MEET THE MONEY®
National Hotel Finance & Investment Conference

RISING ABOVE RATES: SUCCESFUL DEAL STRATEGIES IN A CASH CONSTRAINED MARKET

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Rising Above Rates: Successful Deal Strategies in a Cash Constrained Market

How Deals Get Done?

This boot camp will address what is driving the market and how to get deals done.

- Rapid and substantial increases in interest rates and credit spreads have challenged credit statistics and cash flows and have made debt financing difficult.
- Many lenders are becoming more aggressive in exercising their rights and remedies.
- Construction costs have increased; PIP costs have increased, suppressing financial returns.

This boot camp will address key steps and issues that are critical to identify, diligence, structure, negotiate, and close deals in a challenging environment.

Setting the Stage

MAJOR CONCERNS DRIVING BORROWER, LENDER, AND INVESTOR DECISIONS

Interest Rates and Credit Spreads: Substantial increases in interest rates in the short and medium term and simultaneous widening of credit spreads

Fallout From Bank Failures: Increasing uncertainty and confusion related to failures of multiple banks and the reduction in bank lending

Inflation: Impact of massive government stimulus, significant non-transitory inflation; nominal ADR's rising rapidly but real ADR's have minimal growth

War: Impact of wars in Ukraine and Middle East

Labor and Wages: Challenges with availability of labor and rising wage rates; lack of interest from many with respect to working in a hotel or an office

Lender Patience: Burn-off of lender and brand standard forbearance resulting in necessary equity infusions and leading to restructuring and capital markets transactions, as well as additional foreclosures and bankruptcies

HOTEL OPERATING PERFORMANCE RECOVERY

In the middle of 2020, almost all industry analysts projected a general return to 2019 RevPAR in 2024. For most markets, aided by inflation, 2019 RevPAR was achieved in 2022.

- In prior demand shocks, business bounced back with a slower and prolonged rebound in group and business transient. In this environment, with massive amounts of government economic stimulus ($6-$7 trillion and $3 trillion from the Federal Reserve), and new massive spending bills, demand has recovered faster but has driven significant inflation.

- Leisure had been a key driver of occupancy and of growth in ADR; now business transient is growing and group is more significant

- International inbound travel continues to be challenged by strength of the dollar; there is a large imbalance between international inbound vs. outbound travel

- Corporate travel is recovering but will not fully recover until a substantial majority of employees in urban markets return to offices

- Recovery in the hospitality industry is varying widely by market segmentation and geography, and while struggling throughout with the cost and availability of labor and huge increases in insurance

US HOTEL OUTLOOK

By 2022, RevPAR had exceeded pre-COVID levels (2019) by 8%, driven by ADR which was 14% higher than 2019.

CoStar projects low single digit RevPAR growth over the next few years – this growth is again driven primarily by ADR increases.

	Occupancy				ADR				RevPAR				Supply	Demand
Year	**%**	**Change**	**% of 2019**	**% of 2022**	**$**	**Change**	**% of 2019**	**% of 2022**	**$**	**Change**	**% of 2019**	**% of 2022**	**Change**	**Change**
2022	62.6%	8.7%	94.9%	100.0%	149.43	19.5%	114.1%	100.0%	93.47	29.9%	108.2%	100.0%	1.8%	10.7%
2023	62.9%	0.6%	95.5%	100.6%	155.80	4.3%	118.9%	104.3%	98.07	4.9%	113.5%	104.9%	0.3%	0.9%
2024F	63.5%	0.9%	96.3%	101.5%	160.48	3.0%	122.5%	107.4%	101.93	3.9%	118.0%	109.1%	1.3%	2.2%
2025F	63.9%	0.6%	96.9%	102.2%	164.74	2.7%	125.8%	110.2%	105.31	3.3%	121.9%	112.7%	1.5%	2.2%
2026F	64.0%	0.1%	97.1%	102.3%	169.88	3.1%	129.7%	113.7%	108.72	3.2%	125.9%	116.3%	0.4%	0.5%
2027F	64.0%	0.1%	97.1%	102.4%	174.23	2.6%	133.0%	116.6%	111.59	2.6%	129.2%	119.4%	0.1%	0.1%

Source: CoStar Research (Apirl 2024).

