# More Storm than Tsunami

Karen L. Johnson
Warnick + Company

Much has been made of the skyrocketing hotel default rate and the trend shows no sign of slowing. Occupancy is down, rates are tumbling, bottom line is evaporating, loan payments are being missed, and loans are coming due. Real Capital Analytics reports that, as of July 31, there were 1,100 hotels with $28.0 billion in debt in distress. Many individual investors, expecting a feeding frenzy, are sitting back waiting for a tsunami of hotel assets to hit the market.

One thousand plus hotels is a scary number; however, the Extended Stay bankruptcy accounts for 62 percent of them. The distressed inventory will continue to increase, but for a variety of reasons, relatively few of the distressed hotels will be dumped on the market. And, the biggest wave is still a year off.

## No Mark to Market Rule

Unlike the Resolution Trust Corporation ("RTC") days, there is no requirement for federally insured lenders to "mark to market." Banks are not under extreme pressure to recognize the problem loans on their books or increase reserves. Though the number of troubled lenders has grown to 416, many of the largest commercial lenders are fine. In the second quarter, the seven largest commercial banks earned more than $14 billion. On August 2nd, The Wall Street Journal reported three major lenders *decreased* their second quarter contributions to loan loss reserves by 40 percent from the first quarter. "Banks have taken their medicine early, analysts say; now they can pace themselves." Many states have also relaxed rules regarding insurance company loan loss provisions, reducing pressure on insurance companies to clean up their non-performing loans.

At some point external pressure to foreclose and liquidate may increase, but for now many traditional commercial lenders are only a little bit pregnant. They will continue to "extend and pretend" on most loans.

For those assets that are taken back, lenders report that the offers coming in for foreclosed assets are 30 to 50 percent below internal bank valuations. Lenders we spoke with are not inclined to sell them at fire-sale prices, but rather to hold them. They too remember the vast sums of money that were made during the RTC days and are prepared to hold properties until the market comes back.

Traditional mortgages account for half the hotel debt outstanding, we anticipate that only a portion of these assets will come to market in an accelerating but orderly stream.

## There is No RTC

In the 1990s savings and loan debacle the government interceded and tool control of banks and liquidated assets; however, this time no RTC has been formed to liquidate the assets of failed institutions. After some initial portfolio sales the RTC switched to a highly transparent process in which individual assets were marketed though sealed-bid auctions to maximize competitive bidding and minimize cronyism.

This time around, the FDIC has been arranging marriages between banks and, as a last resort, seizing the institutions; however, the FDIC is running out of capital and their capacity to take over banks is in question. It also appears that there are fewer "healthy" banks for these shotgun weddings. In a new wrinkle, on August 26th the Fed established rules by which private equity firms could acquire and own banks.

The Wall Street Journal estimates that over $40 Billion has been amassed by the private equity firms to buy failed lending institutions. The conditions are more stringent on private equity firms and they claim to be at a disadvantage, but this could be a game changer. Starwood Capital, Lubert-Adler, and Colony Capital (all experienced hotel owners) are reported to be in the running to buy Corus Bankshares. Under the new rules, the private equity firms can't loan money to themselves or their friends, but they can write down and liquidate or retain collateral as they see fit. Unless the loss share agreements with the FDIC stipulate that the federal guarantees pay out only in the event of a liquidation sale to a bona fide third party, the market could be used to price assets for sale to a related company.

***Chicago:***
1200 Shermer Road
Suite 214
Northbrook, IL 60062
(847) 562-2610

***Los Angeles:***
1800 Century Park East
Suite 600
Los Angeles, CA 90067
(310) 229-5798

***Los Angeles:***
4801 Wilshire Boulevard
Suite 220
Los Angeles, CA 90010
(323) 965-7207

***New York:***
70 East 55th Street
8th Floor
New York, NY 10022
(212) 588-8890

***Phoenix:***
2398 East Camelback Road
Suite 1150
Phoenix, AZ 85016
(602) 955-9393

**www.warnickco.com**

The entry of private equity firms to the market will probably slow the liquidation process and filter out many of the best quality or most undervalued assets.

