Hotel Investment Today

How to get a 'yes' on CMBS, other sophisticated loans

Learn the subtle tactics to anticipate and navigate the bumps along the way in a complex loan process.

Special from the International Society of Hospitality Consultants (ISHC). Four Corners Advisors recently worked with a client on its portfolio refinancing strategy. About half its 11-property portfolio had loans coming due over a six-month period. With our capital markets intermediary, we went to market for two separate loans: one, for a multi-unit, multi-state portfolio, and the second, for a standalone property whose incumbent (bank) lender increased the principal and extended the loan. Timing was second half of 2022 at a time when the Federal Reserve was raising its rate by 75 bps quarterly.

For the multi-unit portfolio, we decided cautiously, mostly for reasons of (non-)recourse liability, to take the CMBS route. For these loans, the lender typically packages a series of loans and slices the return levels to create tranches of investment securities – the higher the risk level, the lower the priority of the tranche and the higher the expected return. Creditworthiness of both the securitization and the debtors is assessed by one of three principal ratings agencies via a system that assesses the debtor's financial stability and risks of default. Rating agencies are critical to the process, as the ratings impact interest and spreads.

Michael Shindler

The CMBS process is not uniquely different from a sophisticated "club" loan or one with several participants (except for the securitization described above). I was unaware of all the bumps, switchbacks and mandatory CMBS requirements we encountered along the way. Lessons learned provide a brief overview of some matters an unknowing borrower might wish to consider before pursuing this path.

Due diligence

Lenders underwrite loans with an enormous level of detail. Locate three years of every invoice, service contract, vendor agreement, capital expenditure, personnel chart (with compensation), benefit plan, and historic financial statements to support payment of the CMBS loan... everything. Someone will request it.

The lender's underwriting team will ride herd on environmental assessments, property condition reports, zoning reports, leases, business permits and licenses and maintenance schedules, while its counsel actively participates in the title and survey requirements and title documentation.

Know who is responsible for each of these reports and use an attorney experienced with CMBS loans as borrower's counsel. The process will be expensive enough, but a borrower should not pay to educate its own counsel at the same time.

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Michael Shindler
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Documents

The loan agreement and related documentation will be long, complex, occasionally redundant and, mostly, non-negotiable. There are several security documents in addition to the customary mortgage/deed of trust. New bank accounts are required; the selected depositary bank will have a detailed understanding of the CMBS environment. Work through the documents. Ask the standard questions, but expect, "We cannot change [it] due to ratings agency requirements."

Closely review the "carve out" (often called, the "bad boy") guaranty. This is the one document that a borrower should negotiate thoroughly, as it sets forth those acts that both give rise to personal liability for the guarantor and could make the loan fully recourse.

Requirements, restrictions

Be prepared to create a new ownership entity that meets the lender's (and the CMBS investor's/investors') requirements for a single purpose entity (SPE). The SPE will need to have an independent director whose vote on matters that could adversely affect the collateral is required.

Every title exception is examined and, where possible, required to be "insured over." Additionally, the survey requirements are detailed. The American Land Title Association

(ALTA) has promulgated minimum standard detail requirements for surveys, and the surveyor and the title company speak the language of ALTA, as does the lender's counsel. These items are taken seriously.

Borrower's circumstances may cause the lender to impose a myriad of requirements and restrictions to "fit" the loan into the targeted securities package, including specialized insurance policies. Areas replete with lender restrictions include the following:

* Limitations on compensation or payments to related parties, including intra-company debt and member distributions

* Minimum debt service coverage or debt yield requirements, LTV covenants and material adverse change 'trigger' event

* Restrictions on timing and ability to prepay the loan (other than defeasance)

* Cash sweeps, cash management accounts and deposit account control agreement

* Ongoing obligations and negative covenants that may not be wholly customary

Time

Although a CMBS loan can take longer than a customary bank mortgage loan, a lender is customizing its requirements and targeting the securitization of the loan for a particular package. Be prepared to respond thoroughly and quickly at each weekly update; closing of the loan could be dependent upon its timely inclusion in the targeted securitization.

Other observations

Reserves. If the lender identifies concerns – seasonality, capex deficiencies, ground lease rent payments and other matters – it will require reserves. Reserves are set aside in one of the newly created accounts for a specified purpose with detailed procedures to achieve release. Know the purpose and the procedures, otherwise reimbursement might be delayed. The reserves also reduce the net proceeds of the loan to the borrower. Be prepared to receive less net proceeds than anticipated.

Expense. Attorneys' opinions abound. If a state is involved in the transaction in any way, an attorney from that state must issue an opinion. Title insurance is governed by state law. What a title insurer in one state can insure, another may not be able to do, or the cost of doing so may be considerably higher. Every environmental report, property condition and zoning report, title insurance policy and survey, and the all-necessary appraisals are borrower expenses. Plan for a substantially higher expense obligation than for a conventional single-property commercial loan.

Reporting. Reporting requirements are numerous and, also, mandatory. Comply with them in painstaking detail. Create a reporting template and calendar notifications satisfying the loan agreement and use them.

Changes. A borrower likely will execute a non-binding term sheet to start the process. Expect changes in volatile financing markets, as the lender will modify terms to adapt loan terms to market fluctuations, including the all-important rate spread.

These cautions are not laid out here to attempt to change minds about going through a refinancing. In the current environment, as lenders need solid footing to take on hotel loans, the CMBS and other sophisticated lending groups may well be the only sensible option for a borrower. The borrowers who have not done one of these loans will be well-served to dig into their wells of patience and perseverance when choosing this path.

Michael Shindler, ISHC, is president of Four Corners Advisors, Inc., Chicago, a hospitality transactions consultancy and advisory firm he established in June 2007 and relaunched in May 2014. Shindler's career in the hospitality transactions industry spans more than three decades and includes experience in development, hospitality brokerage and consulting work in the boutique, luxury, resort, gaming and lifestyle sectors.