STATE OF THE TRANSACTON AND CAPITAL MARKETS

While acquisition markets have rebounded significantly since 2020, with many leisure markets trading at a premium to pre-COVID valuations, overall transaction volume is down meaningfully.

- Call for offers delayed/postponed due to credit markets
- Higher quality assets, especially resorts and leisure driven assets, are being pursued by investors, mostly with a long-term time horizon
- New debt financing is challenging given higher interest rates and wide credit spreads

New issue hotel mortgage debt market was improving but is now suffering from much higher interest rates and credit spreads plus underwriting uncertainty.

- Strong sponsors can obtain moderate LTV loans at reasonable spreads
- Most lenders remain highly cautious with credit analysis and underwriting
- CMBS is available but has been dominated by single borrower deals; individual loans are being priced at high coupons

WHY AREN'T THERE MORE HOTEL TRANSACTIONS?

Historically, there is a meaningful lag time prior to the return of normal hotel sales transaction activity; this is despite recurring predictions of large amounts of distressed sellers.

Difficulty in underwriting and in creating pro forma projections is driving potential purchaser underwriting to a 10%-20% discount to pre-COVID valuations, while owners are generally willing to transact at no more than a 0% - 5% reduction from pre-COVID valuations. For certain property types including luxury, drive to leisure destinations, and sunbelt markets, there is almost no discount (and often a premium).

Conventional financing was starting to become more readily available and is still available, at lower leverage levels, much higher interest rates and spreads, and more onerous provisions.

- The conventional financing market is constrained and is expensive

Lenders are observing valuations of the public hotel REITs which have rebounded aggressively, though have subsequently dropped.

Throughout 2020 and early 2021, most lenders had not been taking very aggressive positions and were generally willing to work with owners, provided that the owners funding operating shortfalls; lenders have become increasingly aggressive pursuing remedies and foreclosures.

HOTEL TRANSACTIONS DURING THE LAST DOWNTURN

After major system shocks, it has taken years for transaction activity to recover.

- Single asset transaction activity peaked in 2006 at $23.8 billion, but took 9 years to rebound after the financial crisis to $29.5 billion in 2015.

- Total hotel asset sale transaction deal volume reached $42.7 billion in 2006, prior to the financial crisis. Transaction activity did not fully rebound to 2006 levels for 9 years, when it finished at $50.6 billion in 2015.

- In 2006, average hotel transaction price per key was $125k, it took 8 years, until 2014, for transaction price per key to rebound to pre financial crisis levels of $133k per key.

- Using historical transaction data through the financial crisis as a marker, which took 8-9 years, recovery to pre-COVID transaction activity will most likely be slow and over an extended and prolonged period of time.

HOTEL ASSET PRICING CAP RATES

Valuation for hotels is challenging and requires numerous assumptions.

- Many are still looking at valuation cap rates based on 2019 NOI

- Cap rates on 2020 and 2021 are relatively meaningless, as the NOI may be negative or will be extremely depressed, many are evaluating hotels based on 2019 NOI.

- Hotel REITs are trading at implied cap rates on 2023 of 6.1% to 8.5% with an average of 7.5%

- Hotel REITs are trading at implied cap rates on 2019 of 5.3% - 12.3%, with an average of 8.0%.

INTEREST RATES AND INFLATION

Interest rates have risen significantly based on federal reserve actions.

- From a low rate environment, we have seen a meaningful uptick over the last couple of years in the fed funds rate, Prime, treasury rates, and SOFR rates, and increased concerns about inflation

Currently, 10 year treasury yields are approximately 4.65%.

- Over the next few years, the 10 year treasury rate is forecasted to remain in a fairly tight range between 4.35% and 4.50%

The 30-day SOFR rate is approximately 5.33%.

- SOFR rates are forecasted to peak at these levels, before falling back to 4.75% by Q4 2024, 4.05% by Q4 2025, and 3.79% by Q4 2026.
- These levels are still significantly higher than was anticipated at the end of 2023, when SOFR was expected to decrease to approximately 3.10% by the end of 2024.

