CHAPTER 16

Capital Sources and Financing

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¶ 16.01 INTRODUCTION

The hotel industry has recovered almost completely from the time in the early 1990s when obtaining any type of financing was difficult. With the renewed success of the hotel industry, lenders are more willing to loan to valid hotel projects. This chapter explores the various financing techniques and sources of capital commonly used in the hotel industry. In addition, this chapter discusses the mortgage loan process and what the hotel developer should consider when obtaining a mortgage.

Exhibit 16-1 indicates the breakdown between various financial institutions that lend to the hotel industry.

Exhibit 16-1 Who Provides Hotel Financing

Source: PKF Consulting. Hospitality Investment Survey (1996)
**Other sources included investment banks, SBA loans, mortgage funds, conduits, and private equity.*

Source	Percentage
Bank	58%
Other Source*	36.0
Seller	24.0
Insurance Company	24.0
Pension Fund	18.9
Savings & Loan	3.4

This chapter divides equity and debt sources into the following two categories:

1. Institutions that originate mortgages and maintain portfolios of both mortgages and real estate equities, including:
   —Commercial banks;
   —Life insurance companies;
   —Private credit companies; and
   —Pension funds.
2. Investment conduits, which are primarily entities that invest in hotel real estate mortgages and passthrough income and gain to investors (both private individuals and institutions), including:
   —Real estate limited partnerships (RELPs);
   —Real estate investment trusts (REITs); and
   —Commercial mortgage-backed securities (CMBS).
3. Mortgage financing, which is how most hotels are financed. Topics covered include:
   —Types of mortgage loans; and
   —Obtaining a hotel mortgage.

¶ 16.02 COMMERCIAL BANKS

Commercial banks have historically played the most significant role in providing financing for the hotel industry. However, they have been hurt by the real estate collapse of hotels during the early 1990s. Commercial banks sold off distressed and foreclosed loans and limited new lending to only the most healthy of hotel developers.

A significant new restraint on future hotel lending by commercial banks and by savings institutions is the Uniform Rule on Real Estate Lending established by the four banking agencies (the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision). The Uniform Rule, issued on December 31, 1992, requires every lender to adopt a written policy establishing appropriate limits and standards for granting real estate loans. Such loans are those secured by mortgages, as well as loans made for financing permanent improvements, whether secured or not.

As a supplement to the Uniform Rule, the agencies simultaneously promulgated a set of guidelines that establish the specific factors banks are expected to consider in establishing real estate (including hotel development) lending policies. Although the guidelines are not mandatory, a lender failing to comply with them invites extra scrutiny from regulators.

A crucial component of the guidelines is the loan-to-value (LTV) limits on real estate loans. The LTV ratio is based not only on the value of the property securing the loan but on the value of any acceptable collateral in addition to the real estate. The guidelines set supervisory LTV limits for various categories of loans as follows:

- For raw land, 65 percent
- For land development loans, 75 percent
- For commercial construction loans, 80 percent
- For improved property, 85 percent

The mere fact that a loan is made within the supervisory LTV limits does not mean it will automatically be deemed sound by a bank examiner. The lending institution must evaluate other credit factors as well, including:

- The capacity of the borrower or the sufficiency of income from the property to service the debt;
- The overall creditworthiness of the borrower;
- The amount of equity invested by the borrower; and
- Any forms of credit enhancement, including guaranties, mortgages, insurance, and additional collateral.

The guidelines also recognize that "exception loans" (those exceeding the supervisory LTV limits) may be appropriate if the credit factors justify the loan. Banks must identify these loans in their records and report all significant exception loans quarterly to their board of directors. As an upper limit, the aggregate amount of all exception loans for commercial loans, agricultural, multifamily, or other residential property (other than one- to four-family homes) may not exceed 30 percent of a bank's total capital.

Several types of loans are excluded from the supervisory LTV limits. These include:

1. Loans renewed, refinanced, or restructured without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs) or in connection with a workout, with or without the advancement of new funds, if the restructuring is consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery of the loan;
2. Loans that facilitate the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith;
3. Loans to be sold promptly after origination, without recourse, to a financially responsible third party; and
4. Loans guaranteed or insured by federal, state, or local governments and a wide range of traditional corporate and business loans not considered true real estate lending, even though such loans might involve real estate collateral or improvements.

¶ 16.03 LIFE INSURANCE COMPANIES

Life insurance companies have played an important and varied role in hotel development, from providing direct loans for development to participating as equity partners in the ownership of the hotels. Life insurance companies are among the largest financial institutions in the world. Their primary function is to provide financial security to policyholders through life insurance. The premiums collected by the companies are used largely to maintain reserves from which benefits are paid; these reserves constitute enormous capital pools that must be invested for long periods. Because the inflow of funds from premium payments can be predicted with great accuracy, and because fund outflows (upon the death of individual policyholders) can also be estimated with great accuracy, insurance companies are in a position to commit several years in advance to providing loan funds to borrowers and to make long-term commitments of capital.

