

Who is Lending to Hotels? – Program Summary

FROM: DWT Hospitality Practice Group

TO: Hotel Roundtable Invitees

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The second in a series of executive roundtables moderated by Gerry Adams of Clothier and Head and directed at the opportunities and challenges facing hotel owners and operators in the current economic environment was held on February 1, 2010 at the offices of Davis Wright Tremaine LLP in Seattle.

Chris Burdett of PKF Capital reported on current market conditions and his impressions from the American Lodging Investment Summit (“ALIS”). PKF’s data indicates that RevPAR, ADR and other metrics are expected to improve in the third quarter of 2010. However, 2010 will likely be a flat and difficult year. Notwithstanding, the hotel market is expected to improve and emerge from recession in the Pacific Northwest more quickly than other areas of the United States. The PKF slides are excellent and very detailed. The can be viewed by going to the following: <http://www.dwthospitalitylaw.com>.

Matt Le Master of Davis Wright Tremaine also attended the ALIS conference. His impression of the current state of the industry taken from the conference: the industry will remain flat and move towards economic recovery approaching the end of 2010. This is in part because after essentially a two year depression, long delayed business travel and vacation travel are expected to increase, while hotels are operating very efficiently. Thus, any increase in occupancy should trigger an increase in net operating income. Notwithstanding, this year will be very difficult for operators. In addition, the ALIS conference highlighted a number of recourse and nonrecourse default and forbearance programs. A discussion on default and forbearance strategies and tactics will be a future Hotel Roundtable topic.

Subsequently, the program focused on the availability of debt financing. Four factors make the acquisition of debt extremely challenging: (i) the condition of the lenders, (ii) the condition of the borrowers; (iii) the decreased value of the collateral, (iv) and increased equity requirements.

Hotel debt financing remains scarce and construction lending is virtually non-existent. Public resources over the past twenty-four months indicate that community and regional banks, such as Olympic Coast Investment, Inc., Seahan Bank, City Bank, Nara Bank, Unibank, EastWest Bank, and Umpqua Bank have all provided debt financings in the hospitality space and may be sources of debt financing for 2010. Cohen Financial and U.S. Bank are national institutions that have provided recent debt to the space. Additionally, Calyon, GE Capital Real Estate, IDC Financial Group, Mesa West Capital, and RockBridge Capital, LLC were all in attendance at ALIS and indicated they were in the market to provide debt financing. Thus, each one of these lenders, at least hypothetically, may be a source of potential debt financing; however, reality seems quite different.

Unfortunately, the hospitality industry has entered a “new normal”; lenders have other sources of revenue besides selling debt, the FDIC has imposed significant limitations on the amount of debt some banks can offer because balance sheets are weighed down by non-performing loans, and some lenders appear to be retaining capital in the event the economy gets worst or acquisition opportunities are presented. Accordingly, debt financing ostensibly exists, but the reality is very challenging. The underwriting for any debt is extremely stringent and borrowers must demonstrate impeccable collateral quality.

Current lending terms are also problematic. It was only thirty-six months ago when LTV ratios were often in the range of 80-90% and sometimes even exceeding the value of the collateral. Typical current debt financing terms are: (i) a five-year note, (ii) with a 25-year amortization schedule, and (iii) an LTV ratio between 60% and 65% (a significant load when combined with the double-whammy of a decreased valuation). Some borrowers are obtaining fixed rate loans in the 6.5-7.5% range; and LIBOR-based variable rate loans are commonly at 5.5% or more. In rare instances some life insurance companies are providing low leverage, nonrecourse debt, but full recourse debt is the norm.

Borrowers with loans coming due over the next year should plan for a minimum of six to seven months to obtain financing. These borrowers face a tremendous challenge. They will be trying to acquire new financing based upon horrible net operating income historicals and collapsing valuations. Again, it seems the best course of action in this situation is to seek debt financing early, argue that 2008-2009 was an anomaly and develop a realistic business plan going forward. To qualify for a loan, any prospective borrower should be very thoughtful when approaching a potential lender.

Borrowers who have breached loan covenants or who are not performing will likely not be able to acquire conventional new debt financing. Interestingly, they may be able to extend their debt until times get better. Most lenders do not want to own and operate hotel properties, or sell them at a loss. Thus, defaulting and non-performing borrowers do have leverage, but they need to employ it wisely.

Obviously, we wish things were better, but we believe the debt markets will improve over the year and we believe quality operators will be able to obtain debt financing even in this environment.

If you have questions or comments regarding the hotel roundtable, please feel free to contact Brad Bashaw by email (bradbashaw@dwt.com) or give him a call (206.757.8253) or contact Matthew Le Master by email (mattlemaster@dwt.com) or call (206.757.8077). We will send out an announcement in a few weeks for the forbearance strategies discussion in April. Thank you for attending.