Elevated inflation is being driven by demand and supply issues

INTEREST RATES FORECAST

The following presents the historical and forecast for some of the key interest rates impacting lenders, borrowers, and inflation.

Rates are shown peaking at todays levels.

Interest rates have experienced the fastest increases in history, which has caught borrowers off guard.

	Dec 2019	Dec 2020	Dec 2021	Dec 2022	Dec 2023	Apr 2024	Dec 2024	Dec 2025	Dec 2026	Dec 2027	Dec 2028
10-Year Treasury	1.80%	0.93%	1.52%	3.88%	3.88%	4.65%	4.36%	4.37%	4.43%	4.53%	4.63%
1-Month SOFR	1.55%	0.07%	0.05%	4.07%	5.34%	5.33%	4.75%	4.05%	3.79%	3.70%	3.71%
Fed Funds Rate	1.55%	0.09%	0.07%	4.38%	5.33%	5.33%	4.63%	3.88%	3.13%	2.56%	

Source: Chatham Financial projections and other online sources (as of April 2024).

COMMERCIAL PROPERTY ASSESSED CLEAN ENERGY (C-PACE)

Over 35 states have PACE legislation, giving property owners the opportunity to finance up to 100% of qualified capital improvement costs.

A C-PACE assessment attaches directly to the property allowing it to remain in place when selling to a subsequent owner and does not need to be repaid when refinancing debt.

As Long-Term, Non-Recourse Financing, C-PACE assessments can range from 10 to 30 years.

Delinquencies of C-PACE loans are treated as any other delinquencies in property taxes.

Risk to the owner and borrower is limited to the loss of property, so it is non-recourse.

C-PACE is transferable and assessments "run with the property" so they are automatically transferred to the new owner upon sale or transfer of the property unless they are prepaid.

Details vary by state, but generally are designed to encourage the following:

- Renewable Energy: Electronic vehicle charging stations, solar panels, fuel cells
- Energy Efficiency: Insulation, HVAC and mechanical upgrades, energy-efficient lighting systems
- Resiliency: Stormwater management; fire, seismic, and hurricane measures

C-PACE PROS

- C-PACE financing can cover up to 100% of the costs associated with energy efficient improvements, up to a certain LTV.
- C-PACE financing is usually long term.
- Energy efficient improvements can increase property value through utility expense savings driving Net Operating Income higher.
- C-PACE assessments are transferable to a new owner in a sale scenario.
- C-PACE financing is non-recourse.

C-PACE CONS

- C-PACE financing is only available in certain states that have passed legislation.

- With a traditional commercial mortgage, the primary lender must consent to the C-PACE financing which sometimes limits the pool of current and future lenders.

- The process of obtaining C-PACE financing can be lengthy and complex and time-consuming with a range of legal and financial requirements.

- C-PACE financing does not usually allow for increased overall leverage.

SENIOR LENDER ISSUES AND CONCERNS WITH C-PACE LOANS

Senior lenders have challenges when financing properties that have C-PACE involved in the capital stack.

- The main challenge for most lenders is the implied first lien position created due to the C-PACE loan being securitized by a special assessment applied to the property tax bill, effectively taking first priority and a senior position ahead of the senior mortgage loan.

- Though not a UCC lien and is just a voluntary special assessment, in most states liens related to unpaid property taxes has a higher ranking than a creditor's lien.

- In a foreclosure sale, the only payment due to the C-PACE lender is any current outstanding real estate taxes, not an acceleration of the full outstanding C-PACE balance.

SENIOR LENDER ISSUES AND CONCERNS WITH C-PACE LOANS

There are challenges for senior lenders in how the C-PACE loan affects the cash flow of the property.

- With C-PACE payments being made through the real estate tax bill, lenders have to incorporate the additional payment in their underwritten operating expenses which reduces the Net Operating Income.

- Reduction of cash flow available to pay debt service which is a significant issue in today's rising interest rate environment.

Most lenders include the C-PACE debt in their maximum loan-to-value and loan-to-cost figures.

- On a development project if a lender is currently offering up to 75% LTC and a borrower is including 10% of the total costs as a C-PACE loan, the maximum leverage that same lender will provide to the borrower is now 65% LTC.