## Note Sales

The still solvent banks are selling notes now, as is the FDIC. Some individual notes on single assets are being marketed, but the most common pattern seems to be to package a cross section of product types, wholesale, in a veritable grab bag of notes.

Real Capital Analytics obtained data on the sales of nine *performing* assets/portfolio notes in the second quarter of 2009. After eliminating the two outliers, the average *recovery* on the mixed bag of senior, B pieces, and mezzanine debt was 68 percent.

The obverse might be true for the non-performing notes. Real Capital Analytics reported that, for the four non-performing notes sales for which they were able to obtain data, the notes were sold at an average of 30 percent of face value.

Some speculative wholesale note buyers sort through the notes and offer them to the borrowers first, who can protect their equity by buying their own debt. If the borrower fails to make that transaction, the wholesalers then line up office investors for office notes, retail investors for retail notes, and so on. The notes are then liquidated, still at a discount, but one that affords a high-yield spread. More hands-on wholesalers or property-specific note buyers either foreclose or hold notes to maturity. The non-foreclosure options further reduce the number of hotel properties that will hit the market.

If these very limited non-performing note sale data points expand to a broader trend, the 70 percent discount to face value will increase the urgency to reform commercial mortgage-backed securities ("CMBS") rules. The Treasury Department began considering relaxing tax rules that would facilitate modifications back in June. If the Treasury responds favorably to industry pressure, special servicers may be able to begin negotiating with borrowers *before* the borrower stops performing.

## The CMBS Mess

Nothing like the current meltdown was envisioned when CMBS rules were established. CMBS loans were sliced into tranches and separated at birth in an attempt to limit the participants' downside risk. Then, to maximize the passive owner tax advantages, complex rules and procedures were established. Though most CMBS loans attempted to streamline the foreclosure process by preventing bankruptcy filings through personal guarantees, the rules regarding modifications and the transition from master-to-special servicer transition serves as a brake. Incentivizing special servicers by having them take a first loss position turns out to have the potential to create a conflict. Not surprisingly, the average CMBS foreclosure takes 13 months from initial default to foreclosure.

Why so long? If master and special servicers are not related, the master servicers tend to hang onto assets while they are burning through interest reserves in order to collect the servicing fees and float. They are entitled to them; it's how they get compensated. Though assets may move through the servicing system faster when the master and special servicers are related, the tranches and complexity of hotel business operations results in procrastination. And, when servicers own a piece of the mezzanine debt they may live in denial until operating losses accrue to the bondholders.

The tranche warfare among participants in the $7.4 billion loan pool for Extended Stay America illustrates the potential for infighting. The first mortgage holders have agreed to pay the borrower's $100 million guarantee activated by a bankruptcy filing; this would enable the borrower to enter bankruptcy and get the junior debt discharged. The junior bondholders have sued, alleging that the senior lenders "hatched a Machiavellian scheme" to wipe out much of the $3.3 million in mezzanine debt. If the borrower's end run succeeds, the borrower could end up with title to all the assets and the junior lenders may recapture only the $100 million from the "bad boy" clause designed to preempt a bankruptcy filing.

So, unless the borrower willingly hands back the keys, the hotels with CMBS loans in trouble now:

a) Might eventually get their principal balances negotiated down through a change in the tax laws;
b) Might go through bankruptcy and emerge with the borrower still in the saddle; or
c) Probably won't be liquidated sometime in mid-2010.

Gaining clear title to an asset encumbered by a CMBS loan will probably be like separating a cup of minestrone into its component parts. It can be done, but it will take time and effort. By the time it happens (say minimally the middle of 2010), there should be enough sidelined capital that has been whipped into a frenzy to result in competitive bidding for the CMBS foreclosures.

## Big Players Will Dominate

In June and July eight large investment firms announced initial public offerings ("IPOs") to raise $3.9 billion for investing in CMBS securities, whole mortgages, and, in some cases, to issue new first mortgage debt. Many of these are active and experienced in the hotel space:

After raising $400 million in May, Host Hotels & Resorts has announced its intent to raise $400 million to buy distressed assets. Starwood Capital's August IPO had a $500 million target and raised $810 million. Starwood's plan is to invest in CMBS in the federal government's Public-Private Investment Program.

