A Guide for Lenders Holding Distressed Hotel Loans

by Stephen Rushmore

Today's lodging market has been hard hit by overbuilding and falling demand. As a result, many lenders are monitoring hotel loans that are not current on their debt service payments. 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 interests.

A review of the market of the past twenty years shows that problem hotel loans have been a recurring dilemma. The real estate investment trusts were plagued with hotel bankruptcies and foreclosures during the 1970s. Today, savings and loan associations face an almost identical climate compounded by overbuilding and by a battered oil economy in some areas of the country. Even though the prospect for a quick recovery is doubtful, history has shown that those lenders who are able to monitor and asset manage their delinquent hotel loans were generally successful in either reducing or eliminating their financial losses.

Mortgage lending has always carried a certain degree of risk. Basically, if a mortgage lender lends more money than the amount for which the property can be sold, there is an immediate risk that the loan may not be repaid. In addition, should the property decline in value during the loan term to a point where its value is less than the loan, the lender again faces a possible loss. Factors such as default on interest payments and bankruptcy could further lower the expected yield.

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Offsetting these risks of mortgage lending, mortgages are given the right to foreclose or take back the property in the event of a default. Unlike equity investors, however, most mortgage lenders do not participate in the upside if the property is successful. They receive their interest payments and return of principal, but generally not any value appreciation or other benefits.

Foreclosure History. The perception of most lenders is that hotel/motel loans are riskier than other types of real estate uses (e.g., office buildings, industrial facilities, apartments, and shopping centers). One measure of hotel lending risk is the default history for hotel and motel loans. The American Council of Life Insurance, which is an association composed of a number of large insurance companies, pool their data on hotel loans and publish it periodically.

According to the data provided by its members, in 1982 there were four hotels foreclosed out of a total portfolio of 1,801 lodging loans. This represents a foreclosure rate of under one quarter of one percent. Such a foreclosure rate appears extremely low and probably reflects the healthy lodging market at that point in time.

Looking at the same foreclosure data today, the overbuilding that has taken place during the mid-1980s produces a significantly different picture. As of 1988, The American Council of Life Insurance reports that out of a total hotel portfolio of 1,440 loans, ninety-two were considered delinquent (two or more scheduled payments past due per the original or restructured loan agreement), forty-nine loans were in foreclosure (3.4 percent), and four had been fore-

closed upon since the first of the year (1989). The following table shows the distribution of the delinquent hotel loans on a geographic basis:

Region	Loans
New England	1
Middle Atlantic	4
East North Central	10
West North Central	6
South Atlantic	25
East South Central	6
West South Central	20
Mountain	13
Pacific	3
Other	4
Total	92

It appears that many of the delinquent hotel loans are situated in the energy states (West South Central and Mountain), which are suffering not only from the overbuilding that is plaguing the entire country but also from the decrease in lodging demand brought about from the decline in oil-related business.

Each distressed hotel loan is different and requires a specific, custom-tailored strategy. The following outline summarizes the process of evaluating and dealing with a problem hotel loan:

1. Identify the problem.
2. Determine whether the problem is curable or in-incurable.
3. Develop a plan of action.
4. Implement the plan of action.

Using this 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 locational 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 that 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. Their difficulties usually stem from the 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 an overbuilt market area. 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 relating 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 bor-

rower time for the hotel to recover and does not cause attention to be directed toward 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 a 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 publicity can be particularly 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 with a large amount of banquet business are similarly impacted by rumors of bankruptcy or failing financial trends.
- ☐ 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 a 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.

If the lender ultimately decides to take the hotel back and the other debts on the property are not significant, the parties should consider utilizing a procedure known as a deed in lieu of foreclosure. In this approach, the owner of the hotel relinquishes the deed to the lender who takes over the property. Its major advantage lies in the fact that it can be accomplished quickly and quietly. Borrowers who realize that the situation is hopeless and continued ownership unwarranted can sometimes negotiate a release from personal guarantees in turn for providing a deed in lieu.

Lenders looking at a loan with a curable problem but an uncooperative borrower are generally forced into utilizing a foreclosure to gain possession of the property. Depending on the state in which the property is located, a foreclosure action can take from as little time 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 not hesitate to attempt to terminate the management contract. Most hotel management companies can be bought out of their agreements for two to three times the previous year's management fee. 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.

Distressed hotel loans have many associated issues that complicate an effective corrective procedure for both the borrower and lender. In almost every approach, care must be taken to preserve both the existing and potential patronage of the hotel so that business will have a chance to succeed over the long term. ■