HVS

MARKET REPORT

Monitoring Hotel Loan Performance to Mitigate Risk

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Lenders who originated loans in 2006 and 2007 in the peak of the economic cycle should now be closely monitoring the performance of these loans to develop strategies to mitigate risk and exposure as economic conditions are now vastly different.

Many lenders funded hotel loans during the peak of the economic boom in 2006 and 2007 — when economic conditions were vastly different than they are today. Whether a hotel loan is currently performing, on a watch list, or in an advanced phase of remedial action (workout), hotel lenders should evaluate data in five general categories to have a sufficient amount of information and current knowledge regarding the outstanding loan — in order to assess current, or increasing, risk.

If the risk is increasing that a loan may become delinquent, proactive steps should be taken to avoid an increase to the lender's exposure. Ongoing due diligence in the following areas should be undertaken to mitigate this risk.

1) Market Knowledge

The lender should understand the general characteristics of the market in which the hotel is located. More specifically, an evaluation should be initiated of the historical, present, and anticipated market conditions that affect the asset including: supply and demand data, RevPAR trends for the specific asset compared to its competitive set, new market threats such as new room supply or the repositioning of an existing asset within the market that would result in a competitive threat, the asset's present and optimum positioning within the market, the hotel's mix of business, key account and key account room generation trends, forward-looking evaluation of increased or decreased demand from key accounts, and negotiated rates and what demands are being made from key accounts to reduce rates. To detect risks to cash flow early, it is also important to examine the financial health of the hotel's top accounts.

2) Brand and Management

It should be determined if the brand and/or management can be changed if this strategy would likely result in improved financial performance and value. With the approval of, or in conjunction with the borrower (assuming the borrower is still in control of the asset), the capabilities of the manager should be evaluated to determine if the management in place is effective and qualified to manage the asset in the short- and long-term. If options may be available, the hotel's brand, or its status as an independent property, should be evaluated to determine if it is the appropriate business model to maximize the asset's revenue and value potential. Many owners of properties that have come under financial strain are considering new branding affiliations, some as a proactive approach to repositioning their asset, and others as a result of not having cash flow available to perform necessary or required upgrades to meet branding standards. Either way, a hotel should be positioned for the competitive environment that it is likely to face in the future, not the one that it faced in the

past. Interviews with area general managers, hotel operating and branding companies, and other industry insiders are extremely helpful in keeping a forward-looking approach.

It is important to make the distinction early on between a good manager contending with a bad market, and a complacent manager who may have performed adequately during the good times — but who may be challenged beyond its skill level in more challenging times. Making fair performance comparisons against the rest of the market and like-kind assets, interviewing management executives, and evaluating their strategies to respond to changes in market conditions — are the best starting points. Further, the capabilities of the key members of the on-site management team should be assessed to assure that the team on the field is up to the task of navigating through a very challenging economic environment.

If a franchise is in place, the quality assurance inspections and Product Improvement Plan (PIP) required by the franchisor to assure the property is both competitive and also adhering to franchise brand standards should be evaluated. PIPs should be evaluated critically to determine which components may represent deferred maintenance, which components may support the asset's competitiveness in the current environment, and which may represent expensive improvements for which there may not be market support to drive reasonable return on investment. Candid discussions should be had with franchisors regarding the extent and timing of PIPs to ensure all expenditures will ultimately enhance the value of the hotel or prevent further value decline. While some things may not be considered necessary, if it prevents losing a brand — it may be highly worthwhile. If a PIP-related renovation is required, implementing a proven process to select an architect, interior designer, general contractor, project manager and purchasing support to minimize guest disruption and revenue displacement will ensure cash flow dollars are not lost to inefficiencies.

3) Types and Frequency of Reports

Evaluation of operational and marketing reports should take place on a regular basis to monitor the on-going financial performance of the asset. These reports should include: the annual budget, monthly financial statements, monthly Smith Travel Research (STR) data, monthly booking pace and production reports, monthly guest satisfaction data, employee satisfaction and retention statistics, annual sales and marketing plan, annual capital expenditures plan, franchise quality assurance inspections, and rolling 90-day reforecasts of revenues and expenses.

The data streaming in should be consistent with the market positioning desired for the property. Any inconsistencies should be questioned and dealt with as promptly as possible.

4) The Hotel's Loan-to-Value Ratio

A prime concern from a lender's perspective should be the asset's loan-to-value ratio (LTV). This ratio is generally reflected in the loan covenants and monitoring this ratio is important. There is a distinction between a hotel's market value — assuming a willing buyer and a willing seller and sufficient time to complete a transaction — and its liquidation value. As part of liquidation, transaction proceeds can be 20 to 50 percent lower than the property's market value.

The question needs to be asked: "where will the asset likely be in 5 years"? If the hotel is situated in a market with high barriers to entry that historically has had strong performance — there is a good chance of a future refinancing at a higher value. Conversely, if the hotel is located in a market with low barriers to entry — and the asset will likely be challenged in obtaining and sustaining a mid-to long-term recovery of net income — upside value enhancement may be negatively impacted.

It is important to recognize that given the present difficulty in obtaining financing coupled with the low leverage that is available, an assumed future refinancing within a ten-year holding period, based upon financial improvement, and a stabilized net income may provide the best approach to discern the market value that would result from negotiations between a willing buyer and a willing seller. Failure to factor in a future refinancing will result in understatement of value. A lender must weigh the challenges and problems facing a particular hotel and the likelihood, timing, and cost for which they could be corrected against the value of the asset today — and after an eventual recovery.

5) Borrower's Capabilities and Involvement with the Asset

The lender should evaluate how and if the borrower should be involved in the day-do-day management of the hotel, and determine if the borrower has the in-house capabilities to oversee the hotel and assure that its maximum potential is being realized. Property owners can create or exaggerate hotel problems. Owners who are inexperienced may make costly mistakes making operational decisions related to the hotel, and those who are undercapitalized may be unable to correct mistakes.

After review of the five areas detailed in this article, a lender will be in a much stronger position to develop and implement a plan for the asset that maximizes the value of the loan collateral.