Bayview, which is controlled by Blackstone and has filed its intent to launch a $500 real estate investment trust ("REIT") with the Securities and Exchange Commission, has an even broader mandate. Bayview will target "performing, sub- and non-performing residential and commercial mortgage loans as well as mortgage-backed securities, derivatives and foreclosed properties."

Colony Capital too has filed a $500 million REIT, over and above the nearly $1.0 billion it raised in 2008 for distressed assets.

The only good news in this for individual investors is that some of these newly formed REITS will be providing new debt.

Colony's registration indicates that it may also originate whole mortgage loans for commercial property. Colony asserts that there has been an "over correction" in commercial real estate debt and that there would be a "protracted opportunity" to originate attractive loans.

Apollo Commercial Real Estate Inc. has also filed an application to raise up to $600 million to acquire CMBS debt and to originate senior commercial real estate mortgages. No date has been set for this offering, or Colony's.

Conceivably, these giants could be offering seller-financing on the assets that they acquire through bank and note consolidation and/or purchases. In such a scenario, the assets would not likely hit the market until late 2010 or 2011. But the laws of supply and demand suggest that when all the frustrated capital (that is fearful of getting left out) hits the market, prices will be bid up.

## America on Sale

As frightening as it is to us to have 400-plus banks in trouble, the United States is still thought of as a relatively "safe" place to invest money, especially if the assets can be acquired at prices well below replacement cost. Our contacts report heated interest by Asian and Middle Eastern investors on the coming deals.

The biggest of them, China's sovereign wealth fund, China Investment Company ("CIC") recently appointed Morgan Stanley and the Blackstone Group to manage what may grow into billions of capital, to be invested in hedge funds. Mindful of a W-shaped recovery here in the United States, CIC is moving first on a deal to help buy back the debt on London's Canary Wharf project.

Our direct experience confirms this trend. Warnick + Company has been contacted by numerous Asian and Middle Eastern buyers with significant appetite for lodging assets. One of our Asian clients recently acquired a hotel and golf course in Waikiki at a significant discount – and they are aggressively seeking additional opportunities.

As visibility in the U.S. improves, we can expect renewed interest from offshore investors.

## Long and Winding Road

Three conditions are necessary to break the current logjam: 1) prices will have to bottom out; 2) financing must become available; and 3) clear title must be available.

Host recently pruned four hotels, which had major property improvement plans looming for only $61,400 per room; this suggests that the bottom is in sight. These early movers made all-cash investments, waiting for the financial markets to improve.

The second requirement – capital markets must improve – has occurred for the REITs and private equity firms. As pointed out in the August 29th edition of The Wall Street Journal, "At one extreme of Corporate America is a cadre of companies and banks, mostly big, united by an enviable access to credit. At the other end are firms, chiefly small, with slumping sales that can't borrow or are facing stiff terms to do so."

The final ingredient, clear title, will be a long time coming unless the US government reverses its position on marking to market. Establishing title will occur in a blizzard of note transfers. This is where most of the wealth will be transferred in this cycle and it will accrue to the savviest in deal making.

Small investors have two choices: they can make more reasonable offers now on the banks' REO properties in exchange for seller financing (with only marginally acceptable terms), or wait until the industry giants have acquired enough banks and enough paper to foreclose on and liquidate assets, which these same giants may also finance. A reassessment of what constitutes a reasonable return may be in order for the small investor.

The previous cycles have shown that the early mover makes the most money. This round will go to the titans.

####

## About Warnick + Company

Warnick + Company is a strategic advisory firm that creates opportunities and value-enhancing solutions in lodging and recreational real estate for our clients worldwide. We are in the knowledge business, and the hospitality industry is our passion.

Our multi-disciplinary expertise, real-world perspective, and hands-on experience generate insights that deliver high-impact results. We provide trusted, partner-level attention and a tailored, comprehensive approach to meet your individual objectives.

We have unwavering dedication to your best interests. You can rely on us to uncover the underlying issues, provide candid answers, and craft strategic solutions that achieve maximum benefit and competitive advantage.