CHAPTER 20

Debt Financing

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20.01 NATIONAL OVERVIEW OF HOTEL MORTGAGE LENDING

As with hotel development, hotel mortgage lending tends to be cyclical with various types of lenders moving in and out of the market at different points in time. Until the 1960s, commercial banks, life insurance companies, and credit companies provided the bulk of the lodging industry mortgages. These are sophisticated lenders with vast experience in commercial lending. They understand the business of operating a hotel and are familiar with the many pitfalls associated with this type of lending. As a result of their knowledge, they generally experience a relatively low default record.

During the late 1960s and early 1970s, much of the growth in the lodging industry (and real estate in general) was financed by real estate investment trusts (REITs), which were formed by banks, insurance companies, real estate professionals, and others. REITs relied on short-term bank lines of credit for their lending funds and generally provided construction and interim loans on many types of real estate projects. The rapid development and expansion of REITs led to a sudden upsurge in lending, often to borrowers who had little experience in hotel development, investment, or management.

Since lodging properties had been extremely profitable investments during the late 1960s and early 1970s, builders, developers, and passive investors (including many individuals without prior experience in the lodging industry) came to look upon lodging properties as potentially attractive investments. REITs aggressively sought these lodging property loan opportunities. Often, however, neither the project nor the borrower merited the funds. REITs often financed projects in poor locations, in depressed and overbuilt markets, or with inexperienced developers and operators. Construction loans were sometimes funded in excess of total project cost with no verification of how the funds were to be used.

The combination of REIT over-lending, loose underwriting, and a strong bias in favor of difficult-to-monitor construction lending quickly led to overbuilding in most market areas throughout the United States. In addition, many of the projects were poorly managed and suffered from ineffective franchise affiliations. As a result, many REIT-financed projects failed and were foreclosed.

In the early 1980s, the savings and loan industry began making commercial loans. Because many of these lenders, like REITs, were unskilled in evaluating hotel and motel investments and protecting themselves from poor developers and hotel operators, a number of these loans later went into default, in some cases seriously affecting the economic viability of savings and loan institutions. By the end of the decade, most mortgage lenders had moved out of the hotel market because of the massive overbuilding that had taken place during the mid-1980s. This situation typically takes several years to resolve, after which lenders are likely to once again start financing hotel projects.

One of the best sources of information on hotel mortgages is the data compiled by The American Council of Life Insurance, which represents many of the large life insurance companies in the United States. Each quarter, members of this organization submit data on the mortgages they originate. These data are then organized and published, providing information on the number of hotel mortgages made, their interest rates, terms, and other relevant information.

20.02 SOURCES OF HOTEL FINANCING

A number of mortgage lenders do not like to make loans to hotels and motels. They do not understand the lodging business and believe the potential returns associated with this type of lending are not warranted by the perceived risks. Lenders who do make hotel mortgages sometimes view these types of investments as last-resort lending; they are willing to make the loans only when no better type of property is available to finance.

Hotels are traditionally financed through the following types of lenders: commercial banks, life insurance companies, credit companies, savings and loan associations, real estate investment trusts, and pension funds. Hotels are also backed with purchase money financing.

[1] Commercial Banks

Commercial banks are generally short-term lenders specializing in construction financing with and without take-outs. When a construction loan does not have a take-out commitment from another mortgage lender, commercial banks may provide a short-term (two- to four-year) permanent loan that is added to the construction financing. This combined construction and short-term permanent loan is known as a mini-perm.

In recent years, commercial banks have begun to provide longer-term loans, making banks more competitive with life insurance companies and credit companies.

[2] Life Insurance Companies

Life insurance companies have historically been long-term lenders providing take-out financing after construction loans. Because of the increased competition from commercial banks providing longer-term financing, however, insurance companies have recently started offering construction loans tied in with their permanent financing. Borrowers from insurance companies are often able to obtain a fixed interest rate on permanent loans. Life insurance companies also enter into joint venture arrangements where they provide both debt and equity to hotel projects. In recent years, insurance companies have reduced their involvement in hotel financing, favoring investments in stocks and bonds.

[3] Credit Companies

Credit companies have generally provided construction, standby, second, and other high risk loans for lodging properties. They tend to favor smaller hotels without established track records; as a result they are able to demand higher interest rates and personal guarantees. Credit companies also tend to be hotel lenders on a more regular basis. While many lenders are waiting for an improvement in the hotel lending climate, credit companies remain active lenders.

