HOTEL LOANS: UNDERWRITING, STRUCTURING, AND LENDERS' DUE DILIGENCE

Hotel loans are complex business loans, and hotel lenders need to know the business.

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nce again, hotels are not only acceptable collateral for loans, but also a desirable market in which lenders actively seek business. From being the collateral that no one wanted just a few years ago, hotels have become the collateral that, it sometimes seems, every lender wants.

Although the real estate is a crucial first element of any hotel loan, these loans are far more complex than traditional "pure" real estate loans—because they are, in essence, loans to operating businesses of a particularly volatile nature. And, the security for these loans consists not only of real property, but also of a wide range of other assets that can be difficult to understand, preserve, and control.

Those who make hotel loans must understand all sorts of special issues that are not present in a typical real estate loan. They must understand the elements that enable hotels to function, and obtain appropriate security interests and other controls to protect their position. They must also understand hotel finances. They must analyze the hotel's operations, and the loan documents must reflect reality while protecting the lenders' interests. Lenders may require financial covenants and procedures of a complexity uncommon in typical commercial mortgage loans. Should it become necessary to foreclose on a loan, a hotel lender must be able to take over the entire operation of the hotel and control all the cash flows.

A lender that controls or obtains a lien on most of a hotel's assets, but somehow manages to miss a few, may find after foreclosure that it faces a situation that may range from awkward to disastrous. In the worst case, the lender may have to pay the foreclosed borrower to give up claims to property that was intended to be part of the collateral package but was overlooked.

CHOOSING AND PROTECTING THE FRANCHISE

To underwrite and secure a hotel loan, the lender usually starts by focusing on the basic business package that allows the hotel to operate under a particular brand name and assures that the hotel will be competently managed. Without these two items, a hotel is little more than a nongeneric building with a large number of small rooms.

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> The lender's principal concern is to evaluate and protect the franchise.

Most hotels rely on their franchise agreement (or equivalent arrangements) to give the property a brand name, identify and define the service the hotel sells, and produce a large percentage of its reservations (i.e., to assure a revenue stream). If the franchise is successful and appropriate for the market, the lender will want as much assurance as possible that the franchise will remain in place both while the loan is performing and if the lender ever has to take over the project after default.

A careful lender will analyze the burdens and requirements that the franchise agreement imposes to assure that the borrower will be able to comply with them. These obligations range from routine payment obligations—a percentage of revenues, advertising fees, marketing fees, and so on—to quality control and enhancement requirements that the borrower may find expensive and difficult to satisfy. If the hotel is more than several years old, the franchisor may have identified substantial deficiencies, and may require the franchisee to correct those deficiencies by a specified date (a "product improvement plan" or similar set of requirements). The lender's financial due diligence should identify all these potential requirements, both capital and operating, and take them into account in underwriting the loan.

The franchisor, on the other hand, has its own concerns. The value and strength of the overall franchise, for all the hotels that carry its brand name, may be imperilled if the franchisor fails to withdraw its brand name from a hotel that flunks the franchisor's quality standards. Quality problems are particularly likely during the long and difficult process of loan default, foreclosure, and transition of ownership and management.

These competing concerns typically lead lenders and franchisors to negotiate agreements in which the franchisor gives the lender some comfort, but not an iron-clad guarantee, that the franchise will remain in place even during and after a loan default.

A lender may recognize that if the project does go bad, one reason may be that the borrower chose an inappropriate brand name and franchise (i.e., the wrong market niche). The lender may therefore seek the right, after a foreclosure, to terminate the franchise and "re-flag" the hotel (choose a new brand name).

MANAGEMENT AGREEMENTS

Agreements between the borrower and a third-party hotel manager raise similar issues for a lender. Most important, the lender must fully understand the financial and other burdens that the management agreement imposes on the hotel. Again, the lender is concerned about its rights or those of the manager or borrower to terminate the management agreement.

