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Why Lenders Pulled Back on Hospitality Finance

| By Carrie Rossenfeld
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Porter: "Hospitality is an attractive asset class for CMBS because the relatively conservative LTV, DSCR and above-average margin metrics for hotel loans are accretive to a CMBS pool, but rating agencies will punish a CMBS pool with more than a 15% to 20% concentration in hotel."

CARLSBAD, CA—The improvements in **hotel financials** in recent years led to substantial **lending** to the point where many lenders are overweight in that sector, so they put on the brakes purely from a balancing perspective, **HREC Investment Advisors**' SVP, mortgage brokerage, **Greg Porter** tells GlobeSt.com. Porter, a **commercial real estate** veteran with more than 20 years of experience in lending, brokerage, consulting and valuation, recently joined the firm as a senior member of the **capital-markets** group, headquartered in HREC's San Diego office here in Carlsbad. He is charged with growing the HREC mortgage-brokerage platform and reports to CEO **Mike Cahill** and capital-markets head **Michael Armstrong**.

We spoke with Porter about his goals in his new role and trends in hospitality financing.

GlobeSt.com: What are your goals in your new position with HREC?

Porter: HREC Investment Advisors is already among the largest dedicated hotel sales and advisory firms in the nation, and my objective is to expand the capital markets/mortgage brokerage platform so that our clients can rely on HREC for not only buying and selling assets, but also obtaining **financing** for purchases, for **refinancing** and **recapitalization** efforts. We strive to be the hotel owner's choice for best-in-class service in all arenas of hospitality **finance**.

GlobeSt.com: What trends are you noticing in hospitality financing?

Porter: Lenders are always balancing their allocation of funds among property types so that they don't become overweight in one class. The improvements in hotel financials in recent years led to substantial lending to the point where many lenders are overweight in hospitality, and so they put on the brakes purely from a balancing perspective. The push/pull for hospitality in **CMBS** happens faster than with banks or debt funds that hold the assets because securitization can clear hotel loans from a CMBS lender's books overnight. Hospitality is an attractive asset class for CMBS because the relatively conservative LTV, DSCR and above-average margin metrics for hotel loans are accretive to a CMBS pool, but rating agencies will punish a CMBS pool with more than a 15% to 20% concentration in hotel.

As another example, **SBA** lenders, specifically the CDCs that manage the SBA's risk in 504 loans, have widely achieved their allocation for hospitality, which has made qualification for SBA financing a challenge. This has opened the door for numerous non-bank lenders to compete in the market. Borrowers cannot keep tabs on the varying appetites of bank, debt-fund, and CMBS lenders, but because we have our finger on the pulse of the market, we can direct our borrowers to those lenders with the most appetite and who are the right fit for their financing needs.

GlobeSt.com: As hotel valuations drop, how are lenders' views on hospitality financing changing?

Porter: We are seeing a slowdown in the rate of **RevPAR** growth in most markets, but not a decline, so I would characterize cash flows and valuations as stabilizing. Lenders are hesitant to underwrite to current NOIs given the magnitude of the NOI lifts since the **recession**. So, if a finance request demands reliance on recent NOI, the story behind the NOI lift must go beyond that of a rising market; i.e., what **renovations**, changes in management, changes in flag or other actions led to the improvement. The key is telling the story and targeting the lender with the appetite for the asset's risk profile.

GlobeSt.com: What else should our readers know about hospitality financing? –

Porter: Mike Armstrong, John Siska and I are here to make HREC a true full-service brokerage and advisory firm with best-in-class capabilities across the capital stack, and by way of our periodic Capital Markets Update, we will keep you informed and educated on what is happening in the debt markets.

From our most recent update, Mike and I just returned from the 2017 **Mortgage Bankers Association Commercial Real Estate Finance** convention, where we met with 21 lenders and networked with at least a dozen others. With rates still low by historical standards and relative strength in the debt and equity markets going into the year, the outlook for 2017 lending is rosy. CMBS spreads have tightened significantly since 2016. Conduits have largely sorted out the **Dodd Frank** risk-retention rules that went into effect in December, although the approaches vary between retention of a horizontal slice of the CMBS securitization stack (the B-piece) and a vertical slice of the stack, which still requires a B-buyer, but one not required to retain the position. CMBS lenders are required to limit hospitality to 20% of their securitization total, so an individual lender's appetite for hotel can swing from strong to shut depending on where they are on their latest securitization.

Finally, the approval, underwriting, and closing process can vary from boutique/creative/in-house to corporate/outsourced/multi-layered depending on the shop. The message: the ability to provide market-leading pricing and certainty of execution varies widely. Life companies are active with heavy 2017 allocations, but still

hold out for the strongest borrowers, low LTVs and top flags/markets. Banks' appetite for hospitality has been impacted by the new regulatory environment. Many have hit their hotel thresholds and have turned more conservative, limiting construction lending to 50% to 60% LTC for well-capitalized sponsors. **Debt funds** have pumped the gas to pick up the slack from CMBS and bank lending; many are flush with cash, and we expect the funds to take a bigger piece of the pie in 2017. Many funds and some CMBS players offer mezzanine in chunks as low as $1 million; some principal the piece at closing, then sell; some hold on balance sheet. Some divide the loan into an A and B note and can get total capitalization up to 80% and beyond; some keep it in a single note (Stretch CMBS) that can get non-recourse hotel LTVs up to 75% in a single note.

The consensus for a March rate hike is on the rise given the perceived positive impact of **Trump** initiatives on **economic growth**. While **10-year Treasuries** have moved up 50 basis points since the election, hotel loan coupons remain more than 100 basis points below where they were 10 years ago, which means **acquisition** and **refinance** loan rates are still below historical norms. With the Fed hinting at 75 basis points in hikes this year, the front end of 2017 provides borrowers a window to lock in fixed-term financing at an historically attractive rate.

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