- The Lender will view their "last dollar" as 75% LTC since the C-PACE debt is in a first position.

GROUND LEASES

Ground or land leases are fairly common agreements.

Ground leases can have a term of up to 99 years.

Certain types of land owners do not wish to have significant operating risk and cash flow variability in their holdings; ground leases may address this.

Depending on the specific structure, ground leases may by financeable

GROUND LEASE PROS:

- In some cases, premium developable land is not available for purchase but may be available for long term lease.

- Reversion clauses return the land and any buildings back to the landlord at the end of the lease term.

- Leasing will require less upfront capital and may be more affordable than purchasing land outright.

GROUND LEASE CONS:

- Tenant is usually responsible for all costs and expenses associated with taxes, insurance, and repairs
- Leases are only for a defined period of time and if they expire the landlord may not extend
- Ground leases limit property value appreciation to the Tenant as at the end of the lease, the property reverts to the Landlord
- Many older leases contain Fair Market Value rent reset provisions whereby the rents may increase astronomically and are difficult to forecast and underwrite
- Many older leases do not have the financing language and protections required by today's commercial mortgage lenders, limiting their financability and achievable loan proceeds

PRIVATE INVESTOR DOLLARS (PREFERRED EQUITY)

There is a structural difference between private equity and preferred equity

- Private equity is looking for highly opportunistic returns
    - Targeting 20% - 25% levered IRRs
    - Willing to accept 16-19% levered IRR's in top markets, or more trophy-like assets
- Preferred Equity is structurally senior to Common Equity or Sponsor Equity and as such commands a lesser return
    - Preferred Equity functions economically similar to mezzanine loan
    - Common Equity gets wiped out *before* preferred equity
- Many historical private equity investors are making preferred equity and mezzanine debt investments
    - The return for preferred equity investments is more attractive to certain investors on a risk adjusted basis
- Preferred Equity is looking for opportunistic returns
    - Targeting 15-20% levered IRRs depending on the deal profile and capital structure
    - Expecting mandatory redemption
        - Usually after 3-5 years

Glossary

RELEVANT GLOSSARY

A-Note - A promissory note secured by a mortgage on commercial real estate property that is senior in right of payment to one or more separate promissory notes secured by a direct or beneficial interest in the same property.

B-Note - A promissory note secured by a mortgage on commercial real estate property that is subordinate in right of payment to one or more separate promissory notes secured by a direct or beneficial interest in the same property.

B-Piece Buyer - In CMBS transactions, a bond buyer who takes the riskiest highest-yielding tranche of bonds within an existing pool. It is named for the bond credit rating at the bottom of the spectrum.

Bad Boy Carve-Out - A risk or source of liability for which a borrower's principals may assume personal liability under a Carve-out guaranty for the commission of "Bad Acts".

Cap - A hedge to protect the borrower from the risk that a floating interest rate will rise above a certain level, much like an insurance policy against higher interest rates. Requires a one time payment but imposes no other obligations to the beneficiary.

Carve-Out Guaranty - A guaranty of certain risks for which a lender refuses to look solely to the collateral. Also sometimes a contingent full guaranty of the loan, to discourage the borrower from doing certain bad things (like a voluntary bankruptcy). These matters are all "carved-out" from the otherwise nonrecourse nature of the loan, giving the lender access to the other assets of the guarantor.

Commercial Mortgage Backed Securities (CMBS) - fixed rate bonds collateralized by diversified pools of first mortgages on commercial properties located throughout the United States. A simple bond structure is used to create individual bond classes, called tranches, which each carry a distinct rating and risk/return profile.

Conduit loan – A type of commercial real estate loan that is secured by a first position mortgage on a commercial property, which is then bundled with other loans and sold on the secondary market.

GLOSSARY

C-PACE – C-PACE stands for commercial Assessed Clean Energy, and is a state policy-enabled statute which allows developers and building owners access to capital so they can make energy related improvements in existing buildings and in new buildings, and is designated to make renewable energy cost effective and accessible.

Debt Service - Payment of interest and principal on a loan. May be paid monthly, quarterly or annually.

Debt Yield - The annual return a lender gets on its loan to a borrower, calculated as NOI divided by the outstanding debt balance; essentially measures the cap rate to the lender.