Because an insurance company's obligations usually are measured in fixed dollars (e.g., the face amount of a life insurance policy), in theory it need not be overly concerned with the depreciation of the dollar through inflation. As a result, insurance companies always have been a major source of fixed-interest mortgages for hotel developers. However, during the period of high inflation that began during the Vietnam War and lasted throughout the 1980s, insurance companies found it necessary to offer a variety of indexed or variable insurance and annuity plans that gave insured persons some hope of hedging against the continued erosion of the dollar. Thus, insurance companies themselves were forced to seek an inflation hedge, resorting to financing techniques such as variable interest rates, equity participation, and other formulas.

Because of their volume of lending and the fact that they are subject to much less regulation than commercial bands and savings institutions, insurance companies have been responsible for many of the creative financing techniques that have surfaced during the past quarter century. Indeed, some insurance companies in the 1980s became virtual partners with developers or property owners by entering into joint ventures and participating loan arrangements that enabled the insurance company to share in any future growth of the property. This trend has all but disappeared following the real estate crash that began in the hotel business in 1987.

Insurance companies are still a significant financing source for the hotel industry. However, they have been reluctant to originate new mortgage money for hotels because of the serious overbuilding that occurred in the early 1990s. With occupancy rates increasing in both 1995 and 1996, it remains to be seen whether insurance companies will once again take the lead in financing of hotel projects.

Insurance companies along with commercial banks are turning with increasing frequency to the purchase of real estate securities rather than whole mortgages.

¶ 16.04 PRIVATE CREDIT COMPANIES

In the early 1990s, when the traditional financing sources—commercial banks, savings institutions, and insurance companies—were unwilling or unable to provide real estate capital, private credit companies sought to expand their normally small share of the market. Credit companies, often called "lenders of last resort" because of their typically high interest rates and arduous terms, are usually real estate subsidiaries of large industrial companies. They generally peg their lending rates as a float over prime or at a comparable spread. Although credit from these lenders is generally expensive, they have become especially useful in providing the funds needed to acquire underutilized hotel property with appreciation potential.

At the height of real estate financing in the late 1980s, twenty-one major credit companies offered funding programs. The most prominent companies included European, Japanese, and American corporate loan subsidiaries. By the mid-1990s, the picture was quite different. Only a few major credit companies remained active; although they had an abundant supply of funds, they were highly selective. Nevertheless, they were prepared to extend their lending capabilities to a wide range of underwriting alternatives, as is discussed subsequently.

1. *Permanent loans.* Credit companies invade life insurance company and pension fund territory by structuring fixed-rate permanent mortgages, junior debt, and participating debt/equity deals. Unlike other permanent lending sources that loan for ten years or more, credit companies typically structure loans on a shorter term of three to seven years. Credit companies match their yields to their own commercial paper offerings, which are short-term obligations.
2. *Construction loans.* Credit companies are formidable competitors for the banking industry. Although both credit companies and banks use short-term capital that is suitable for funding construction and variable rate loans, credit companies are not governed by federal, state, and local banking regulations. Credit companies are more flexible while having the same financial understanding as banks because of their asset-based lending experience, including corporate lending and paper financing.
3. *Other types of financing.* Although credit companies are known for funding highly aggressive risk-oriented projects, the real estate credit crunch created excellent opportunities for them in conservatively underwritten real estate transactions. For example, credit companies frequently charge rates of as much as 1 and 2 percent of the total transaction amount per year for funding a standby commitment.

Credit companies also fund standby transactions with the expectation of taking a short-term ownership position in the property until the project has an opportunity to stabilize cash flow in a tough market condition. Of course, under all such conditions, credit company pricing reflects risk and reward return.

The credit company's biggest funding advantage over its competitors is its ability to provide commitments for financing on projects before or during cash flow stabilization. Although such lending underwriting involves higher risk, credit companies use a variety of deal structures that enhance the quality and reduce the risk of the total financing package.

Credit companies have been highly selected in financing hotel projects. They often demand that the investment returns exceed 20 percent. Hotels require significantly higher debt coverage ratios, often one-and-one half times the debt-service payment. Although they are rare, LTV ratios of as high as 85 percent are available. The higher-risk hotel deals require the borrower to give the lender a significant equity position (often as much as 50 percent or more).

Credit companies are a creative and active force in the real estate market. They have a direct link to the capital markets by their ability to raise capital through selling and guaranteeing commercial paper. As a result, credit companies may capture a larger market share from traditional lending sources in the future years.

¶ 16.05 PENSION FUNDS

Pension funds are tax-exempt capital funds held by corporations or labor unions (private pension funds) or state and local governments (public pension funds). Their

purpose is to pay retirement benefits to employees or union members. They represent the fastest growing pool of capital in the United States, and they undoubtedly will play a major role in hotel real estate financing in the future.

