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Hotels in financial distress and their resolution

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The COVID-19 pandemic had an unprecedented, rapid, and severe negative shock that reverberated through the global travel industry and leaving in its wake, a trail of economic destruction and uncertainty, business closures, rising unemployment, and social upheaval from lockdowns and stay-at-home orders. Particularly hard hit is the U.S. lodging industry, which bore the brunt of the pandemic, exhibiting staggering declines in lodging fundamentals when demand from corporate, leisure, and group travelers came to a screeching halt from governmental restrictions on domestic and international travel.

To put the numbers into perspective, hotels have experienced the greatest decline in lodging fundamentals with profound effects on profitability. According to STR, hotel revenue per available room declined (RevPAR) by 50% in 2020 (STR, 2021a). The effect of this decline in the top-line operating metric on bottom-line profitability is even more dramatic. For 2020, hotels experienced an 85% drop in gross operating profit (GOP) and a 103% decline in net operating income (NOI) (STR, 2021b). The freefall in lodging fundamentals induced by the pandemic is having a severe negative impact on hotel values, risks and returns. In a recent study, HVS estimates that hotel values will decline between 20% and 35%, depending on the characteristics of the hotel, its market, and location with recovery in prices taking an average of five and a half years (Lloyd-Jones et al, 2020). Full recovery in lodging fundamentals is not expected until 2024.

A major implication of this pandemic on the hotel industry that is frequently overlooked and goes unreported is the number of hotels that fall into financial distress, their distress condition, and how distress is resolved through various resolution outcomes. Although COVID-19 has increased the level of financial distress, lender willingness to work with borrowers to resolve distress coupled with federal stimulus and lending programs have forestalled the wave of distressed transactions that investors were expecting. In this article, I discuss various financial distress conditions and resolution outcomes followed by highlights of research findings in the lodging sector. Finally, I explore the current state of financial distress in the lodging sector brought about by the pandemic.

What is financial distress?

Financial distress is commonly defined as a condition in which a property faces financial challenges and difficulties in generating sufficient cash flows to cover its debt service payments. A borrower becomes delinquent by failing to make a periodic payment on a loan. This delinquency can be cured by making the necessary delinquent payments to bring the loan current. However, when delinquency is left uncured for a specific number of periods, typically 90 days, the lender will file a notice of default against the borrower in which case the borrower is considered to be in default. Thus, financial distress is a process involving a sequence of adverse financial events that affect the financial performance of the property.

How is financial distress resolved?

The distress process begins when a loan becomes delinquent, leading to restructuring or foreclosure, and ending with liquidation or the sale of the property to a third party. Once a loan borrower has defaulted on a loan, the lender will consider a number of options or remedies to resolve the financial distress to recover the loan proceeds. Depending on the intention of the borrower whether to retain ownership of the property, the lender will consider forbearance and loan modification or foreclosure.

Forbearance/Loan Modification

If the borrower intends to retain ownership of the property, the lender can use forbearance or modify the loan terms, which can provide some temporary relief to the borrower (Clauretie & Daneshvary, 2011). Forbearance is usually defined as a situation where a lender allows a borrower to stop making fixed loan payments for a specified period of time, which provides temporary payment relief to the borrower until the situation that induced the hardship subsides and cash flow normalizes. Once the forbearance period expires, the borrower is expected to make up all the missed or deferred payments. Unlike the Global Financial Crisis (GFC) when lenders filed a wave of foreclosures on defaulted loans, lenders were more willing to provide forbearance relief to thousands of hotel owners who were unable to make their loan payments when owners were forced to temporarily close hotels and/or operate with negative cash flow during the pandemic Short-term forbearance relief provided to borrowers generally ranged from the utilization of reserves to cover loan payments to deferral of loan payments for three months to a year. Unlike forbearance that does not change the loan terms, loan modification results in a permanent change to the loan terms. Loan modification which provides permanent payment relief may include an extension of the

loan maturity term, change in the amortization period, involve a loan payment modification, an interest rate reduction, or any combination of these options.