Debt Covenant - Is a requirement that certain financial credit metrics are acheived.

Debtor in Possession (DIP) Financing – DIP financing is used by companies that have filed for bankruptcy protection under Chapter 11 and usually has priority over existing debt, equity, and other claims.

Defeasance - A process to substitute collateral when looking to sell or refinance an existing property

DSCR (**Debt Service Coverage Ratio)** - NOI divided by annual debt service payments, where the debt service includes interest and principal amortization.

Extension Test - In order to qualify for an extension beyond the initial maturity date for a loan, several requirements or covenants must be met such as DSCR ratios, debt yield, etc.

Equity Kicker - A lender's right to receive a percentage of appreciation or ownership of the collateral.

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GLOSSARY

Hedge - Any transaction to shift to a third party a risk of market fluctuations. Typically refers to mitigating the borrower's exposure to interest rate fluctuations by purchasing a Cap or entering into a Swap. Borrowers cannot yet enter into Hedge transactions to cover fluctuations in real estate values, but these may be around the corner, assuming continued development of the derivatives market

Interest only (I/O) - A loan that has no required principal amortization during the loan term. A loan may be interest only for a defined number of years, and then has a principal amortization schedule.

Intercreditor Agreement - An agreement among lenders that sets forth the various lien positions and the rights and liabilities of each creditor and its impact on the other creditors

Mezzanine debt - A subordinated debt instrument secured by a pledge of equity in the borrower.

Mezzanine Financing - A hybrid of debt and equity financing typically used to finance the expansion of existing companies. Mezzanine financing is debt capital that gives the lender the rights to convert to an ownership or equity interest in the company if the loan isn't paid back in time and in full. It's generally subordinated to debt provided by senior lenders such as banks and venture capital companies.

Monetary Default - The failure to pay interest, principal, or other financial obligations promptly when due.

Non-Recourse – A provision in a loan that prohibits the lender from seeking debt repayments from the owner of the property, and the lender can seek recovery only from the property itself.

GLOSSARY

Portfolio Lender - A lender that originates mortgage loans and holds them on its balance sheet.

Property Improvement Plan (PIP) - A requirement by hotel brands that owners undertake renovations and upgrades to meet current brand standards. PIPs are generally required when a hotel joins a brand system or when a branded hotel is sold.

Real-Estate Owned (REO) - Property owned by a lender, usually a bank, after an unsuccessful sale at a foreclosure auction.

Recourse - A provision in a loan that allows the lender to pursue the personal assets of the borrower if a loan is in default.

Securitization - The process of combining mortgage loans and then marketing different tiers of the repackaged instruments to investors. Mortgage-backed securities combine mortgages into one large pool, the issuer can divide the large pool into smaller pieces based on each individual mortgage's inherent risk of default and then sell those smaller pieces to investors. The process creates liquidity by enabling smaller investors to purchase shares in a larger asset pool.

Servicer - A company that administers existing loans.

Single Purpose Entity - A newly formed entity whose sole purpose in life is to own and operate particular collateral. The rating agencies established elaborate rules for these entities (e.g., cannot share letterhead or telephone number with another entity).

Special Servicer - Third party company that handles payments and communications for loans that have gone inti default

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GLOSSARY

Subordinate - Refers to the fact that one entity's position is inferior to another; for example, the mezzanine lender is subordinate to the primary lender, meaning that the primary lender is paid first and the mezz lender is paid next; thus, the mezz lender is in a riskier position if there is not enough NOI to pay them.

Subordination and Non Disturbance Agreement (SNDA) - An agreement that subordinates a management agreement to a loan and may provide that in the event of a foreclosure, that the management agreement may remain in place.

Sweat Equity - The equity value in a property that is earned by a developer who increases its worth through the developer's intangible efforts, such as by obtaining zoning or planning consent, negotiating option rights, producing schematic drawings for a potential form of development, or negotiating terms for a pre-leasing. The developer may convert its Sweat Equity into a share in the future value of the completed development.

Warm Body - A creditworthy individual, as opposed to a borrower-related entity that might sign a guaranty but has no real assets.

Waterfall - The priorities for application of cash, such as in a Lockbox.