Only a small percentage of pension fund assets are invested in real estate mortgages or real estate equity. The percentage seems certain to rise, possibly to as much as 10 percent of total assets. The asset and liability structure of pension funds is somewhat similar than that of life insurance companies in that the inflow of funds is continuous and stable and payment obligations are actuarially determinable (i.e., accurate predictions can be made of the payments that must be made in future years). Consequently, pension funds would seem to be a logical source of long-term real estate loans.

However, just when pension funds started to invest significantly in the real estate market, the market crashed in the period between 1987 and 1993. Many pension funds had invested in real estate funds as part of their investment strategy. These funds for the most part were closed-end funds, from which capital could be withdrawn only in limited amounts and at specified times. When real estate values began to decline sharply, the funds had to wait for a considerable period to close their accounts, at which point they suffered significant losses. As a result of these experiences, pension funds are now turning more and more to direct investment in mortgages and real estate equities. The trend to mortgage securitization offers pension funds an easy way to invest in commercial mortgages, while the resurgence of REITSs and the easing of tax limitations on pension fund investment in REITs are making the REITs an ideal intermediary for equity investment.

¶ 16.06 REAL ESTATE LIMITED PARTNERSHIPS (SYNDICATION)

The limited partnership as a form of ownership of real estate is discussed in Chapter 15. In this chapter, the RELP is viewed as a source of real estate capital because of its primary role in the process known as syndication. In its broadest sense, a syndicate is a group of investors who pool their capital for investment in real estate. A syndicate may be any form of business entity, but by far the most popular format has been the limited partnership, because it represents the best combination of tax benefits and business efficiency.

Real estate syndicates experienced a sustained boom in the years prior to enactment of the the Tax Reform Act of 1986 (TRA 1986). However, the TRA 1986, whose fundamental thrust was to minimize the role of taxes in investment decision making, had a major impact on hotel real estate syndication. The use of a RELP to pass losses directly through to investors was reduced almost to the vanishing point by the limitations placed by TRA 1986 on the deductibility of passive losses and the extended recovery (depreciation) period for real estate. The result has been that tax shelter–oriented real estate syndications have essentially been eliminated since passage of TRA 1986. Real estate syndication will remain an important part of the investment scene, but primarily in private rather than in public markets.

[1] Basic Syndication Structures

In a typical real estate syndicate, the investors constitute a single class, with each receiving a pro rata ownership interest in the syndicate for a one-time investment in cash. New investors are not admitted once the syndicate has been formed, and no provision is made for redeeming syndicate interest during the life of the syndicate.

This basic pattern is subject to a number of variations. Perhaps the most common is to create a multiclass syndicate in order to broaden the market for syndicate shares. A multiclass syndication has more than one class of investors, with each class entitled to different investment returns. The idea is to offer investors a range of choices, similar to the choices available to purchasers of securities, who may choose, for example, between bonds, common stock, and preferred stock.

At least three different approaches to the multiclass syndicate can be distinguished: (1) different classes of interest within the same syndicate; (2) land/building split; and (3) equity/loan split.

[2] Specified-Property or Blind-Pool Syndicates

In a specified-property syndicate, the particular property or properties to be acquired is identified in the offering statement and can be evaluated by the investor before he puts up his money. A blind-pool syndicate raises its capital before it has acquired any or less than all of the properties it will eventually own. A single-property syndicate almost always specifies the property to be acquired, although this is not necessarily the case. On the other hand, a multiple-property syndicate may or may not be a blind-pool syndicate, although it usually is.

[3] Master Limited Partnerships

Master limited partnerships (MLPs) are large limited partnerships whose interests are publicly traded, either on a stock exchange or in the over-the-counter market. They are designed to combine the investment advantages of partnerships with the liquidity of corporate stock. The high liquidity of MLP units is achieved through the issuance of depository receipts that can be traded freely.

In most cases, a real estate MLP uses a two-tier arrangement in order to simplify ownership of the underlying real estate assets. The MLP (the investment vehicle) has outside investors as its limited partners and the sponsor as its general partner. The MLP itself becomes a limited partner in a second (operating) partnership that owns the real estate and for which the sponsor also acts as general partner. The TRA 1986 sharply reduced the attractiveness of MLPs for real estate by limiting the use of tax losses from properties to shelter income from active sources. As a result, the MLP has been largely replaced by the real estate investment trust (see ¶ 16.07). However, some MLPs continue to be traded in the public securities markets, and it is possible that they may come back into favor once again.