[4] Savings and Loan Associations

Savings and loan associations make both construction loans and longer-term permanent loans. Although these institutions became major players in hotel financing in the early 1980s, many of them did not have the expertise to originate good quality loans. Most savings and loan associations left the hotel lending business by the late 1980s because of intense regulation and scrutiny by government officials.

[5] Pension Funds

Pension funds represent a huge potential source of capital for financing real estate. However, until recently, very little pension fund capital found its way into hotel/motel mortgages or joint ventures. Most experts agree that this source of financing will be more readily available in the future and will probably be long-term with either a fixed or floating rate of interest. Pension funds are highly regulated and it may be difficult to utilize them as a source of funds for a business-oriented investment such as a hotel.

[6] Purchase Money Financing

Purchase money financing is a loan provided by the seller that enables the purchaser to buy a property with less equity money. This type of financing is generally

subordinate to a first mortgage, which enables the buyer to keep the existing mortgage in place, eliminating the necessity of obtaining new financing. The seller benefits by knowing that closing will not be contingent upon obtaining financing. In some instances, the seller is able to negotiate a higher selling price if purchase money financing is provided.

20.03 DEFAULT HISTORY FOR HOTEL AND MOTEL LOANS

Mortgage lending has always carried a certain degree of risk. Basically, if the property sells for less than the amount of the loan or if the property's value during the term of the loan declines until it is lower than the loan value, the lender faces a loss. Default on interest payments or bankruptcy also lower the lender's expected yield.

In order to offset these risks, lenders have the right to foreclose or take back the property in event of a default. Unlike equity investors, most mortgage lenders do not participate in the upside if the property is successful; they receive the principal with interest, but generally do not receive any value appreciation or other benefits. Thus, a mortgage lender faces downside risks if the property is not successful, shielded by the basic value of the real estate, but does not benefit to a large extent if the property is successful.

The perception of most lenders is that hotel loans are riskier than other types of real estate loans (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, an association of a number of large insurance companies, pools its data on hotel loans and publishes it periodically. According to its data, four out of a total portfolio of 1,801 lodging loans foreclosed in 1982. This represents a foreclosure rate of under one quarter of one percent, or 0.25 percent, which is extremely low and probably reflects the healthy lodging market during that period. Few hotel loans were made during the late 1970s and, as a result of decreased development, the hotel industry recovered from the overbuilding and prospered during the early 1980s.

By contrast, after the overbuilding of the mid-1980s, the same organization reported that as of June 1988, out of the total hotel portfolio of 1,518 loans, 114 were considered delinquent (i.e., with two or more scheduled payments past due per original or restructured loan agreement) (7.5 percent), 56 loans were in foreclosure (3.7 percent), and 15 (1 percent) had been foreclosed upon since the beginning of the year. The following table shows the distribution of the delinquent hotel loans on a geographic basis:

	Number	*Percentage*
New England	2	2%
Middle Atlantic	1	1
East North Central	19	17
West North Central	7	6
South Atlantic	23	20
East South Central	7	6
West South Central	26	23
Mountain	18	16
Pacific	3	3
Other	8	6
Total	114	100%

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 overbuilding but also from the decrease in lodging demand brought about by the decline in oil-related business.

The rate of lodging property foreclosure is only one factor to consider when evaluating the loss exposure from hotel lending. If history is an indication of future trends, the lenders currently experiencing delinquent hotel loans will probably not suffer major losses if they are able to take back the defaulting property, change management, infuse new capital, and reposition. Most of the REITs that were able to asset-manage their delinquent hotel loans properly did fairly well and recovered most, if not all, of their capital. Some even came away with a profit.

20.04 RISKS OF HOTEL MORTGAGE LENDING

Hotel mortgage lenders attempt to minimize the risks associated with investing in lodging properties by developing strong underwriting criteria. Underwriting criteria are essentially guidelines that the lender follows in order to evaluate both the contemplated hotel lending transaction and the borrower. The risks involved encompass both the debt and equity positions and fall into two general categories: cash flow risk and the risk of a loss of a portion of the property's market value.

Cash flow risk is the risk that the cash flow generated by the property's operation will be insufficient to cover one or more of the following: operating expenses, debt service, or adequate return on equity. Market value risk is the risk that the overall value of the property will decline so that, in the event of property disposition (i.e., sale or foreclosure), there will be insufficient capital to cover one or more of the following items: mortgage indebtedness, total equity investment, or value increases reflecting inflation. Virtually every hotel mortgage default, foreclosure, bankruptcy, or loss of invested equity can be attributed to one or both of these risks.