Foreclosure

If the borrower has no desire to retain ownership of the property, then the loan goes into financial distress, in which case the lender resorts to several additional options to resolve distress. When property value has declined below the loan amount, the lender can authorize a pre-foreclosure short sale, note sale to a third party, discounted payoff, or permit a deed-in-lieu of foreclosure (DILF) whereby the property is voluntarily conveyed to the lender to avoid a foreclosure proceeding (Hambly, 2009). In the case of a short sale, note sale, and discounted payoff, the proceeds from the sale are usually less than the amount owed on the loan. In such cases, the lender can forgive the difference in amount, or the lender can pursue a deficiency judgment against the borrower requiring the borrower to pay the difference. As a last resort, the lender can file for foreclosure. Foreclosure is a process by which the lender attempts to repossess the property to recoup any unpaid balance by re-acquiring and selling the property to a third party. If the lender files for foreclosure, the property could be sold during the foreclosure process via a distress sale and a foreclosure auction or trustee sale. A distress sale or an auction sale can also occur prior to the lender initiating a filing of foreclosure. Alternatively, the lender could foreclose on the property, acquire title to it, and dispose of the property via a real estate owned (REO) sale to a third party (Clauretie & Daneshvary, 2011). An REO sale occurs when a lender sells the property after having foreclosed on the property and acquired title to it. Thus, there is a sequence in the resolution outcomes that begin with some disposition options for the lender prior to any foreclosure proceeding followed by additional resolution options during the foreclosure process and ending with a post-foreclosure REO sale.

What are the costs of financial distress?

Financial distress that results in foreclosure is a lengthy, complex, and costly event for all parties involved in the transaction of a distressed asset. Lenders and investors in the securitized debt market take a direct loss when a loan goes into foreclosure and then liquidated. These costs, which are incurred from the time a mortgage loan becomes delinquent until liquidation, include direct and indirect costs such as lost principal and interest payments, moving expenses, maintenance, repair, and renovation costs, property management, collection and servicing fees, legal and administrative fees, sales commissions, and seller concessions (Mortgage Bankers Association, 2008; Frame, 2010).

Measuring the financial distress discount

The financial distress discount is measured upon the sale of the property. It can be measured using two different approaches. In the first approach, transaction or sale prices of distressed and non-distressed hotels over a period of time are gathered along with the property characteristics. The transaction prices of non-distressed hotels reflect market prices, so the objective is to capture the discount relative to market prices. This discount is measured by comparing the transaction prices of distressed hotels and non-distressed hotels in a multiple regression framework that also controls for factors

such as hotel size, hotel age, location, chain scale, and time among other variables. For example, if a 100-room non-distressed midscale hotel sold for a price of $50,000 per room and a similar financially distressed hotel sold for a price of $30,000 per room in the same month and location, the estimated discount is 40% (1 – (30,000/50,000)). In the second approach, the discount can be measured by comparing the price differences for a hotel that has been sold multiple times or repeat sales. In this case, a hotel that may have been previously non-distressed when it was first purchased could have entered into financial distress after a period of time and subsequently sold a second time. The discount is measured using the same method in the previous example by comparing the most recent distressed price relative to the previous non-distressed price. There is no need to control for other factors that could affect the sales prices other than time.

Research findings on the financial distress discount

When a property is in financial distress, the existing real estate research indicates that its value will decline and the distressed property sold off at a significant discount relative to market prices (Doerner & Leventis, 2015). Much of the research on financial distress has focused on the residential sector. This line of residential research shows a foreclosure discount between 7% and 24% (Clauretie & Daneshvary, 2011). On the other hand, the financial distress discount on hotels is much higher. Research shows that the lodging sector had the highest loan default rate and loss rate among all the major commercial property types (Kroll Bond Ratings, 2016). It is estimated that more than 9% (over 4,700 hotels) of active U.S. hotels experienced some form of financial distress following the GFC (Singh, 2017). The level of financial distress in hotels tends to be greater than other real estate sectors for one main reason. Unlike other major commercial property types (such as office or retail) that are subject to long-term leases, hotel rooms are leased on a daily basis so demand for rooms (occupancy) and the price paid for rooms (average daily rate or ADR) fluctuates on a daily basis, which renders the hotel sector vulnerable to external shocks such as the pandemic. These external shocks contribute to a much higher level of cash flow volatility, which leads to a higher probability of financial distress (Wheeler et al., 2016). What it means for hotels is declines in lodging fundamentals will magnify the decrease in profitability. This is due to the high operating leverage of hotels driven by higher fixed costs in hotels. Operating leverage measures the sensitivity of profits relative to changes in revenue so the greater the ratio of fixed costs relative to variable costs, the higher will be the degree of operating leverage.