¶ 16.07 REAL ESTATE INVESTMENT TRUSTS

Real estate investment trusts (REITs) as a form of real estate business structure are discussed in Chapter 15. In this chapter the emphasis is on REITs as a source of capital. REITs are playing an important role in the development of hotel property, especially since 1990. The resurgence of REITs can be traced to a number of causes:

1. *High yields.* As a result of the real estate collapse following the passage of TRA 1986, hotel properties suffered price declines ranging from 25 percent to 40 percent in most parts of the country. Many investors began to perceive hotel properties as a much more attractive income vehicle than common

stocks or bonds, which generally were becoming quite expensive. In addition, with interest rates having declined sharply, investors holding funds in money market accounts or CDs were seeing their income return decline sharply.

2. *Institutional demand.* A significant source of new investment in REITs has come from such institutional investors as common stock mutual funds, pension funds, and yield-seeking institutional investors.

3. *Financing source.* In the early 1990s, the traditional sources of real estate financing (thrift institutions, commercial banks, and insurance companies) sharply reduced their lending because of the high volume of distressed and foreclosed loans in their portfolios. Hotel developers, managers, and owners saw REITs as a means of raising new capital from the general market to pay down debt and grow their asset bases. Learning the lesson of previous REIT excesses, the new REIT sponsors structured their offerings on a much more conservative basis.

The resurgence of REITs in the early 1990s largely reflected the public's view of REITs as investments capable of generating high current yields as well as moderate appreciation in value over a period of years. Investors came to understand that cash flow was a more appropriate measure of a REIT's income than the "net income" measure used by business corporations. Cash flow (now known as funds from operations or FFO) disregards the paper write-offs for depreciation and amortization but reflects interest and amortization costs associated with debt financing.

One concern about REITs is whether high yields can be sustained if cash flow declines on underlying hotel assets. This could happen as a result of competition by the many new REITs to acquire desirable properties. The answer to this concern is that REITs can use two types of leverage to maintain or even increase yields: debt leverage and equity leverage.

[1] Debt Leverage

Leveraging yields with debt encompasses traditional mortgage financing as well as various corporate financing techniques. Mortgage financing, while not easily avoidable in the early 1990s, undoubtedly will make a comeback as the hotel market improves and valuations become more stable. A REIT generally must meet the underwriting standards for mortgage financing as a non-REIT borrower of equivalent credit standing and with an equivalent asset portfolio.

REITs do have an advantage over non-REIT borrowers in that their large diversified portfolios enable them to use non–real estate financing techniques as well. For example, a REIT may issue long-term debt in the form of a bond or note that may be sold either to the general public or to private institutional investors. As long as the cost of such debt capital is below the free-and-clear return from the real estate portfolio, the REIT achieves positive (upside) leverage.

Another approach is to issue commercial paper or to use a bank credit. Commercial paper consists of corporate notes having maturities from 5 days to 270 days. The notes can be sold directly by the REIT to the customer-buyer or through a dealer. A bank line of credit will carry a floating rate of interest over prime and may require a compensating balance to be maintained whether the credit is used or not. In both cases, the short-term nature of the borrowing means that interest rates paid by the REIT are likely to be very volatile. This may affect the stability of the yield, an important consideration for public investors.

[2] Equity Leverage

Equity leverage is the process of selling new equity at a premium over the book value (original issue price) of existing equity. To illustrate, assume that a single share issued by a REIT for $10 earns 10 percent ($1 per share) on its original cost. Assume further that investors now are willing to buy this stock at a price-earnings ratio of 20, to yield 5 percent. The result is a market value of $20 per share.

If a second share of stock is then issued by the REIT, it can invest a total of $30 (the initial $10 plus the new $20) and the same 10 percent yield will then earn $3 (or $1.50 per share). The trust has increased earnings per share by 50 percent but also the market value per share by the same amount.

Thus, equity leverage may be undertaken at any time at which the market value of a trust's stock commands a premium over original issue price. (If the stock is at a discount from that price, however, the issuance of new stock at that level will *dilute* the original issue price per share owned by existing stockholders.) It follows that the higher a trust's return on book value (original issue price), the greater is its capacity for growth.

Note that the use of debt leverage can achieve the same result as that just described. Suppose the REIT, instead of issuing another share of stock at $20, borrows $25 at 8 percent interest. If the REIT can maintain this 200 basis point (2 percent) spread between its free-and-clear return on assets and the loan interest rate, it will achieve the same 50 percent increase in earnings per share from $1 to $1.50; with the same market yield requirements, its stock will increase from $20 to $30 per share.

¶ 16.08 COMMERCIAL MORTGAGE-BACKED SECURITIES

Commercial mortgage-backed securities (CMBS) are a major source of debt capital for commercial real estate and the hotel industry in particular. This section provides a brief historical overview of CMBS, which shows why securitization has become a favored method of financing for hotel owner/operators and other commercial property borrowers. It then explains the different roles that investment banks may play in the securitization process, outlines the steps involved in the underwriting and rating processes, and concludes with a focus on recent economic trends in the hotel industry and how these changes influence the industry's relationship with CMBS as an ongoing provider of debt funding.

