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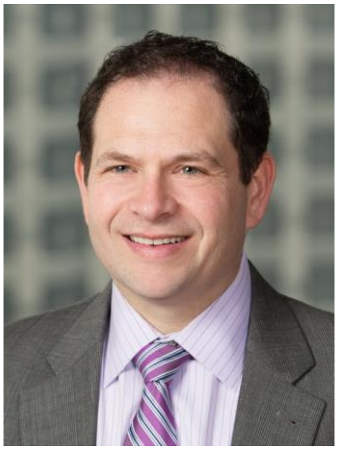
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Latham Hospitality Leader Eyes Creative Approaches To Debt

By **Andrew McIntyre**

Law360 (March 28, 2023, 9:44 PM EDT) -- With interest rates markedly higher than they were a year ago, companies are looking for creative ways to lock in the low rates even if the asset needs to be sold or receive an additional injection of capital, a Latham & Watkins LLP hospitality leader told Law360 in a recent wide-ranging interview.



Gary Axelrod

Gary Axelrod, co-chair of Latham's hospitality, gaming and leisure group, said companies that hold debt that was originated at low rates, before March of 2022, are now holding onto a major asset in the form of the low interest rate. But figuring out how to keep that low rate in place if an additional transaction on the property occurs can be tricky, and requires creativity.

Axelrod, a partner, practices out of Latham's Chicago office. He also discussed the rising cost of insurance premiums as weighing on the hotel sector.

The Marriner S. Eccles Federal Reserve Board building is seen March 16, 2022, in Washington, D.C., March 16, 2022. A Latham & Watkins LLP hospitality leader says the Federal Reserve rate hike cycle has had significant impacts on the commercial real estate market. (Saul Loeb/AFP via Getty Images)

This interview has been edited for length and clarity.

We're a year into the [Federal Reserve rate hike] cycle. What's been your takeaway on some of the impacts on the commercial real estate market of these rate hikes?

It's been significant. It's chilled financing to some extent, because not only has that impacted what level the index is, and pretty much everyone shifted from Libor to [Secured Overnight Financing Rate] now, which used to be under 1%, to I think today it's at 4.7% for SOFR. So not only do you have the index increasing substantially, but spreads have also widened. So when you could previously get Libor plus 250 to 300, or even 400, all in you're under four and a half or 5%, you're now looking at deals that are anywhere from 8 to 10% for the same relative loan-to-value leverage amount. And so that's definitely put a little bit of a chill on the market. Costs have gone up as a result. And then you layer in all of the knock-on effects of rate increases and inflation, which, while inflationary times are good for hotels because they can raise rates on a daily and hourly basis, it has other consequences where, even though the top line can grow with inflation, the profit margin might not grow at the same pace because you've got increased employee expenses. It's still a tight labor market. Unemployment's still relatively low. And the cost of rate caps is exceedingly high. We're seeing lenders being cooperative in redoing their strike rate requirements because of the increase in the index. Where some deals used to have a 2 or 3% strike, you now have to go to 4 or 5% so that you're not in the money immediately. And it's very expensive, obviously, in that circumstance. And then the one area that I think it's really impacted deal flow … is the cost of insurance is skyrocketing. The insurance markets are … certainly in distress, in the sense that there's been a lot of catastrophic matters that have come up and it's challenging, especially for a larger deal, to find an insurance stack that meets all the requirements for the lenders but is also commercially reasonably available. The combination has made the transaction market and the financing market a little more volatile than anything we'd all like to say.

When you talk about the cost of insurance going up, are you talking about properties in flood-prone or hurricane-prone or fire-prone areas, or do you think that's sort of trend across the board? Nationwide?

I think the insurance agents will tell you it's both, right? … In Florida where you might be near the water, after what happened down there. California has issues. But I think that dislocation in the market affects the entire market. And so it's a combination across the board. You are seeing lenders with requirements that for certain size insurance stacks, that everyone has to be a certain rating with S&P, for example. But depending on the size of the insurance stack or tower as they call it, not every insurer is meeting those requirements. So there's been a lot more negotiation around what levels of insurance are required and what ratings than ever before. And it's not prohibitively expensive, but it's definitely expensive. And the other area where I think people have been impacted as a result of the insurance is for those who have blanket policies where their property insurance coverage is blanket in nature and covers more than one asset. I think lenders are now getting a little skittish about what that maximum liability amount is for that blanket policy, just because the likelihood of claims has gone up. And so we're seeing a lot more discussion around that too, where an institutional borrower has a blanket policy but the maximum wasn't high enough for the lenders. And so they had to go out and buy an additional coverage, or provide recourse for a loss resulting from not having sufficient coverage. And so that was a relatively new dynamic that's popped up a couple times over the last six months.

I want to go back to the hospitality space. I know you do a lot of work there. What are the key questions you're getting from hospitality clients right now?