When an external shock hits the hotel sector, owners and managers are unable to cut expenses quickly, which leads to a decrease in income and consequently insufficient cash flows to cover debt service payments. Given the greater risk evident in hotels, one would expect the distressed sales discount to be greater for hotels than other property types in the commercial real estate sector. This expectation is confirmed in recent research in the lodging sector.

A recent study of 6,340 U.S. hotel transaction prices from 2008 to 2016 found that property characteristics and financial distress conditions significantly influence the

pricing of distressed hotels (Singh, 2020). In this study, financial distress was measured using indicator variables for an auction/distress sale, REO sale, and short sale. The results of the study revealed a discount of 30% for a short sale, 33% for an auction/trustee sale, 42% for a foreclosure sale, and 44% for an REO sale when compared to non-distressed normal market sales. Once a hotel falls into financial distress, and irrespective of the extent of the distress, the results reveal a hotel discount that will be greater than 30%. What is most important is the magnitude of the distressed sale discount documented in this study is greater than the discount found in other commercial property sectors such as office, retail, industrial, and multifamily. These findings suggest that investors perceive hotels as risky investments and therefore demand greater discounts to compensate them for acquiring distressed hotels. The study also found that discounts were lowest for hotels disposed via short sale and auction/distress sales, which appear to be the most effective resolution outcomes for distressed hotels. Other notable observations from the study results include the following:

- The effect of hotel size showed that larger hotels trade at higher transaction prices.
- The effect of hotel age on pricing suggests that older hotels transact at lower prices.
- Larger hotels are discounted less at auction but subject to greater discounts when sold as REO, which favored the sale of larger hotels via an auction
- Discounts are lower for newer hotels and higher for older hotels when they are sold as REO.
- Extended-stay hotels perform better in auction sales with lower discounts than other hotel types.
- Resorts face the lowest discounts at auctions, whereas interstate and small metro/town hotels experience significantly greater discounts than suburban hotels. However, interstate and small metro/town hotels perform worse as REO sales.
- Luxury hotels enjoy a premium at auctions whereas independent hotels face discounts. The REO discount for midscale, upper midscale, and upscale hotels are also relatively lower than independent hotels.

These results imply that financially distressed hotels sold at auctions face relatively lower discounts than hotels sold as REOs. Thus, the findings favor the use of auctions for the disposal of larger distressed hotels, extended-stay, resort, and luxury hotels. Finally, a paired sales analysis of repeat sales transactions using the latter approach found the distressed sale discounts to be similar to the discounts estimated using the former approach. The results show a median discount of 42% when a hotel goes from non-distressed to a distressed condition and a slightly larger discount of 44% when the hotel is in foreclosure.

Financial distress during the pandemic

The external shock from the pandemic has led to thousands of hotels to fall into financial distress. With government restrictions, hotel closures, and little or no demand,

many hotel owners were forced to seek relief from their lenders. While some hotel owners have received some relief from lenders, others are still waiting for some form of relief. The wave of foreclosures that many expected has not materialized with private equity capital waiting on the sideline for distressed hotels to come to market. Until these hotels are brought to market and sold, the data on resolution outcomes is not available to draw any insights on the distressed sales discount. What is available is data on the current state of financial distress of hotels in the midst of the pandemic. In this section, I provide some insights into the current state of financial distress in the lodging sector. The data on conduit loans is obtained from Trepp LLC, a leading provider of commercial mortgage-backed securities (CMBS) and commercial mortgage information.

CMBS are bond securities whose payments are derived from a loan or a pool of commercial mortgage loans on various property types such as hotels, offices, industrial, retail and multifamily apartments. Unlike banks that originate loans to hold on their balance sheets, conduit or CMBS lenders originate loans on commercial properties with the specific intent of securitizing them into CMBS. The loans are pooled together and transferred to a trust, and the bonds backed by the loans are then sold to investors. Once a CMBS transaction has been securitized, and bonds have been sold to investors, the transaction is managed by various entities that includes the master and special servicer. When a loan from the mortgage pool is delinquent, it faces imminent default or is subject to bankruptcy, and is transferred to special servicing. The special servicer is responsible for servicing defaulted loans or loans facing imminent default. It is the special servicer that determines the most effective workout strategy to resolve the loan which may include loan modification or extension, or foreclosure.

