Hotel Lenders- Workout or Foreclosure?

With the downturn in the economy more and more hotels will experience financial difficulties. Those with large amounts of debt will have trouble paying monthly debt service when net income starts to drop. Those with mortgages coming due during 2009 and 2010 will have challenges getting replacement financing. In both cases the hotel owner will probably have to negotiate some type of relief plan with the lender to avoid foreclosure and losing the property. Before approaching your lender to ask for assistance, it is helpful to understand what the lender looks at before deciding how to precede with a problem hotel loan- my column investigates the lender's thought process.

Today's lodging market has been hard hit by falling demand and room rates. As a result, many lenders are monitoring hotel loans that are not current on their debt service payments or are close to the end of their terms. When faced with these distressed situations, lenders must make some important decisions regarding a plan of action that will best protect their long-term financial interest. In the past when hotels faced similar down-turns (1974, 1991, 2001), lenders who were able to monitor and asset manage their delinquent hotel loans were generally successful in either reducing or eliminating their financial losses.

Each distressed hotel loan is different and requires a specific, custom-tailored strategy. Using a step-by-step approach, the process of dealing with distressed hotel loans will be detailed.

Identify the Problem What is the problem? Before the lender can start working toward a solution, the nature of the problem must first be determined. Distressed hotels typically evolve from one or more of the following precipitating factors:

Problem location- Poor access, poor visibility, and other vocational factors hamper a hotel's ability to attract patronage and generate occupancy. Unless a hotel can overcome a suboptimal location with a strong identity (franchise) or management, locational problems are difficult to overcome.

Physical factors- A deteriorated hotel in need of upgrading and replacement of furniture, fixtures and equipment will not be able to optimize its occupancy and average room rate. This can create a competitive disadvantage what adversely affects the generation of revenues. If the hotel suffers from functional problems relative to an efficient layout and utility, operating expenses may be inordinately high.

External conditions- An abundance of lodging supply and/or a decline in transient demand are external factors that can impact a hotel's ability to achieve a satisfactory occupancy and average room rate. Over time, a hotel may also suffer from a declining or noncompetitive neighborhood.

Identity (franchise)- Optimal product identification is a critical component for a successful hotel. If a hotel's franchise affiliation does not fit the market or enhance the property, earnings are likely to suffer.

Management- A number of hotel management companies are incapable of operating a property in an effective manner. These difficulties usually stem from an inability to generate revenue while at the same time controlling expenses.

Ownership- Hotel owners often create or exaggerate hotel problems. Those who are incompetent are likely to make too many mistakes. Those who are undercapitalized are unable to correct the mistakes. Those who are dishonest do not really care about their mistakes.

Determine Whether the Problem is Curable or Incurable. Some of these precipitating factors are curable while others are not. For example, a lender could do little to improve the operating results of a hotel suffering from a large decline in local market demand. On the other hand, if a hotel is losing patronage because the property is in need of a complete renovation, the lender might want to assume ownership, make such an investment and attempt to enhance the earnings. In general, problems related to location and external conditions are usually incurable over the short term, whereas physical factors and identity, management, and ownership problems are typically curable.

Develop a Plan of Action. Once the nature of the problem(s) has been identified and a determination made as to whether the problem is curable or incurable, the lender must evaluate the advantages and disadvantages of either restructuring the loan with the borrower or proceeding with an action to gain possession of the property.

If the financial problems of the hotel are attributed to one or more incurable factors and the borrower is basically honest, the lender should consider restructuring the loan to provide some type of short-term debt service relief. This course of action gives the borrower time for the hotel to recover and does not cause attention to be directed towards defending a foreclosure or bankruptcy. In addition, the restructuring can be accomplished quietly without the negative publicity associated with litigation.

Curable problems, particularly those related to ownership, often signal the need for a more forceful approach. If a property's owners are incapable of recognizing and curing the situation that negatively affects a hotel's earnings, the lender should consider the various measures available to gain possession of the hotel. Before proceeding with this course of action, however, the many ramifications of it must be considered.

A hotel is a retail business that depends on continuous patronage to survive. Any publicity that even hints of a hotel's financial difficulty will usually have an adverse effect on attracting future business. A foreclosure or bankruptcy can devastate a hotel's occupancy rate and seriously erode a lender's security. The following list contains situations in which negative publicly can be part curly harmful to a lodging facility:

-The hotel has a significant group orientation that depends on meeting and conference business. Meeting planners are usually aware of situations that could jeopardize the success of their function and will steer clear of hotels that have known financial difficulties.

-Hotels that are dependent on visitation directed by travel agents will quickly feel a decline in referrals from agents who may be wary about their ability to collect their commissions.

-In addition to having an effect in these situations, the negative publicity will place the hotel on C.O.D. delivery basis with most purveyors, stimulate many employees to seek new and more secure employment, and generally create an operational nightmare.

Implement the Plan of Action. When a lender takes back a hotel, it assumes an ownership position that requires significantly more supervision than was previously provided a higher level of liability, and generally a great deal of aggravation. Lenders who are not equipped to handle this burden in-house can find assistance by utilizing asset management services that will take over some of the ownership responsibilities.

Lenders looking at a loan with a curable problem but an uncooperative borrower are generally forced into utilizing a foreclosure to gain possession the property. Depending on the state in which the property is located, a foreclosure action can take from as little as a month to as long as several years. Faced with an imminent foreclosure, a militant hotel owner may put the hotel into bankruptcy, which could extend the timetable another one to four years.

In addition to these primary issues pertaining to the handling of distressed hotel loans, there are some other considerations worth mentioning:

-If the problem is largely due to incompetent management, do hot hesitate to attempt to terminate the management contract. Some hotel management companies can be bought out of their agreements. Sometimes a foreclosure will terminate the contract, or if the hotel is in bankruptcy, the court might be willing to exercise its power and replace management. In either event, when looking for new management be sure to investigate their ability to operate in a profitable manner.

-As a lender, keep a low profile. Publicity does not usually enhance distressed hotel situations.

-Remember that history has shown that most hotels will turn around over time. It is usually advisable to stay with a hotel and attempt to improve its operating results rather than dumping it on the market at a significant discount.

Now that you understand how hotel lenders will evaluate your request for relief, you should be better prepared to present your case in a way that will show your lender how they would be better off working with you during this downturn rather than working against you by resorting to foreclosure.