RUSHMORE AND ARASI

HOTEL LENDERS TOUGHEN UNDERWRITING REQUIREMENTS

Tracing the progression of hotel and real estate lending practices over the past 20 years reveals some interesting trends. The dominant lenders in the hospitality financing arena have changed several times, with their success records tied directly to the level of underwriting sophistication.

During the late 1960s and early 1970s, much of the growth in the lodging industry was financed by a newly conceived entity known as the real estate investment trust (REIT). As time revealed, these lenders were generally unskilled in evaluating and structuring hotel transactions, and their poor investment decisions quickly lead to hundreds of hotel and motel foreclosures and bankruptcies.

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The large (and stable) insurance companies became the major hospitality lenders during the mid-1970s. Unlike the REITs, the insurance companies had many years of large-scale real estate lending experience and had the foresight to establish hotel lending departments to handle the specialized underwriting requirements of hospitality financing. As a result, the insurance companies have had a fairly successful lending record in the hotel industry.

The most recent entry into hotel-motel financing are the savings and loans. Until several years ago, these institutions were primarily single family home lenders. With deregulation, they are now heavily involved with the commercial mortgage field. Although it is too early to evaluate their level of success in hotel lending, the apparent overbuilding taking place in many major markets indicates that a REIT-type shakeout is a definite possibility.

While many lenders are willing to finance lodging properties, dealing with sophisticated hotel-oriented institutions is advantageous from several points of view. The loan origination process can be greatly expedited when the lender has hotel expertise and is knowledgeable about local lodging markets, managing agents and franchise affiliations. Structuring the payment schedule to match the start-up flow of income with initial debt service requirements is more easily arranged through an experienced hotel lender. Even assistance in negotiating a more advantageous management agreement can be expected from lenders who know the industry and its players.

The underwritng criteria used by sophisticated hotel lenders are generally specific and thorough. Recognizing beforehand what these institutions are looking for enables hotel owners and operators to develop financing packages that will suit these needs. The following

continued

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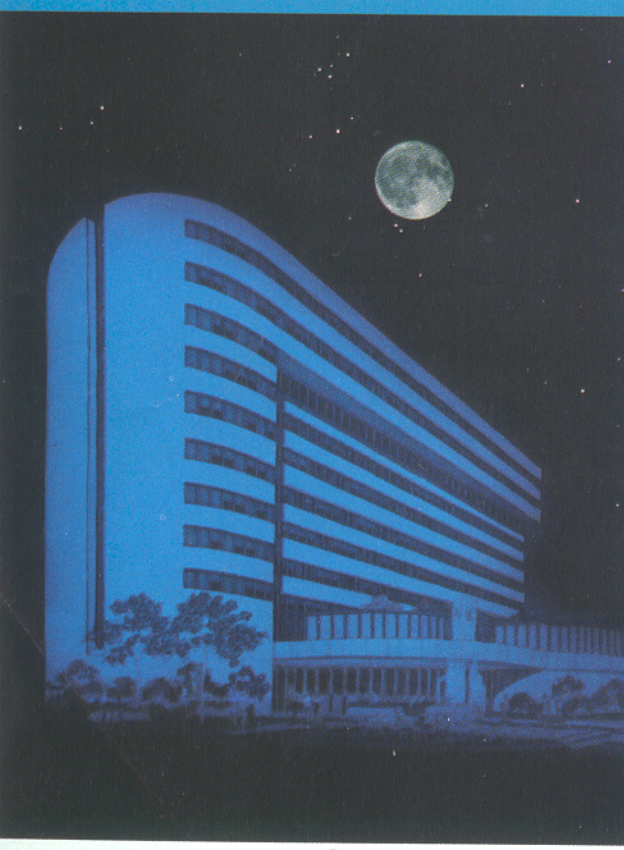

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check list includes some of the major items knowledgeable hotel lenders are currently requiring.

Most hotel lenders require a professional management company to be on-site and to operate the property during the term of the mortgage. Specific requirements typically include:

- Lender approval of managing agent and the specific terms of the management contract.
- Sophisticated lenders will follow the checklist contained in our September 1984 *Lodging Hospitality* column entitled "The Right Management Contract For You." Particular attention is placed on the managing agent's past operating performance. Historic income and expense statements from comparable lodging facilities are scrutinized to validate management's competency. Companies that fail to disclose their operating ability are generally not proud of their results.
- Lenders will want the option to either maintain or terminate a managing agent in the event of a debt service default, foreclosure or deed in lieu of foreclosure. During the term of the mortgage, even if the loan is not in default, the lender will require that the management agreement cannot be terminable by either the owner or operator without lender approval.
- If the managing agent's incentive fee is not subordinated to first mortgage debt service, financing will be extremely difficult to obtain. Lenders do not like to stand aside for anyone and look for operators willing to accept part of the financial risk.
- Timely notification from the franchisor if a default in the payment of a franchise fee or any other circumstance that could jeopardize the franchise.

Knowledgeable lenders recognize the importance of a franchise affiliation and generally require a suitable agreement be signed prior to originating the loan. In addition to approving the franchisor and agreement, a lender will often request the following:

- A document known as a "comfort letter" that allows a lender to continue using a franchise in the event of a foreclosure or bankruptcy.

The underwriting process utilized by exeperienced hotel lenders includes a number of important provisions and documentation. The following is a partial list of these items:

- Survey, architectural plans, engineering reports and title reports.
- The mortgager will usually insist on an escrow for the replacement of furniture, fixtures and equipment. An amount equal to two to three percent of total revenue is the norm, which should be sufficient to periodically redecorate and replace worn equipment.
- Combination market study and appraisal paid for by the lender.
- The lender will want to see real cash of 25 to 50 percent of the total cost put in by the equity investor.
- Access to financial statements and reports including:

1. Monthly profit and loss with full supporting schedules.
2. Daily reports.
3. Year-end audited reports.

While all these underwriting provisions may not be in your loan documentation at this time, be prepared to see them as lenders toughen their underwriting requirements.