Hospitality Law

Financing for Hotels: Do Lenders Have Any Room for the Inns?

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As the commercial real estate market continues to gradual thaw from the ice age of 2008, hotels are making a modest return to the deal spectrum as evidenced by the recent trade of hotels in major US markets. Among the latest active players are DiamondRock Hospitality, Hersha Hospitality, Pebblebrook Hotel Trust and Chesapeake Lodging Trust. Pebblebrook and Chesapeake are the relative newcomers on the scene. Pebblebrook made news recently when it purchased the 422-room Intercontinental Buckhead in Atlanta from Intercontinental Hotels Group PLC in an all-cash deal for $105 Million and just announced that it was under contract to acquire the Hotel Monaco, a 183-room hotel in Washington, DC, for a purchase price of $74 Million.

Chesapeake arrived on the scene in June 2009 and, according to the company's website, by January 2010, completed their first public offering and by March of this year had closed on their first hotel acquisition - the 498-room Hyatt Regency Boston. Since then, the company has acquired a 188-room Hilton in Los Angeles and a 153-room Courtyard by Marriott at Disneyland in California for a total purchase price of $71 Million, and on July 6, announced it was under contract to purchase the Boston Marriott Newton for a purchase price of $77.25 Million.

Not to be outdone, DiamondRock bought the 821-room Hilton Minneapolis in June for $155.5 Million and Hersha closed on the 113-room Holiday Inn at Wall Street in New York for a combination of cash and partnership units totaling $34.8 Million.

So where are these and other investors finding the capital to fund these kinds of deals in what has been a relatively tepid market? And how are current owners dealing with the strain on maintaining debt service in a sputtering economy?

In general, lenders have been slowly returning to the table as they rediscover their appetite for commercial real estate. We have even seen in the last month a new collateralized mortgage-backed security "CMBS" offering from JPMorgan Chase and Ladder Capital Finance of bonds backed by 36 fixed-rate commercial mortgages which are secured primarily by retail properties in various states across the country. While it seems unlikely that CMBS deals will return to the pace and popularity they enjoyed up until 2 years ago, it is at least a positive sign that lenders are getting off the bench and back into the game. However, lenders continue to exhibit some reluctance with hotels as compared to other commercial real estate asset types. Unlike an office building or shopping center, the hotel business onsite must also be evaluated in addition to the real estate. Given the recent turmoil with the domestic economy coupled with the lurking threat of terrorism, the hotel business has taken some lumps. Each of the investors mentioned above have seasoned veterans who can steer an owner through a down economy. Diversity of location of hotel assets can help offset a slide in occupancy that may be experienced in a particular area of the country. As we have recently witnessed with the BP oil spill in the Gulf of Mexico, natural disasters can have a devastating effect on a regional economy, in this case the Gulf Coast, which relies to a large extent on tourism. Diversity of hotel products among luxury and full service, select service and extended stay properties have also provided some insulation from market swings driven by the down economy as consumers, and now business travelers, search for value pricing when it comes to hotel accommodations.

The product type will have bearing on the lender's underwriting of any new loan or refinancing of an existing loan. Most lenders typically have steered clear of any hotel that is not branded with a recognized hotel chain unless the owner has successful experience operating boutique-concept hotels.

Current owners may face a "catch-22" when deciding how to allocate limited capital between debt service and necessary capital improvements. Some owners will have no choice but to defer capital commitments, and falling into a competitive disadvantage with newer or recently renovated products within the market area that will be more attractive to guests. Another impact is on the franchise side where capital that might normally be deployed for renovations and upgrades, whether discretionary or pursuant to a product improvement plan, are not made because the capital has been shifted to debt service. This tactic exposes the owner to potential default under the franchise agreement which in turn will put the owner in technical default under the loan.

If an asset was acquired at the height of the real estate market in 2005-2006, refinancing may not be an option, and a sale of the asset may not be a viable solution since current asset values may not be adequate to satisfy existing debt. Assumptions of existing loans by purchasers can be one alternative, but the strength of the purchaser financially and its experience with hotel properties will dictate whether a lender consents to an assumption. The franchisor may also play a role in determining whether a loan can be assumed depending on the purchaser's ability to satisfy the franchisor's conditions to operate under its flag. Non-institutional owners will need to continue to seek cooperation from lenders, franchisors and property managers to develop structures that will provide owners with as much flexibility as possible to allow them to focus on producing strong operating results. The good news is that most lenders seem to be cooperating with borrowers to restructure loans since lenders will likely only take over a property as a last resort (no pun intended) and recent industry reports have indicated a positive outlook on the hospitality sector for the balance of this year.

In the end, based on the level of hospitality experience, historical performance, property management and the size of a company's portfolio, institutional investors will likely have greater access to capital for both refinancing of existing debt and acquisition capital. Some examples: In December 2009, Hersha amended its $175 million existing revolving credit facility with TD Bank, N.A. as the lead bank. The amendment extended the term through the end of 2011 and decreased both the minimum permitted debt service coverage requirement to 1.20x and the minimum ratio of EBITDA to debt service to 1.25x. Additionally, the interest rate on the prime rate portion of the loan was restructured to the prime rate plus 150 basis points while the interest rate on the LIBOR rate loan was modified to be the greater of LIBOR plus 350 basis points with a 4.25% floor. The loan amendment also ties the outstanding amount at any time during the term to the lesser of the committed amount under the loan and 67% of the appraised value of the properties securing the loan.

Last February, Hersha refinanced a $29.8 million mortgage loan on the Hilton Garden Inn located in the Tribeca neighborhood New York City that it had assumed when it acquired the property in June 2009, only 6 months after it had opened. Although the property had a limited operating history, because of Hersha's performance record, Hersha was able to refinance the existing loan with a new non-recourse loan, increasing the loan amount to $32 million with a fixed interest rate of 8.25% for a term of 5 years.

In July, Pebblebrook closed a new $150 million senior secured credit facility with Banc of America Securities LLC and Wells Fargo Securities, LLC as the joint lead arrangers for the credit facility, with a maturity in July, 2013, with a one-year extension option and an option to increase the available amount of the credit facility to $200 million.

Institutional investors also have the added capability of raising capital through public offerings. Both Pebblebrook and Hersha recently closed public offerings where each anticipated raising over $100 million in gross proceeds. In a press release, Hersha stated that it intended to use the proceeds of the offering to repay outstanding indebtedness under its revolving line of credit as well as general corporate purposes.

DiamondRock has gone the route many investors have been recently pursuing by acquiring the $69 million senior mortgage on the Allerton Hotel, a 443-room in downtown Chicago, from the current mortgage holder at a discount on the face amount. In a press release, DiamondRock said it intends to continue a foreclosure action that had been commenced with the goal of owning the hotel upon completion of the foreclosure action. The current owner had acquired the property in late 2006 and performed a significant renovation. Through this strategy, DiamondRock will end up either owning a hotel asset in a major market in apparent good condition or will have made a return on the difference between its purchase price for the mortgage and the payoff if it is ultimately not the winning bidder at the foreclosure auction. It will be interesting to see how many other hotel assets trade in this manner down the road.

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