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Hotel Financing Series, Part 1: How a Hotel Loan Differs from Other Real Estate Loans

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As business and trade are slowly re-opening up across the UK, in this issue of *REF News and Views* we are revisiting articles commenting on real estate finance legal matters. Clearly, the pandemic isn't over, and we continue to closely observe changes in the regulatory environment and movements in the market and will share any important updates as and when they arise.

One of the key industries that was growing rapidly prior to the pandemic is the hotel industry. Although heavily affected by the pandemic, we are seeing green shoots from the re-openings, and also several opportunity acquisitions currently in progress. We use this opportunity to introduce a specific hotel financing series, given this area will no doubt return to its former glory post-pandemic.

In this six-part hotel financing series, we will take a close look at some of the common issues and terms in hotel financing facilities. The commentary has a European focus, especially with respect to security and cash control mechanics.

In this Part 1 of the series, we discuss the key differences between a hotel financial facility compared to a general real estate facility. Obviously, real estate financing has many specialties in itself, and the approach taken differs from transaction to transaction. As a general comment, hotel financing is one such area which requires a very different approach. The key distinction here is also attributed to the fact that a hotel property is a single-purpose real estate, and so understanding how (well) the hotel business runs is key to the analysis of the business and, therefore, the appropriate terms of the facility.

In addition, it is important to bear in mind that, as with many businesses, the cashflow is not fixed and often cyclical, unlike real estate facilities where the rent is somewhat fixed, subject to any issues which may arise with tenancy. This has two implications. Firstly, covenants should therefore be specifically tailored to the hotel business and measured against the success of the business, as opposed to conventional real estate covenants. In particular, the financial covenants and cash controls are quite specific, and we will be covering these in more detail in later parts in the series. It is important for lenders to analyse the underlying business by looking at the profit and loss statement and management accounts, as well as other reports – such as projected revenues and expenses, capital expenditure (both incurred and projected), labour issues, regulatory issues, etc. – when analysing the hotel business. In addition, it is common for lenders to keep closely monitoring the reporting given the cyclical nature of the business.

A second implication of the cyclical cashflow is that it is not uncommon for borrowers to ask for some flexibility with respect to the use of cash. A traditional real estate facility may require the borrower to deposit all net rental income into a controlled account with the lender, but with hotel facilities this may not be possible. This is because the timing of the cash outlays may not necessarily coincide with the deposit of the gross profit for each specified period, and so the borrower may need to retain some of the cash in order to meet expenses anticipated for the next period, or pay some of the expenses upfront prior to the cash coming in. As a countermeasure for this, often lenders may look at setting up a buffer against the periodic debt service, such as cash reserves. Additionally, the franchisor may require control over operating accounts and capex sums to be retained as part of the franchise arrangement. These may be for the purposes of providing a guarantee or towards minimum capital expenditure towards renovations/improvements. This is discussed in more detail later in this series.

Many hotels operate under a particular brand, and the brand name/reputation plays a substantial role in the value of the hotel. Due diligence on the franchise arrangement and the hotel management arrangement (if the owner hires a professional manager to run the hotel) are of prime importance. With franchise agreements, often the franchisor has a specific list of requirements (also called the “brand standards”) which needs to be adhered to in order for the hotel to stay part of the brand. The franchisor also conducts periodic reviews to ensure the quality of the brand is maintained, and also provide requests on the owner to make certain improvements. It is important for these items to be addressed, as failure to do so may attract certain penalties (for example, the franchisor may step in to take over, or even terminate the franchise agreement if they are of the view that the franchisee fails to maintain brand standards). For the lenders, this means taking care in conducting due diligence with respect to the running of the hotel, the suitability/track record of the hotel management, and also reviewing the relevant franchise agreement and/or hotel management agreement. Finally, the franchisor sets standards with respect to maintenance and ongoing updating/refurbishing of the facilities, and so it is also important to also look at the underlying sponsors and confirm they have the financial resources and projected cashflow to meet any required capital expenditure.

With respect to exit strategy, unlike other real estate which usually boils down to looking to sell the property and/or secure tenants (where a key tenant is involved), the exit strategy for lenders in a hotel financing facility is more complex. One can’t simply sell the hotel quickly where the loan is distressed, as chances are the hotel business wasn’t performing in the first place, which resulted in issues with complying with the terms of the facility. Therefore, the lender must be prepared to run the hotel business, or appoint a nominee who has the requisite experience and capability to do so until the lender can find a purchaser. In addition, the pool of potential purchasers are also narrower given hotel operation requires expertise in the area, and often the franchisor may want to approve the potential purchaser. This is where the agreement with the franchisor (and, if applicable, the hotel operator) becomes key. In hotel financing transactions, the lender usually enters into tripartite agreements with the franchisor (a non-disturbance agreement) and if applicable, a duty of care agreement with the hotel manager. These documents set out the circumstances in which the lender may step in to take over the obligations of the hotel owner/operator if they are in breach of the relevant agreement, and also provides other protections to the lender (and also the franchisor) by requiring the franchisor to first notify the lender if there is any breach by the hotel owner (borrower) which would give rise to termination rights, and so the lender may take steps to cure the default and avoid the franchise agreement being terminated. This is discussed in more detail later in this series.