Well, in the wake of Silicon Valley Bank and Signature Bank, the number one question is, 'hey, can I move my money and what do the loan documents say?' But I think that's going to be a short-term panic. Clients are looking for distress. We didn't really face the distress that I think everyone expected during COVID. I think part of that was it was a short-term blip in a sense that lenders understood that there's nothing people are going to be able to do differently because of COVID and the lockdowns. And so everyone geared up in 2020 for that distress. It turned out that there were very few distressed deals. There were a couple capital market transactions or PIPEs, private investment in public equities. And so those PIPES got done, but at the asset level, there wasn't as much rescue capital needed, in part because lenders were cooperating with borrowers and in part because of the stimulus that's government provided with [Paycheck Protection Program] loans and the like. So that staved off, I think, a lot of that distress. And then as the market recovered, you started with drive-to destinations because you didn't have to fly, and people still wanted the leisure travel. Business travel is coming back but hasn't come back all the way. But now the combination of the impact of business travel still not being back to full strength coupled with the disruption in the financial markets with rate increases and the like, I think people are now expecting to see more distressed deals. And we're seeing a little bit of that now. I've done two deals where we bought debt and then foreclosed on the asset. So I think that's a pretty good indication of some of the distressed deals that are happening. Whether that will continue or not, it's hard to tell because I do think there's so much pent-up demand on the buy side with dry powder and capital that you do wonder in a scenario where a distressed owner runs a process, if so many people will be throwing their hat in the ring to try to get that deal that it will in essence become another seller's market, so to speak. And it won't be as distressed as people think.

I'm wondering how the volatility in the interest rate market is affecting deals. In terms of … some deals maybe not going through with changes in rate expectations. … Can you talk about how the volatility and unpredictability in the interest rate environment affects deals before they close after they're signed?

It's all about underwriting, right? It's the predictability of the underwriting and it definitely has an impact. There's less flexibility to make mistakes that you might otherwise have in a very robust market, right? Because with labor costs up, with inflation rising. [Revenue per available room] has continued to climb. … Can RevPAR continue to climb indefinitely as inflation starts to taper off? But the cost in employment and insurance and all the other expenses eat into it. Your ability to build on that cushion gets tighter and tighter. And then you've got supply-side issues in hotels in particular with [Property Improvement Plans], and pricing comes in a lot higher. So all of it makes your underwriting that much more critical. And even the slightest movement can turn an OK deal into a bad deal. There doesn't seem to be a lot of good news surprises. It always seems to be bad news surprises.

I want to get your take on the [commercial mortgage-backed securities] market right now. I guess let's talk about it in the hospitality space. What's your sense of where we are right now? There's been a lot of talk over the last several years of this CMBS wave of debt coming due and difficulties in refinancing. Has that wave come or is that wave coming? What's your take on that?

It has not come yet, and I just looked this up. There is a report that CBRE did. ... As a percentage of loans and special servicing, we're not at crazy rates. So back in 2020, special serviced loans were about 26% at its peak. But now it's reverted back about 6.4%. And there's been a relatively steady decline since August, September of 2020, which is what you would expect back in the tail end of the first wave of COVID. Before COVID, you were probably closer to 2 or 3%. So you're higher than you were three years ago, but I don't think you're at a critically distressed state yet. … The wave of maturities that's coming up, that's where you could see some real distress because the refinancing markets will likely require, absent rates coming back down and spreads coming back down, you might need some equity infusion to cover debt service and to make the capital stack fit, so to speak.

If you think about this difficulty and refinancing, would it follow that the hotels in drive-to locations, leisure hotels might have a little bit of an easier time refinancing, and it may be the conference hotels that may experience more difficulty?

One hundred percent. Because they're so reliant on business travel still, which just hasn't come back to what it used to be even though it's improved. And the other thing is, a lot of those urban convention center hotels, … they were performing well leading up to the pandemic and there were significant financings on a lot of those assets and they were trading, and so you have the double whammy of refinancing and high principal amounts with expensive debt service mostly floating. … And then their occupancy plummeted and hasn't come close to what it used to be. So absolutely, I think that trend will continue. There was recently foreclosure in Minneapolis of a large convention center hotel. It was a

CMBS loan. It was the Hilton Minneapolis hotel.

There's a lot to watch in the economy in the hospitality sector. What are the key things you're watching over the next couple of months?

Given that I come from a transactional perspective, my practice is primarily transactional not really operational, I am looking at creative ways to recapitalize assets, taking advantage of what might be perceived to be very favorable debt that can either be assumed or a structured transaction to keep that debt in place without requiring a lender consent or a loan assumption. Because you have wildly different spreads between existing debt from pre-March of '22 to now, and that is, in some instances, the best asset that an owner can have, is favorable debt terms that can remain in place for potential capital providers or buyers. So a lot of what we're looking at and I'm focused on is coming up with creative solutions, where someone can inject capital into an asset while keeping the existing debt in place or buy an asset. And similarly we're looking at owners who are looking to raise that capital and working to try to structure deals so that they can bring in capital to perform a [Preferred Equity Position] or really just to right size their balance sheet a little bit, but use their asset of a loan with term but lower spread to create additional value to those capital providers to come in.

It sounds like creativity may be the word of the day.

Yeah, right. Exactly.

--Editing by Alex Hubbard.
