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How to Make the Best of Bad Times
By Timi Anyon Hallem* and Karen Johnson**

The economic news is bad and getting worse. Occupancy fell off a cliff in October and is not recovering. Your loan may be due and no new financing is available. Your cash flow is not meeting debt coverage covenants and your lender wants you to pay down a portion of the note. Your lender or equity partner has refused to keep funding cash flow deficits when a renovation has gone over budget or gone on longer than expected.

These are real problems faced by hospitality property owners in today's markets. The hurdle for such owners is to properly analyze their options. In a world of bad choices, how do you find the best choice? This article will offer some suggestions on how owners should approach today's issues to maximize the chances for an acceptable restructure of existing financing.

Understand the Depth of the Problem and Formulate a New-Reality Business Plan: The crucial first step is to understand the depth of the problem. This means undertaking an intense analysis of:

- the state of your business,
- the state of your loan documents, and
- the lender's or servicer's method of operation.

You cannot approach a lender regarding a loan workout without understanding the economics of your property. The goal of a workout is to revise your loan in a way that will allow it to become performing.

You will need a brief business plan that addresses the new state of the world, and how you intend to survive it. That requires an honest assessment of what your operating costs

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and net cash flow before debt service will be for the next two to three years.

Be prepared to succinctly explain how your property is operating relative to the market. (Use your Smith Travel Star reports.) You might also want to commission a benchmarking report that shows what the average flow through is for a property of your size and type, and then compare your margins to the industry norm. (Both Smith Travel and PKF Consulting can provide the industry norm information, for $500 to $600.) The goal of this study is to show to your lender or servicer that you are operating the hotel in a competent manner.

Do you have any looming capital expenditures? If they are brand mandated, is there any flexibility? Gather your franchise agreement and any recent correspondence. Lenders are reluctant to take any action that would void a franchise agreement, so you may have a little leverage if your flag can be pulled in a bankruptcy.

Review Your Loan Documents and Ask the Tough Questions: Once you have formulated your new-reality business plan, you can move on to the second major task: a thorough review of the loan documents and unadjusted payment schedules, in which you ask the following tough questions:

- Will the cash flow support the current loan value with a lower interest rate, or do you need to defer all interest payments?
- Is the balance too much to support no matter what the interest rate?
- If the loan is not supportable, what options does your lender have? (Put yourself in his or her shoes.)
- Is there a guaranty from a financially-solvent entity that the lender can call upon if the loan goes into default?
- Are there loan covenants that would lead to recourse if bankruptcy is filed by the owner?
- Is the loan cross-collateralized with another (performing) property, so that losing one property will mean the loss of both properties?
- Is the borrower a single asset entity so the lender has no one to pursue, or does the borrower have other assets which would be at risk?
- Is the property owner-operated, so that you can argue that the lender avoids paying management costs by keeping you in place?

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- Is the property franchised, and is the flag a condition of the loan?
- If flagged, is the flag at risk because of the quality scores or condition of the property?
- If flagged, is the franchise term expiring and are the property cash flows insufficient to finance the renovations needed to renew the flag?

Bankruptcy is an imperfect mechanism for restructuring a loan. First, your loan agreement may state that your non-recourse loan will become fully recourse to the borrower and any guarantor if a bankruptcy if filed. If these provisions are enforceable (and they have not yet been tested in court), then filing bankruptcy may trigger more liability than you now have. Even if the borrower is a single asset entity, if the filing of a bankruptcy causes the loan to be recourse to the guarantor, then bankruptcy is not an option.

If there is no bankruptcy and the property is foreclosed, the lender may be able to sue the borrower for the "deficiency" - the difference between the principal amount of the loan and the value of the property at the moment of foreclosure. If the borrower has no other assets, this is an empty threat. If the borrower has other assets, then the borrower's other assets are all at risk.

Understand the Mindset of Your Lender or Servicer, and Work With Them To Restructure the Loan In A Manner That Fits Your Needs: Your last major task is to understand the mindset of your lender or servicer. While they intend to make decisions that will facilitate the greatest net recovery of the principal outstanding, they may be reacting from a combination of panic and ignorance of the hotel industry. Their solution may be to slash and burn. Get an attorney or work out specialist who understands the business and can help you (a) reason with the lender or sevicer and (b) keep emotions out of the discussion to the greatest degree possible. You will need to concentrate and provide explanations that don't use too many buzz words, on one hand, or give the appearance of talking down to them, on the other hand.

In an ideal world, the lender will work with you, the borrower, to restructure the loan. The restructure could take a number of forms.

The loan could be divided into a "good loan" in an amount and at an interest rate that can be supported by the property, and a "bad loan" on which interest accrues and which will only be paid if the property recovers sufficiently to pay that loan.

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Lenders can take preferred equity positions in the ownership entity instead of a "bad loan" so that if recovery comes, the lender can get the upside in return for restructuring the loan.

Alternatively, the lender can agree to defer interest for a period to allow the market to recover. This is more likely if your loan has been packaged as part of a Commercial Mortgage Backed Security (CMBS) and you are working with a servicer. Sometimes a neighborhood or relationship lender even agrees to contribute to operating expenses to keep the property afloat, although this is very rare today and a non-starter for a loan packaged in a CMBS offering.

If the borrower has access to additional equity from an "angel," then the borrower can offer to pay down the loan balance in return for a lower interest rate and longer term. This can avoid foreclosure. However, if the cost of the angel money results in the borrower losing its economic stake in the property, then this is not a useful alternative.

If there is no way to restructure the loan, the owner may be able to give the lender a "deed in lieu of foreclosure" instead of requiring foreclosure (thereby saving the lender both costs and time) in return for a release of all personal liability to the borrower and sponsor.

Restructuring can be a useful tool. It can provide the time and economic assistance needed to save an owner's investment. But lenders will only restructure loans if it will obviously net more towards the original principal balance than foreclosure and sale. Does the restructuring turn the loan into a performing loan? Does it make economic sense? You will need that business plan to convince the lender that restructure makes sense. That requires a thorough understanding of all of the relative bargaining positions of the owner and the lender. And that requires solid knowledge of the property and the loan documents.

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