As of March 2021, based on an analysis of Trepp LLC data by the author, an estimated 2,007 out of 3,666 hotels securitized by CMBS (conduit loans) have fallen into financial distress. Of these 2,007 hotels, the financial distress of 1,881 hotels was COVID-19 related with owners/sponsors of these hotels seeking payment relief from lenders due to the hardship caused by the pandemic. On the other hand, financial distress of the remaining 126 hotels appears to be unrelated to COVID-19 because the financial distress in these hotels arose well before COVID-19. The loan terms of 1,739 hotels were found to be modified by the special servicer with 1,012 modifications involving no transfer to the special servicer, whereas 727 modifications occurred after a transfer to the special servicer. An additional 268 hotels were held up in special servicing without receiving any modification. Temporary COVID-19 relief or forbearance provided to borrowers in most cases involved deferral of reserve payments and/or deposits, and utilization of reserves to cover debt service payments. Forbearance periods generally range between three months to a year. In some cases, payment relief included a deferral of monthly loan payments and waiver of loan covenants or a combination of these terms. On the other hand, permanent loan modifications were relatively few with an increase in interest-only periods and/or an increase in maturity term as the most common type of permanent modification.

Of the 995 hotels that are in special servicing, 869 transfers were due to COVID-19 with 581 hotels considered to be in severe financial distress. An estimated 356 hotels were

at least 90+days delinquent (61.3%), 165 hotels were in foreclosure (28.4%), 13 hotels had non-performing matured balloon loans (2.2%), and 47 hotels (8.1%) were REO. Of the 581 hotels, owners of 11 hotels have also filed for bankruptcy. Hotels in foreclosure, non-performing, and REO (225 or 38.7%) status have a greater likelihood of being liquidated at a significantly discounted price with a substantial loss to the CMBS trust. While special servicers have appointed receivers for many of these hotels whose owners/sponsors have defaulted on their payments, in other cases, lenders have engaged legal counsel to proceed with the enforcement of remedies, and to dual track foreclosure while discussing various workout alternatives and possible loan modifications. Discussions and negotiations between special servicers and borrowers have been ongoing regarding workout strategies for payment relief terms and options. If financial distress in these latter cases is left unresolved, special servicers will move to initiate foreclosure and take title to the hotels. Similar resolution outcomes await these hotels, that is, they will be disposed of at a discounted price via an auction, distress, trustee, or REO sale.

Implications for hotel owners/borrowers

If the pandemic persists well into 2021, owners and lenders will incur substantial costs and ongoing financial distress could lead to greater loan default and foreclosure with the potential for significant losses upon loan resolution. To the extent that financial distress is costly, the financial decisions made by hotel owners will be affected by these costs as well as influence the resolution outcomes. Borrowers and lenders should pursue workout strategies that will minimize losses and yield lower disposition sales discounts (Clauretie & Daneshvary, 2011). There are several options available to hotel owners in financial distress.

- The most common form of relief that hotel owners can seek from lenders is still forbearance. Lenders are likely to focus on more deferred payments for reserves, using capital reserves to fund debt service and waivers of default loan covenants. When the financial condition of the hotel improves, any deferred or missed payments have to be made up with no forgiveness.
- If the pandemic persists and lodging recovery is prolonged or remains uncertain, loan modification strategies should be pursued to include changes to loan terms such as interest rate reduction, and maturity date and/or amortization period extension. In some cases, lenders may require additional capital infusion from borrowers or some principal paydown of the loan.
- If foreclosure is inevitable, a deed in lieu of foreclosure, note sales to third parties, and discounted loan payoffs are additional loss mitigation strategies to avoid a lengthy and costly foreclosure process.
- Hotel owners can benefit from public policies and legislation that help borrowers fund short-term needs and encourage and incentivize lenders to provide forbearance, and work out distressed loans to avoid foreclosure. Despite the CARES Act and other lending programs passed by Congress and the Federal Reserve, which benefit hotel owners with bank debt, those holding CMBS debt are unable to or face difficulties in obtaining relief under existing federal programs because of restrictive loan agreements.

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