Management agreements also create practical issues because they give the manager physical possession of the hotel and control of its cash flow. A management agreement should therefore possess some of the characteristics of a "lockbox" agreement and require the orderly application of cash flow from operations consistent with the loan documents.

A lender's first instinct may be to insist that all revenues be applied first to pay debt service, but most lenders recognize that if the manager cannot pay operating costs, the hotel will quickly deteriorate and lose its clientele, its future cash flow, and hence much of its value. So, most lenders permit, and even require, normal operating costs to be paid ahead of debt service.

The manager and the lender often disagree as to how to treat the manager's management fee for operating the hotel. In a lender's ideal world, every dollar payable to the manager would be subordinated to debt service. If the hotel cannot carry the loan, the manager should be the first to suffer. The lender could argue that this approach creates the right incentives for the manager. It also acknowledges that the incremental costs to a multi-hotel manager to manage one or more hotels are thought to be relatively low, typically lower than the management fee.

In the real world, however, managers usually refuse to "subordinate" any part of their basic management fee, whether a percentage of revenues or a fixed fee to cover the manager's basic expenses of managing the hotel. If, however, the manager receives a combination of fixed fee plus incentive fee (percentage of net cash flow, profits, or some similar variable), a manager may be

willing to subordinate some or all of the incentive fee. The manager may recognize that when the hotel is not paying debt service, it might not produce any incentive fee either, depending on the incentive fee formula, so the subordination may mean little.

If the manager is the borrower's affiliate, rather than an outside third party, the lender may achieve a somewhat better outcome in the lender-manager negotiations, but the lender also acquires a new set of concerns.

Many hotel management companies provide not only management services, but also goods and services like insurance, reservations, marketing, advertising, consumables, and other items. Often, they purchase these goods and services from, or provide them through, their own affiliates. Management agreements usually require management companies to provide these items at competitive rates. But, the lender may find it difficult to judge whether rates are competitive, and when policing of rates may be lax. Subtle overpricing in trading with affiliates represents an opportunity for any hotel manager.

If a lender believes that purchasing arrangements with affiliates are simply creative ways for hotel owners to take money out of cash flow ahead of payments to the lender, it may want to eliminate them entirely, or at least to require that they be subordinated to the loan if the loan ever goes into default.

> The lender must be sure that it controls the land needed to operate as well as the rental income that the hotel earns.

THE PROPERTY

Once the lender has satisfied itself concerning the hotel brand name and management, it must turn its attention to the physical property.

Controlling the Land

Every mortgagee must control the land under and around the collateral real property. If a lender takes over a hotel after a borrower defaults, but does not control the land that the property requires to operate, the lender does not have a viable asset. The lender's mortgage must cover not only the main hotel building, but also whatever other real estate the hotel needs to operate.

For example, if the hotel parking lot or valet parking service requires use of a neighbor's land, the borrower must mortgage whatever rights the neighbor has given the hotel operator regarding these arrangements. The same goes for an adjacent golf course, health club, or other amenity. These issues arise most commonly at resort properties or in an integrated mixed-use development or commercial park.

In short, the lender must be certain that, in the event of foreclosure, it will control whatever real estate rights the hotel needs to continue to operate. If the borrower has not mortgaged those real estate rights, the lender cannot foreclose on them. If the borrower holds the pertinent real estate rights in a form that is anything less than full ownership, mortgaging them probably requires cooperation from third parties. Agreements to assure this cooperation must be in place at the loan closing to prevent surprises, problems, and expense later.

Controlling Revenues

In addition to obtaining all the right mortgages on the real estate, the hotel lender needs an "assignment of rents" so that it can collect any rental income that the hotel earns (such as from retail tenants) from the moment of default until the lender actually takes title to the project.

Although hotel revenue may be intuitively equivalent to rental income, in the eyes of the law it is nothing of the sort. Hotel revenues are governed not by real estate law (which has somewhat clear-cut rules regarding mortgages and assignments of rents), but by general commercial law—which requires a separate process for the lender to "perfect" its claim to the revenues from hotel operations.

