



More distress on the horizon

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Editor's note: This story is part of a new series from HotelNewsNow.com, in which we address topics related to the tumultuous conditions of the hotel industry. Also see the resource, ["Hotel real estate terms you need to know."](#)

REPORT FROM THE U.S.—It's like a boulder rolling down a hill gaining speed, and the people at the bottom can see it coming.

In the case of the hotel industry, it's the number of loan defaults and hotel foreclosures that is quickly increasing. Many of the defaulted loans were originated between 2005 and 2007, when loan underwriting standards went out the window. More are on the way.

Trepp LLC, a provider of commercial mortgage-backed securities (CMBS) and commercial mortgage information, tracks hotel loans, including those in CMBS pools. There are about 3,800 hotel CMBS loans, according to Trepp. Of this amount, about 2,300 were done in 2006 and 2007. Almost none were done in 2008.

"That's where so much of the focus is at," said Mark Woodworth, executive VP of PKF Consulting. "That was the peak of the cycle when the cost of debt was at the lowest point and contributed to high values."

In January 2008, 0.48 percent of all hotel loans in the CMBS pools were delinquent, according to Trepp. In January of this year, the percentage increased to 1.72 percent. This month, it increased to 4.24 percent.

In January 2008, 0.2 percent of the hotel loans in the CMBS pool foreclosed. In January this year, that percentage increased to 0.65, and in July, it increased to 1.22 percent.

Out West

What's going on in California mirrors what's going on in the rest of the country, said Alan Reay, president of Atlas Hospitality. In the Golden State, the number of hotels in default or foreclosure increased 125 percent in 60 days (mid-May through mid-June)—31 hotels were foreclosed on, and 175 are in default. San Bernardino County leads the state with 19.6 percent of them. Riverside County follows with 16.1 percent.

Nonfranchised hotels account for a disproportionate number of foreclosures—87 percent. However, franchised hotels make up 59 percent of default properties. As the economy worsened, it affected all properties, not just smaller hotels in tertiary markets. (Read "[California to see record number of hotel foreclosures.](#)")



Mark Woodworth

Reay said the extent to which the number jumped in 60 days is surprising, but the overall number isn't surprising because 2,500 hotels in California were financed from 2005 to 2007, the height of the market. Many more properties are in trouble. Currently, only 8 percent of those 2,500 loans are in default or foreclosure.

Defaults and foreclosures continue to spread across all segments of the market throughout the country, Reay said.

"It started with independent, nonflagged hotels in tertiary markets, but the past 60 days, it's been branded properties in primary locations," he said. "Every hotel, unless there's no debt, is struggling right now. Full-service hotels or business hotels are getting hit the hardest. The economy segment isn't getting hit as hard, but it's still getting hit. New York, resort locations, Arizona, Florida, Nevada, the Caribbean and Texas are all taking a hit. The heart of the Midwest, where we didn't see a big increase in rates, might not get hit as hard."

Government regulators are giving lenders more time and leeway, Reay said.

"It's a slower process than what we saw in the 1990s," he said. "It's denial and delay. Lenders are doing whatever they can to make sure they don't take properties back. But that only pushes the problem back. At this stage, we're seeing a number of owners walking away and closing hotels."

Walking away

The 258-room W San Diego is a prime example. Sunstone Hotel Investors, a REIT, gave the keys of the hotel back to the lender, Centerline Servicing. The financing for the hotel was part of a CMBS pool. Sunstone paid US\$96 million three years ago, and the debt was US\$60 million. Sunstone stopped paying the loan two months ago.

(Read "[Sunstone to forfeit W San Diego.](#)")

"Sunstone couldn't pay debt service, and the hotel wasn't worth what they owed," Woodworth said. "They couldn't engage the lender in any discussion to restructure the loan to make the situation better for all involved only because CMBS laws say you can't restructure the loan until it's become delinquent. This will contribute to problems in the industry."

Other examples in California: The St. Regis Monarch Beach goes to auction this month; and the owner of the Renaissance Stanford Court in San Francisco, JER Partners, walked away from the property, Reay said.