[1] The Evolution of CMBS

Commercial mortgage-backed securities are bonds or other debt instruments collateralized by loans secured by commercial real estate. CMBS are created by combining loans into pools of $100 million or more and depositing them into a trust that then produces fixed-income securities sold to institutional investors.

Mortgage-backed securities (MBS) have a longer history as a source of debt financing for single-family housing. CMBS evolved from this residential market and arose as a thriving source of debt capital for income-producing property during the real estate recession and savings and loan (S&L) collapse of the early 1990s. (A major difference between MBS and CMBS involves prepayment provisions. Whereas MBS loans are prepayable, mortgages in CMBS are generally locked out from prepayment; consequently, the investor does not have reinvestment exposure.)

The collapse in commercial real estate values triggered a major recapitalization beginning in 1989, when the Resolution Trust Corporation (RTC) was appointed chief

liquidator of S&L loans and real estate owned (REO) properties. The tidal wave of RTC offerings that followed during the next several years created a need to tap into the securities market to bring liquidity to commercial real estate. Investment banks were hired as loan sale advisors, and they consequently beefed up their commercial mortgage departments with real estate professionals who helped underwrite and dispose of the RTC offerings, incorporating mortgage securities structuring technology learned from the residential mortgage arena. Independent rating agencies at the same time increased their commitment to this emerging market by standardizing the underwriting criteria by property type, which was incorporated into the sizing of debt proceeds and the structuring of the underlying CMBS pools. This RTC-driven market was mainly functioning as an agency, or "best efforts" business, yet a small group of investors were earning an arbitrage by acting as a principal, purchasing RTC loans and selling them as rated and non-rated securities independently.

By the end of 1992, the RTC had disposed of approximately $11.6 billion of commercial real estate assets financed by CMBS, while the industry's traditional lenders (S&Ls, commercial banks, and life insurance companies) were experiencing unprecedented loan losses. This prompted these conventional lenders to move away from direct lending on commercial real estate. Instead, they bought long-term Treasury securities, enjoying a favorable spread between short-term and long-term rates (the Federal Reserve lowered short-term Treasury securities 200 basis points during this period).

Concurrently, stricter commercial real estate lending regulations were imposed by the Federal government. These restrictions led to larger loan loss reserve requirements and provided another impetus for traditional lenders to shift capital away from direct lending to buying CMBS—a natural for life companies that were already familiar with commercial real estate as collateral.

A dramatic transformation of commercial real estate finance was in full swing in 1993. In addition to the change in the role of traditional lenders—who were quickly becoming the largest buyers of CMBS—property owners were also changing the ways in which they raised equity, forming real estate investment trusts (REITs) and other capital markets vehicles to recapitalize their portfolios while issuing CMBS for leverage. Many borrowers looked to Wall Street to provide debt capital and issue single-borrower, multi-class transactions using sophisticated underwriting and structuring techniques.

By mid-year 1993, the RTC had securitized nearly $14 billion in performing commercial mortgages. This liquidation forced the markets to confront the issues of securitization. The establishment of underwriting standards, rating criteria, valuation techniques, and more standardized structures paved the way for further growth in CMBS and allowed the private sector to take the helm from the RTC and become the dominant issuer of CMBS.

Since that pivotal year, CMBS issuance has grown to reach approximately the $100 billion mark for total issuance. As the market matures, it has encompassed a broader group of both issuers and property types. In a 1994 study on income property securitization, Kenneth Leventhal & Co. pointed out that the market will continue to be influenced by interest rate fluctuations, competition from other lending sources, underlying real estate market conditions, regulatory changes, and information technology developments.

Despite such variables, the CMBS market has nonetheless witnessed increased efficiencies, including better availability and analysis of information to investors, improved reporting from servicers, better performance monitoring by rating agencies, and further standardization of transactions. All of these are becoming more uniform in terms of both structure and collateral, according to Duff & Phelps, a rating agency, which reported in early 1996 that such increased consistency translates into lower capital costs for borrowers. Another sign of the CMBS market's underlying strength

was that in 1995, CMBS substantially outperformed corporate bonds at a time when spreads were largely unchanged.

[2] Roles of Investment Banks in CMBS

Investment banks that represent borrowers in a CMBS transaction act in either a best efforts or a principal capacity. This distinction has important implications for borrowers in terms of allocation of risks.

