noted national authority on the valuation of vacation ownership properties and has authored books on timeshare property assessment and timeshare property valuation for ARDA and the Appraisal Institute. She has also provided litigation support and depositions for several projects and often serves as an expert witness, having provided testimony for numerous cases.

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