The risks associated with hotel investing are fairly easy to define; their causes, however, are complex and are generally related to:

- Location
- Improvements
- Management
- Ownership
- Economy and competitive environment

[1] Location

A lodging facility must offer both accessibility and visibility to its potential patrons. The demand generators from which a property draws its patronage must be close in terms of distance and travel time. Convenient access from adjacent transportation systems is also an important locational criterion. In most instances, the risks attributed to locational problems cannot be corrected. Locations may improve or decline over time, but this type of change is usually slow. When underwriting a potential hotel with a marginal location, the lender should not rely on the possibility of a locational improvement to justify the investment. It is important that a hotel

appraiser thoroughly review the characteristics of the hotel's location to ensure that the mortgage will not be adversely affected by location risk.

[2] Improvements

Hotel improvements include the building, furniture, fixtures, and equipment. The quality of a hotel's improvements affects its perceived style, class, and image. Physical deterioration and functional obsolescence in turn affect the quality of improvements.

Furniture, fixtures, and equipment in particular constantly age and deteriorate, necessitating periodical upgrading or replacement. Replacement of short-lived items should be funded by a reserve for replacement escrow. This escrow fund is generally maintained by the management company, but the lender should also closely monitor its use.

Changes in style and utility result in functional obsolescence. For example, shag carpets, rotary dial telephones, and black and white television sets are out-of-date and functionally obsolete. An old or inefficient layout or design from the perspective of either the guests or the staff may also be termed functionally obsolete. Traffic flow, the ability to provide the proper level of service, and general cost controls of payroll, utilities, and maintenance are examples of areas that can become functionally obsolete. An infusion of capital can correct most types of functional obsolescence. Major functional defects that cannot be easily corrected, however, could cause a permanent decrease in hotel value.

A hotel's improvements must be of a satisfactory physical condition and must be functionally adequate to satisfy the intended market. Underwriting criteria should include a thorough property inspection by both a hotel appraiser and hotel engineer to ensure that the improvements are suitable.

[3] Management

Hotels and motels are more than real estate—they are labor-intensive retail businesses requiring constant supervision by professional management skilled in the techniques of operating lodging facilities. The two major areas of hotel management requiring the highest degree of competency are marketing and cost control.

Marketing a hotel requires creating an image or style of operation that attracts a sufficient level of transient demand and provides a satisfactory level of guest services. Marketing generates occupancy, average room rate, and food and beverage volume. Together these represent a hotel's revenue.

Cost control is the ability to monitor and limit unnecessary costs so the property operates efficiently and generates profit. Cost control must be instituted carefully so the guest receives the proper price/value relationship. Hotel management must find the right balance between service provided and profits generated.

The operating ability of the management is a key component of the underwriting criteria. Lenders should investigate a hotel's management both from a guest service point of view and from a profit outlook. The management company should be able to document its competency by showing profitable operating results from similar hotels

that they manage. (See Chapter 17 for further discussion of the selection of a hotel management company.)

[4] Ownership

Although the equity owners of a hotel may not be personally liable for the repayment of the mortgage debt, hotel lenders should carefully investigate the creditworthiness of the owners and their ability to fund potential cash needs over the life of the loan. During the early years of a hotel's operation or during a major renovation, the equity owners must be prepared to fund cash shortfalls to cover debt service and, sometimes, operating expenses. Many properties that default on their mortgages are newer hotels that faced these initial cash needs without sufficient shortfall reserves. The financial strength of the equity ownership is therefore an important risk consideration for the mortgage lender.

[5] Economy and Competitive Environment

Once a hotel is constructed and financed, the risks associated with the national and local economies and the competitive environment are beyond the control of the investors. The key to limiting these risks is to perform a thorough market analysis before entering into the transaction. The following list includes some of the questions that should be asked in a market analysis.

- Is there sufficient market demand to justify the existing lodging supply?
- Is the market demand growing at a sufficient rate to justify the expected expansion in the lodging supply?
- Is there sufficient diversity in the type of transient demand within the market area?
- How is the local demand affected by external economic changes?
- How could changes in the local economy affect the expense factors of a lodging facility?
- What is the potential for additional competitive lodging facilities to enter the market?
- What are the chances for existing supply to be removed from the market?

When the mortgage lender is aware of all these investment risks associated with hotel lending, the proper lending criteria can be established. The following section outlines some of the underwriting criteria that can be utilized to minimize hotel investment risks.