Some securities firms do not commit capital to transactions, but rather act in a financial advisory and/or brokerage capacity to borrowers and investors. Such firms are said to act on a "best efforts" basis. They assist in structuring the transaction and brokering the rated certificate classes to investors. After the certificates have been rated and sold, the borrower is funded from the proceeds of the sale. In such a best efforts transaction, the borrower does not know the rate or amount of debt proceeds to be received until the securities have been sold, and the borrower assumes all of the risks involved in the transaction, including:

- The risk that the transaction can be rated.
- The risk of what rating each class of certificates will be assigned (i.e., the amount of certificates that receive high ratings versus those that receive low ratings).
- The risk that the certificate classes, including the unrated classes, can be sold, and assuming that the classes can be sold, the risk of at what spread to Treasuries (i.e., price) each class of certificates can be sold.
- The risk regarding how long a period of time it will take to consummate the transaction. (The pricing and funding of a principal transaction typically takes between 60 and 90 days, while a best efforts placement can be expected to take between seven months and one year.)
- The risk that interest rates will increase during the processing period for the transaction. (In a best efforts placement, since there is uncertainty as to whether and when the transaction will close, it is not possible for the borrower to effectively hedge this risk.)
- The risk of assuming all costs of the transaction, regardless of whether it is consummated.

While a best efforts transaction may result in lower costs to the borrower, the foregoing risks make it clear that any savings over a principal transaction can be lost by interest rate movements and unfavorable rating agency treatment during the securitization process.

In a principal transaction, the investment bank/lender makes a permanent mortgage loan to the borrower, who is funded at the inception of the transaction. The aforementioned risks involved in a best efforts placement are assumed by the lender, who shepherds the loan through the rating and securitization process.

This distinction was particularly important from 1993 to 1995, when traditional lenders (who had always provided certainty of funding) remained on the sidelines. At that time, investment banks such as Bear Stearns, CS First Boston, Lehman Brothers, and Morgan Stanley were accustomed to acting as an agent on CMBS because of their experience at working with the RTC, but they were reluctant to risk their own capital. As conventional lenders returned to aggressive lending again in 1995, more Wall Street firms did begin to act as principal.

[3] Underwriting Criteria for Hotel Property Loans

Despite their better economic performance after the early 1990s, hotels did not derive any immediate capital benefit from CMBS, because rating agencies and bond buyers (many of which were former hotel lenders with unpleasant memories) were hesitant to put capital back into the sector. Gradually, though, CMBS investors have developed greater comfort with hotel collateral.

Each segment of the hotel industry—resort, full-service, limited service, or extended stay—has its own unique characteristics that need to be examined in the context of underwriting. What follows is an overview of general underwriting criteria for the structuring of securitizable hotel loans.

In general, hotels are underwritten to ascertain a stabilized net operating income (NOI) from a trailing twelve-month cash flow to determine supportable debt proceeds at different debt service coverage ratios (DSCRs). NOI equals the actual net income of the properties before interest, depreciation and income taxes for the trailing twelve-month period adjusted if necessary to cap the growth of departmental profit and occupancy. In addition, NOI takes into account all of the various operating expense line items to make sure they are consistent with historical and market performance. The underwriter evaluates the performance of the property over the previous five years to look for consistency while researching demand and supply characteristics of the market to essentially "mark the property to market." After a stabilized NOI has been determined, debt proceeds and pricing can be determined by applying a pricing matrix based on DSCRs at various proceeds levels with different amortization schedules. The price of a hotel loan or the all-in rate is based on a spread over the yield on the ten-year or fifteen-year Treasury security. Pricing varies by the quality of the collateral, but the most favorable pricing is generally given to loans with the highest DSCR.

[4] Role of the Rating Agencies in CMBS

Independent rating agencies (i.e., Standard & Poor's Corporation, Moody's Investors Service, Inc., Fitch Investors Service Inc., Duff & Phelps, and others) assign ratings on debt and other securitized transactions with regard to the capacity of an issuer to meet its debt obligations in a variety of economic circumstances. Higher ratings come from the issuer's ability to make interest and principal payments under severe economic conditions.

The four highest ratings categories—Triple A, Double A, Single A, and Triple B—represent what is referred to as "investment grade" CMBS. A typical CMBS issue is divided into several classes by payment priority with each class receiving a separate rating.

The rating agencies have been careful to establish very conservative criteria for rating CMBS—in most cases, the result of in-depth studies of historical loan performance data (e.g., American Council of Life Insurance (ACLI) loan performance data and the Russell-NCREIF property performance indices). Through such studies, the agencies have sought to identify loan characteristics that influence performance and to establish reasonable assumptions regarding defaults and losses resulting from foreclosures. While such studies provide the basic framework for the rating process, the agencies adjust their expectations according to the unique characteristics of each transaction, especially those that most influence real estate performance.

Rating agencies review the economics for the property type that collateralizes the loans in a CMBS pool the same way that they consider the economics of the industry in which a borrowing company belongs when rating a corporate debt transaction.