This distinction can create problems for hotel lenders if a troubled borrower takes refuge in bankruptcy. In the early 1990s, bankruptcy courts often concluded that hotel revenues were partly or completely beyond a mortgage lender's reach until the lender actually took ownership of the hotel.

Congress modified the bankruptcy law in 1994 in a rare example of federal bankruptcy legislation that treats a lender more favorably than general state law. Under the new rules, if the lender has obtained a valid security interest in "the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging proper-

ties," the lender can assert a claim to that income even during the hotel owner's bankruptcy.

Even if a lender has a valid security interest in lodging income, however, it may still need to take further steps to control food and beverage income. And, the courts will carefully scrutinize the language of the lender's documents. If the documents deviate from the new bankruptcy language, courts might decide the lender's rights are invalid or incomplete. Moreover, the new bankruptcy provisions might not help lenders that closed and documented their loans before they knew what Congress wanted them to say in their security.

Even when the lender can assert a claim in bankruptcy over hotel revenues, the bankruptcy courts do not give the lender total control over that revenue. To the contrary, that revenue stream constitutes "cash collateral," to be fought over between lender and borrower. Today, however, the lender has an important role in that discussion. This was not always the case.

Controlling the Hotel's Personal Property

As part of its underwriting process, the lender must confirm that the hotel has all the personal property it needs to operate successfully. In its financial analysis, the lender must estimate the costs of preserving, maintaining, and replacing that personal property and it must acquire a lien on the whole vast array of that personal property: furniture, food, equipment, linens, silverware, television sets, computers, and a long list of other items. Without a solid lien on all those assets, a lender that has to foreclose on a hotel may find that it owns a property that it cannot operate, and that is incapable of producing the projected cash flow.

Not only must the lender obtain a good lien on the physical personal property, it must also control assets and rights of a less tangible nature. For example, a hotel's liquor license is often a fundamental element of its profitability. Each state has its own rules, often strange and counterintuitive, for the steps a lender must take to protect its claim to the hotel's liquor license.

In some states, a lender can control the liquor license by a procedure as simple as having it issued in the third-party manager's name, and making an appropriate agreement with the manager. Other states allow a lender to take control of a liquor license after default only if the lender's loan documents contain special "magic language" regarding the liquor license. In some states, the best a lender can do after foreclosure is to reapply for a new liquor license and hope for the best.

Other intangible assets crucial to successful operation can include telephone numbers, agreements with reservation services, service contracts, catering agreements, other contracts, and a wide variety of other miscellaneous rights—even two-way radio licenses. Ideally, the lender will identify, understand, and obtain control of every one of these assets.

The Costs of Due Diligence

The "due diligence" process for a major hotel loan represents a management challenge to any lender. The lender wants to be certain that its security package includes everything and leaves no room for future surprises; that the lender controls all significant "inputs" to hotel operations; and that the financial numbers accurately reflect reality. On the other hand, full "due diligence" takes time, effort, money, and coordination of the efforts of many professionals.

An outside due diligence team, if left to exercise its own judgment, may leave no stone unturned in its thorough review of the hotel, driven in part by fear of missing something or making a mistake. The result: a huge bill for due diligence work. Although borrowers usually agree to pay their lenders' due diligence bills, in the current lending market borrowers have taught lenders to control their reimbursible expenses or the borrowers will find other lenders. So, both borrowers and lenders must control the cost and scope of any due diligence exercise.

The lender needs to bring proportion and intelligence to the due diligence process. It should coordinate the legal and accounting due diligence with the loan underwriting process in a timely and organized way. If the transaction involves a portfolio of hotels, the diversification of the pool may give the lender opportunities to control the cost of due diligence through aggressive use of "sampling" techniques. The existence of a creditworthy third-party manager may simplify any due diligence that may be necessary at an operational level.