"If the value of what I own is less than what I owe, what's the motivation to pay the lender?" Woodworth said. "We'll certainly see hotel closings. We'll see some chain-link fences put up around hotels. When you close a hotel, it's an incredibly painful exercise. It's not an easy decision to make, but some lenders will do that because it's cheaper than staffing a hotel."

Opportunities

Because of the expected large number of defaults and foreclosures, there will be the best buying opportunities since the 1990s, Reay said. The opportunities aren't good right now, because lenders are delaying the sale of properties. They want to recover their debt, because they can't take such large losses.

“This mirrors the housing market—lenders haven’t learned,” Reay said. “The problem is a glut of these deals (in resorts especially) are negative before any debt service. You’re not going to get financing for it, so you’ll have to pay cash. But how long are the lenders willing to lose money? Big funds will wait to get into the market until they stop seeing RevPAR declines.”

But this type of market isn’t bad for everybody. Just ask Steve Van, president and CEO Prism Hotels & Resorts, a third-party management/owning company with 40 hotels in its portfolio. The company, which has a strong presence in the CMBS market, specializes in turning around distressed hotels quickly. During the last downcycle, the company received 115 management contracts. So far during this downcycle, the company has added 20 properties from its lender clients.



Alan Reay

“We’ve doubled (from 20 to 40) since October and expect to double again (to 80) by year’s end. This is a huge growth opportunity for us,” Van said, adding that some of the distressed properties Prism took over turned out to be long-term assets.

This time around (the last downturn was 2000), there’s a higher percentage of higher-end properties because the upper-end hotels are so overfinanced and revenues are down 30 percent.

“When they’re down that low, you can’t make debt service,” Van said.

Van said 5.4 percent of all U.S. hotels are in default. That number will increase to 8 percent to 10 percent by the end of the year and reach 15 percent to 20 percent by next year.

“And our business will grow proportionately,” he said. “We’re looking to pick up properties in L.A., Chicago and New York. Lenders are saying they’re taking hotels back. There are more than 25 receiverships pending on top of the 40 we already have.”

(To read more about hotel defaults from Steve Van, visit www.hoteldefaultblog.com.)

Prism is appropriately staffed and ready for growth, Van said. The company has hired 20 people since October.

“It’s a great time to be hiring talent,” he said, adding that Hilton recently laid off some regional folks.

Van said Prism learned two lessons from the last downturn. The first is the company needs to act quickly because things only get worse. This time, the company is involved with more receiverships instead of waiting until foreclosure occurs.

“We get in as soon as possible and take control of the cash,” he said. “A lot of damage can be done in 120 days.”

The second lesson: The best thing you can do for a property is to increase its sales as quickly as possible.



Jeff Westgor

“You need to steal market share,” Van said. “Most borrowers have done a good job of cutting costs because that’s easier than increasing sales.”

Despite the defaults and foreclosures, lenders won’t take their losses yet.

“There’s consternation and grief among lenders,” Van said. “It’ll take one year or longer for the lenders to work through that. The prices haven’t adjusted to the market yet. It’s going to be a while before lenders are going to sell.”

Lower end of the market

However, the lower-end hotels are selling because one can usually get US\$5 million or less from a local bank as long as the borrower is willing to sign, Van said.

Jeff Westgor, president of Hotel Brokers International, said deals involving HBI members are less likely to be affected by defaults and foreclosures, because they are involved with loans worth US\$10 million or less. Nonetheless, HBI’s transaction volume has declined 60 percent in the trailing 12-month period because there’s a wide bid/ask gap. Still, there’s 20-percent increase of visits to the HBI Web site in the first half of this year.

“That tells me people are on the sidelines, looking,” Westgor says. “About 20 percent of the 2009 sales in the first half were lender owned or distressed assets and that number will continue to grow as the economic problems continue in the second half of 2009. There will clearly be more REOs and distressed sales coming to market in 2010 and 2011.