Hotels are generally considered to be the most risky type of commercial property—clearly different from other sectors in that they provide services to short-term guests with revenues coming largely from room rents as well as such extras as restau-

rants and meeting rooms, especially at luxury hotels. Small increases in occupancy rates or room prices go a long way toward improving profitability because of considerable fixed costs. Yet unlike other income-producing properties, hotels do have increased expenses as occupancy increases; therefore, maximizing occupancy does not always equal maximizing long-term profits.

Because the performance of hotels depends largely on the active management of operations, the rating agencies place particular emphasis on the quality of property management teams. Well-managed properties with competitive positions in their regions present attractive collateral for commercial mortgages.

[5] Outlook for the Hotel Industry as a Component of CMBS

Smith Travel Research reported that 1995 was the most profitable year in the lodging industry, and as of mid-year 1996, hotel fundamentals remain strong. Industry occupancies for 1995 were at a 10-year high, averaging 65.5%, and room rate increases continued to outpace inflation in 1996, leading to further improvement in industry profits and operating margins. Revenue is expected to grow at slightly under 7 percent, with an operating leverage of 67 percent, meaning that 67 cents of every dollar earned is profit.

As profits continue to rise substantially, the hotel investment market is witnessing accelerated activity. Although this has fueled a rise in hotel values, it is still less expensive to buy rather than build, although the margin continues to narrow. In 1996, hotels in most segments could be purchased for approximately 80 percent of replacement costs, up from 1995 levels of 50 to 70 percent, according to HVS International.

Combine that with forecasts of historically high hotel profits in the next two years, and it is obvious why the industry is in an expansion mode. Construction starts are up, concentrated mostly in the limited service sectors, such as extended stay hotels. Many hoteliers have recently announced plans to expand their sets of offerings and markets, and some industry experts report expectations of overbuilding in the economy segment within the next few years. This may cause some concern that the hotel market is once again heading toward an overbuilt bust reminiscent of the 1980s. The pessimism may be largely unfounded, however, as several basic market characteristics are, thankfully, very different now. Some examples:

- Demographics are heading in the right direction for continued hotel demand. A robust level of business travel as well as a steady growth in leisure travel are both expected to continue as baby boomers reach middle age.
- Most new hotel construction is concentrated in the budget and extended-stay segments, which has been undersupplied and should be able to accommodate new supply in balance with rapidly growing demands. Meanwhile, the full-service sector has the advantage of essentially no new supply coming on board.
- The possibility of some oversupply on the horizon is offset by lower leverage ratios and, inherent in the CMBS process, the stricter underwriting criteria that come from rating agency review—a marked difference from the lending attributes of past periods of excess.

The health of the hotel industry at large combined with the ability of the CMBS market to better scrutinize funding requests and make more rational lending decisions should ensure that CMBS lenders remain committed to providing hotels with a viable borrowing option. This will allow hotel owner/operators to continue to take advantage of reasonable acquisition and expansion opportunities and eliminate overleveraging in their existing debt, which in many cases is based on higher interest rates or overinflated values of the past.

¶ 16.09 MORTGAGE FINANCING

Hotel owners use a wide variety of mortgage loans to structure a financing package that meets their objectives. The following sections discuss the various types of loans typically employed in hotel financing.

[1] Construction Loans

A construction loan is a short-term loan made during the period in which a project is under construction. The moneys from a construction loan are disbursed over the development period for amounts determined by the actual progress of construction. Interest is typically tied to a floating rate (usually prime), exceeding this rate by one to three points. Most construction loans call for interest only. Personal guarantees, as well as completion bonds, are normally required by construction lenders. Construction loans are paid off when the project is completed and the hotel opens. The lender that provides the permanent financing after the construction loan has been paid off is called the take-out lender.

[2] Construction and Mini-Permanent Loans

When a lender provides both the construction financing and a short-term permanent loan (two to five years), the arrangement is called a construction and mini-permanent loan. The terms of the construction segment of the loan are similar to those of normal construction loans. The mini-perm often has a fixed interest rate rather than a floating rate, and it may have an amortization. The advantage of construction and mini-perm financing is that the borrower does not have to find a permanent take-out lender, which can be difficult to locate for a new hotel without an operating history. Once the hotel has been operating for two to four years and has an established track record, the borrower is better able to attract a long-term permanent lender at more favorable terms.

[3] Permanent Loans

A permanent loan is obtained after the term of a construction or mini-permanent loan that are used to pay off the previous lender. Sometimes sufficient funds remain to allow the equity investors to remove some capital. The permanent loan carries either a fixed or floating interest rate and amortization over a twenty- to thirty-year term. The length of the loan typically extends for five to twenty years, depending on the lender. Most permanent loans made on stable hotels with established earnings do not require personal guarantees. If they do, the borrower can generally negotiate removal of the guarantee when a certain debt coverage has been achieved.

[4] Term or Bullet Loans

If a construction lender does not want to provide a mini-permanent loan after the construction has been completed, the borrower can line up a term or bullet loan as the take-out. By using this type of loan until the property establishes a track record, the borrower is better able to obtain more favorable terms on a long-term permanent loan.

