



Is Your Hotel Underwater?



This article was written for
News You Can Use!
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It has been estimated that one in five hotels in the U.S. will default on their loans by the end of 2010. Worse yet, international ratings agency Fitch, Inc., estimates that the number of defaults may reach 30% by the end of 2012. Unfortunately, our NH hotels are mirroring the national trends. Demand has dropped significantly since October of 2008, the last month that most of us consider normal. Exacerbating the problem, unwarranted new hotel construction increased supply faster than demand even before 2008, and in many markets, hotel revenues and cash flows are at historic lows. What has remained constant, however, is the debt service payments of these hotels.

Most hotel managers have trimmed expenses as far as they can without diminishing their product and service quality, but it is rarely enough to return these properties to profitability. The only strategic option available to the property is to reduce the amount of debt.

It appears that in many markets, the return of revenues to 2007 levels may take another five years. In markets with significant new supply, the return to the levels of 2006-2007 may never happen. For example, Manchester, NH received an astounding number of new hotels in the last ten years. A large demand generator for that market was inbound travel for corporate training. However, since the recession began in 2008, companies, almost overnight, have learned to train with teleconferencing and web-based interactive training. They have no reason to return to the expense and inconvenience of in-person training. It is likely that the lower demand in this city (and many others) is *permanent*. What this means for hotels is that *the solution must be permanent also*. A period of interest-only payments does nothing to address the problem of too much debt.

US banking regulations facilitate several types of debt forgiveness. The most common process is called a bifurcation. In a loan bifurcation, the note is divided into two parts, part A and part B. The part A is a note based on the amount of the loan that the property can afford. The part B is the remainder of the note, that which the property cannot afford. The property is obligated to pay on the part A note only. What happens to the part B note is a matter of negotiation.

So what should hotel owners do if they have too much debt on their hotel?

1. **Address the problem immediately.** Many ownership groups we talk to have exhausted all other sources of cash before they talk to their bank. Talking to your bank while you still have cash will help preserve cash that will be increasingly difficult to accumulate. Why deplete it before addressing the problem? Don't think that banks will not negotiate with you because you have *personal guarantees*. It is in all parties' interests to find a negotiated solution, and that rarely involves exercising the guarantees.
2. **Be realistic with the bank and propose a solution.** Banks need you to come to them with a solution. There are reasons why they can't propose one. Debt reduction is often in the interests of the lender, because if properly structured, it will actually yield the lender more money than a foreclosure will and it can be accomplished quickly with a minimum of legal expense. Negotiated reductions are becoming more common as banks are realizing low yields through the foreclosure process.
3. **Don't forget the capital budget.** When doing your analysis, don't forget that there needs to be enough cash flow after the debt restructure to fund the inevitable capital reinvestment to keep your property competitive. Failure to plan and negotiate enough concessions to allow for capital reinvestment will make it impossible to compete in the future.
4. **Understand that you have a problem of economics, not a legal problem.** Loan documents invariably empower banks with all the legal rights imaginable (and some unimaginable ones). However, the problem is one of cash shortfalls, and all the lender's legal rights cannot solve the problem. Approach the bank with a solution, not with a lawyer. Your lawyer can only talk to the bank's lawyer, and inserting your lawyer between you and your lender is a certain way to turn an economic problem into a legal one.

It is important to understand that in many markets, the debt of your competitors will be restructured one way or another, because most markets are now oversupplied. Properties with high debt relative to their competitors will have a difficult time competing. Debt reduction is often done through foreclosures or bankruptcies, but in order for the reduction to produce the best result for the property owner and the lender, it should be accomplished through negotiations between owners and lenders.

Delta Capital Group, LLC has been restructuring Hotel debt for over 30 years. We can help you negotiate through the maze of debt restructure. Please feel free to call our NH office at 603-778-6322, or check us out on the web at www.deltanow.com.