

# Drop your debt now or face the consequences

*Getting your debt house in order may be the most important action for long-term property values*

The hotel industry in the United States is in for long term debt restructuring that will challenge the very viability of the industry. Since the crash of 2008, hotel owners have cut costs, streamlined staffing and dropped RevPAR (revenue per available room) to levels that in many cases do not cover even half of their debt service. Worse, hotels that restructure their debt or enter into bankruptcy or receivership are emerging from that process with dramatically reduced debt and, consequently, the ability to set much lower room rates than competitors in the neighborhood. This, in turn, pushes the marginal hotels to restructure. They put pressure on the healthy hotels that have to drop their room rates to levels that now threaten their ability to make debt service payments. The debt restructuring will continue for years until the entire industry has lowered its debt to a level that can be serviced and profitability restored.

## *Why does this happen?*

Simply because the hotel industry, unlike almost every other industry, has little ability to "sell off" excess inventory and return to stability by reducing supply. A hotel room brought on line is inventory for 50 years. It does not go away in an excess environment, and it is very difficult to repurpose hotels to other commercial activities. The airline industry can reduce airline seats quickly by mothballing

By Brad Mead, president of Delta Capital Group, LLC



airliners in the Arizona desert. Car dealers can reduce inventories by having an inventory reduction sale and return to proper levels within two months. The hotel industry has no such ability, and ultimately, everyone starts cutting rates to fill the inventory as industry RevPAR drops. The only adjustable parameter once operating costs are trimmed is debt.

## *So what does a hotel owner do?*

First, if you have streamlined all your other costs and are still losing money, then you need to restructure your debt. Your lender has little interest in discussing this with you unless you default on your payments. Once you are 90 days in arrears, most lenders are required to put your loan on "non-accrual," which means they have to start writing your loan "down". The FDIC requires banks to take action and that is your moment to negotiate a restructuring. Trying to discuss a restructure with a bank prior to being 90 days in default is usually non-productive.

Most borrowers will hear from their banker as soon as they go 30 days in arrears and that pressure will mount as the loan goes 60 days in arrears. The FDIC requires that the banks put the loan on non-accrual at 91 days. Usually the loan then transfers into the "workout"

department on the theory that the original loan officer is too tied to the loan to effectively be objective. Obviously the original loan officer does not want to lose the loan because it reflects on his reputation. As a practical matter, that loan officer has limited things he can do until the loan goes to "work out". The "work out" guys have a lot of flexibility and that is where the deals are usually made. We will often say to bankers who are pleading to make just one payment to keep the loan "under 90 days" that we want the loan to go to "work out" so they might as well send it there now. Once they understand that we know the game, they give up and send it over to the "work out" department.

Depending on the debt, your loan can be bifurcated through FASB (Financial Accounting Standards Board) Regulation 15 in which the bank is permitted to divide your loan into two pieces - a Part A that you can service and a Part B that you can't. The Part B is written off by the bank, although you can still be held liable for that amount. In general, the lenders will sell those Part B's for 10 percent to 50 percent on the face dollar to other investment groups who then will negotiate to collect from you something more than their discounted purchase price. If SBA is a lender, there are a number of strategies to engage SBA in an Offer in Compromise, whereby the SBA dismisses the debt on the property, although they may still hold a borrower's personal guarantee to collect the sums owed. These guarantees can also be mitigated through an Offer in Compromise process.

*Dropping debt is the most strategic thing you can do*

The key in all cases is to actually drop the principal owed. Just deferring the principal or going to interest only payments does not solve the fundamental problem of being overleveraged. Debt restructuring, done properly, always involves reducing the principal amount owed. Otherwise you are just moving the debt obligation into the future on the theory that the economy will come roaring back someday to levels similar to 2007. That might happen, but it is a "fool's errand" to rely on it. Better to set your debt levels that will work in today's environment.

*Why would the lender take the hit?*

All FDIC insured lenders are "process driven". Your banker's main goal is to stay employed. If he does everything by "the book" he will enhance his chances to keep his job. However, banks are highly regu-

lated and are required by the FDIC to write down loans if the collateral value drops below the loan value. As a borrower, if you demonstrate (typically through a third party appraisal) that the property value has declined to 50 percent of the loan, then the bank is required to write the loan down to that level. They have no choice. However, the banker is not playing with his own money but rather the bank's money. If he follows a process that every bank has for writing down loans then you can get a restructured loan at a level that your business can support. The key is to give the banker the right "process cover" so he can make the argument to his loan committee. By understanding the regulatory environment under which the bank must operate you can control the ultimate debt level of your property.

*What about my Personal Guarantees (PGs)?*

Most operators do not have PG's

that are worth anything by the time their hotel is in default. Unless those guarantees have serious collectible assets behind them, the bank is very reluctant to attempt to collect on them. If a borrower negotiates in good faith with a bank then, in general, they will not move against the guarantees unless there is the prospect of fraud or misrepresentation.

Now is the time to get your debt house in order. Lenders are making deals because they have to and the prospect of a quick turnaround in the industry is small. It may well be the most important action you take with respect to improving the long term value of your property. ■

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