The terms of a bullet loan are similar to construction financing—it carries a floating interest rate of one to three points over prime, has little or no amortization, and personal guarantees are sometimes required.

[5] Accrual and Zero Coupon Financing

An accrual loan is a mortgage where all or part of the interest accrues and is not paid until some point in the future—sometimes at the maturity of the loan. This structure reduces the amount of the debt service that has to be paid and assist hotels during initial start-up years when there is usually insufficient cash flow to cover debt service.

¶ 16.10 OBTAINING A HOTEL MORTGAGE

Obtaining mortgage financing for a hotel venture is probably the most critical step in both the hotel development and the acquisition process. Since mortgage debt generally represents the largest source of cash invested in a hotel transaction, finding a mortgage lender is a make-or-break issue. Without a lender, the contemplated transaction will usually die.

Lenders, realizing this great power, are often difficult to approach. Coupled with the fact that most mortgage lenders do not make hotel loans, finding suitable financing can be difficult.

The key to obtaining hotel financing is to put together a transaction that clearly shows excellent financial potential and low investment risk. It must be presented to the lender in a highly professional manner so that the opportunity stands out from all the other submissions.

The following steps are involved in obtaining a hotel mortgage:

1. Determine how to approach the lender.
2. Put together a mortgage submission.
3. Negotiate the important terms.
4. Submit an application.
5. Obtain a commitment.
6. Fulfill the terms of the commitment.
7. Close the loan.

[1] Approaching the Lender

The first step in obtaining a hotel mortgage is to determine whether to retain the services of a mortgage broker or to attempt the process alone. A mortgage broker's services can cost between 1 percent and 3 percent of the amount borrowed. While this might seem expensive, it may be worth the expense, since the transaction cannot be completed unless sufficient financing is secured. For new hotel owners without a lengthy track record of successful projects, the services of a hotel mortgage broker can be invaluable. Owners with extensive experience in the hotel industry and good financing contacts are better able to successfully complete the process without a broker. In any event, contacts are vitally important, and the proper introduction to the right person and the right lenders will give a project the necessary initial attention.

[2] Compiling a Mortgage Submission

A mortgage submission is a package of information that describes the hotel investment, the financing requirement, and the structure of the contemplated transaction. It should provide the lender with sufficient information to generate interest in pursuing the mortgage. As with the overall process, the mortgage submission should be complete and have a professional appearance. The information a lender looks for in a mortgage submission includes the following:

- Description of the hotel project and contemplated transaction.
- Description of loan and requested terms.
- Resumes and financial statements of owners.
- Economic market study and appraisal.
- Owner's projection of income and expense.
- Description of management company experience and operating ability.
- Operator's projection of income and expense.
- Rendering or photograph of the property, including an aerial photo of the site with appropriate maps, plans, and legal description.
- Architectural plans and specifications.
- Estimate of all project costs—particularly if the hotel is to be constructed or will undergo a major renovation.
- Identification of project team, including architect, interior designer, and contractor.
- Copies of all major contracts—management contract, franchise agreement, ground lease, and tenant leases.

[3] Negotiating the Terms

Once the lender shows interest in the contemplated project, the important mortgage terms are negotiated, including the following:

- Interest—rate, fixed or floating
- Term
- Amortization schedule
- Prepayment
- Personal guarantees
- Accrual facility
- Commitment and closing fees
- Timing

[4] Submitting a Mortgage Application

When the borrower and the lender have agreed on the terms of the loan, a mortgage application is submitted. A mortgage application formalizes the information generally provided in the mortgage submission.

[5] Obtaining a Mortgage Commitment

Once the loan has been approved by the lender, the lender issues a mortgage commitment, which describes the loan and its terms. The commitment may also contain a request for additional information as well as contingencies. Normal contingencies in a mortgage commitment include (1) an appraisal showing that all the property has a specified minimum value; (2) a satisfactory title report; (3) a survey guaranteed to the lender; (5) an engineering report showing a sound structure and equipment; and (6) satisfactory credit reports for the principals.

The borrower is usually required to sign the commitment letter and return it to the lender with a nonrefundable commitment fee of between 1.5 percent and 3 percent of the amount borrowed.

[6] Fulfilling the Terms of the Commitment

The bank's commitment letter generally states that the borrower must provide additional information (e.g., appraisals, studies, and certified financial statements) and fulfill certain obligations (e.g., subordinating the management contract, obtaining rights under the franchise, and transferring the liquor license). These must be completed before a specified date or prior to closing the loan.

[7] Closing the Loan

When the borrower has complied with all the provisions of the commitment and the transaction has reached its culmination, the loan is ready to close. At this point the borrower and the lender (and the seller if appropriate) meet and exchange and sign the necessary documents, and the moneys borrowed are exchanged.