20.05 RISK REDUCTION IN HOTEL MORTGAGE LENDING

A hotel mortgage lender can take a number of steps to reduce the risks it faces in making hotel loans. For example, a detailed economic market study and appraisal

should be commissioned and paid for by the lender (not the developer). The study should be performed by an MAI with extensive hotel operational and appraisal experience and should include:

- Ten-year cash flow forecast, assuming the operating performance demonstrated by the intended management.
- Complete room-night analysis showing the occupancy and average rate of all existing lodging properties in the market area, documented economic growth rates, and status of all proposed hotel projects.
- Detailed analysis of property taxes for both the subject property and competitive properties, and the impact on these taxes of any sale, refinancing, or reassessment.
- Break-even analysis, both before and after debt service.
- Occupancy impact study of all new or proposed lodging facilities on the subject property and competitive properties.
- Appraisal capitalization rate, based on the financing structure intended for the property, and not derived from sales of other lodging facilities.

In reviewing the economic study and appraisal, use of the following strict lending criteria is recommended to ensure that the lending risks have been minimized.

- In the local market area, no single demand generator should control more than 30 percent of the area demand.
- The local market must show a minimum demand growth of 2 percent per year average for all market segments.
- No single market segment should account for more than 75 percent of the total market demand.
- The subject property must have a minimum of three consecutive years of profitable operating history.
- The subject property must be currently operating within 10 percent of its projected stabilized occupancy.
- The subject property must have covered the intended debt service for the past two years. The minimum acceptable debt service coverage based on this year's projection would be 1.25 to 1.
- The management company must have demonstrated experience in profitable management of similar types of properties, specifically with respect to size, class, market segments, food and beverage facilities, concept, amenities, and location. The firm must have a minimum of three years experience as a management company and have a sufficiently sized support organization with proven expertise in marketing, financial controls, food and beverage operations, and engineering.
- The subject property should have a national or regional chain affiliation in the form of either a franchise or a first-tier management company.
- Any management contract or franchise agreement must be freely terminable by the mortgagee in the event the property is acquired through foreclosure or deed in lieu of foreclosure.
- The ownership entity must have background and experience in the lodging industry.

- The ownership entity must have the financial ability to cover all anticipated cash flow needs, as well as sufficient reserves to fund unexpected financial requirements.
- The property must maintain a reserve for replacement account with the mortgage lender for the replacement of furniture, fixtures, and equipment (FF&E). The reserve must be funded by at least 3 percent of total revenue.

Once the loan is made, the lender can further reduce risk by closely monitoring the progress of the property and constantly looking for signs of trouble. This mortgage servicing includes the following activities:

- Periodic physical inspections of the property to determine whether maintenance and replacements are being performed when required.
- Review of all inspection reports issued by the management company and franchisor and enforcement of all recommendations contained in such reports.
- Review of all financial statements prepared by the hotel (daily reports should be obtained if necessary).
- Monitoring of the reserve for replacement so see that it is used productively.
- Quick response to situations that could indicate financial difficulties.

By using strict mortgage underwriting criteria and a thorough monitoring system, the hotel mortgage lender can greatly reduce the risk exposure and still participate in the benefits of hotel lending.

20.06 TYPES OF MORTGAGE LOANS

Hotel owners utilize 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 monies from a construction loan are disbursed over the development period for amounts that are justified 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-Perm 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-perm

loan. The terms of the construction segment of the loan are similar to 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-perm loan. Monies from the permanent loan 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 20- to 30-year term. The length of the loan typically extends for 5 to 20 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 is achieved.

[4] Term or Bullet Loans

If a construction lender does not want to provide a mini-perm loan after the construction is 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 assists hotels during initial start-up years when there is usually insufficient cash flow to cover debt service.

20.07 OBTAINING A HOTEL MORTGAGE

Obtaining mortgage financing for a hotel venture is probably the most critical step in both the hotel development and 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 very 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 one and three 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 requirements, 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. Some of 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, plot 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, 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; (4) an environmental study showing there are no hazardous materials on the property; (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 and 3 percent of the amount borrowed.

[6] Fulfilling the Terms of the Commitment

The bank's commitment letter generally states that borrower must provide additional information, such as appraisals, studies, and certified financial statements, and fulfill certain obligations, such as 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 lender (and seller if appropriate) meet and exchange and sign the necessary documents, and the monies borrowed are exchanged.