HOTEL APPRAISALS

The appraisal of a hotel can be even more sensitive and complex than an appraisal for a loan secured by more standard commercial real estate. The volatile nature of a hotel's income—fluctuating sharply from week to week, month to month, and during the course of the business cycle—gives an appraiser a canvas on which to paint almost any picture. And, that picture may change substantially between the first discussion of the loan and its actual closing. A hotel lender cannot accept appraisals blindly. More than for most forms of real estate, lenders must participate in, understand, and accept the assumptions, process, and analysis that drive the appraisal.

The ultimate estimate of value must be consistent with the lender's beliefs regarding income volatility, conservatism, and forecasts of demand for room-nights in the particular market niche where the hotel operates. Unprotected by long-term leases, the variables of demand—crucial to determining income and hence value—can change, quite literally, overnight.

Reserves and the Prevention of "Back Door" Financing

Due diligence and underwriting for a hotel must also identify and evaluate some physical risks that are not readily apparent. Even if the hotel complies with all building codes today, for example, it may hide time bombs in the form of building systems or materials that are outdated or missing and will need to be replaced or retrofitted in just a few years.

Perhaps because of the volume of people passing through a hotel and a hotel's general visibility, hotels often seem to be an early target for new building code requirements, such as requirements for the latest sprinkler systems, replacement of refrigerants, new fire suppression systems, improvements in access for disabled customers, and so on. (Franchisors' requirements can sometimes equal or exceed those of the building code.) In analyzing the financial future of a hotel, a lender must consider the likely need for major projects of this type, even if they are not yet legally required.

Whether future capital outlays are driven by retrofitting requirements or normal wear and tear and changes in fashion, the lender's financial analysis must set aside appropriate reserves for these outlays. The lender's security package must give the lender appropriate control over those reserves to assure that after foreclosure they are available to the lender.

If the hotel owner or manager fails to set aside appropriate reserves, the hotel is borrowing from the future to pay for present operations or to enhance profitability artificially. This "back door" financing inevitably must be repaid by whoever owns the hotel when the time comes to make these capital outlays.

In negotiating and documenting a hotel loan, the lender should include appropriate covenants and restrictions regarding reserves. The trend in this area, subject to market pressures, may be to establish larger rather than smaller reserves. If a lender believes the agreed-on reserves might not cover projected outlays, it should ask the borrower to provide some other sources—personal guaranties, a cash deposit, a letter of credit, whatever—from which the extra cost can be funded.

The lender also needs to watch for, and prevent, other forms of back-door financing, including the following:

- Overselling of prepaid discounted rooms;
- Substitution of leased for owned fixtures, furnishings, and equipment;
- Longer aging of payables;
- Inappropriate reduction of inventory levels;
- Deferred payment arrangements or outright loans from the hotel manager to the hotel; and
- Any other form of artificial short-term reduction of operating costs at the expense of future income or value.

These financing strategies are not too different from strategies employed by management of any operating business under stress. A hotel is, in large part, just another operating business. A lender must analyze and finance it as one.

A lender also needs to monitor a hotel more like an operating business than like an office building. Because the position of that operating business changes nightly, a hotel loan agreement should require reporting more extensive and more frequent than is required by a typical commercial real estate loan. The reports to the lender should probably tie to the manager's reports to the owner and satisfy specific accounting, recordkeeping, and computerization requirements. The lender may also want copies of the inspection reports

prepared after each inspection of the hotel (announced or unannounced) by the franchisor.

Because of the volatility of a hotel's income, some lenders are willing, at least to some limited degree and for some limited period, to tie loan payments to operating results. For example, New York City hotel owners know that February is typically a very bad month and October a very good one. A lender might agree to defer part of each March interest payment for several months, and the borrower might agree to make an extra amortization payment every November 1.

This theme has any number of variations, all of which will create some concern for a lender, but may be necessary to make the loan work and get it closed. It is all part of the process of tailoring any hotel loan to the realities of the hotel business and to the characteristics of the hotel being financed.