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Hospitality real estate: A discussion of structuring transactions

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In most real estate cycles, good commercial real estate brokers focus on "working smarter" rather than working harder. In 2009, however, brokers are not only working smarter, but are working harder, too. Due to the state of the economy, professionals in our industry must add real value through services that take advantage of our specialized skills, knowledge, and experience.

In past articles, I have focused on creative selling solutions and financing alternatives such as installment sales, wrap-around mortgages, and the SBA 504 program. I have also discussed tax-deferred exchanges, lease/purchase agreements, and repositioning opportunities, along with targeted strategies for identifying older hotels in good locations that can be demolished and replaced with modern hotels or major retailers. In this article, I discuss road blocks that have created the need for more flexible solutions in finalizing transactions, while providing examples of actual transactions in which differing types of selling solutions were used to complete the assignments.

It is no surprise that the economy is having a big effect on the hotel business: revenues are down, and as a result values have also dropped. There are plenty of good buyers looking for product, especially in mid-sized, limited-service hotels priced from $2 million to $8 million. These buyers are being very cautious, however, and so are lenders (that is, if one is available at all). Many potential buyers are waiting on the sidelines, hoping to jump in at the bottom of the market, and others are making purchase proposals that are heavily weighted toward a further drop in revenue and values.

Do banks want to lend? They will tell you that they want to, but actually obtaining a loan remains very difficult. Particularly in the hospitality market, we will need to see an increase in lending before business can start to rebound. Some financing is available, especially when the SBA 504 program is appropriate. Several of the fees and restrictions for this program have been eliminated, and with a top limit of $2 million, properties with a value up to $7 million can be purchased with 20% equity.

Problem properties are becoming prevalent, as more and more hotels are unable to meet their monthly mortgage obligations, lenders are looking for alternative solutions. It does not appear that there will be as many foreclosures as in the early 90s, due to some of the negotiated solutions that the industry is learning to effectively implement. The key factors for the lenders to review will be the condition of the property, the quality of management, and the strength of the current business plan. Many lenders are suggesting that owners put their properties on the market for sale and discuss any shortfall in the ability to cover debt at a later time, very similar to short sales in the residential market. I believe this is a very effective means of addressing the problem, unless it is clear that a continuing deterioration of the property will be evident in the near term.

Some solutions:

In the past 30 days we have completed two lease purchase agreements, one for a resort inn located in the White Mountains of New Hampshire and the other for a franchised hotel in Massachusetts.

The agreements were fairly similar in that the lease terms can run up to five years, but a purchase and sale agreement was executed to transfer the property at the end of the lease term, or sooner at the request of the tenant. The tenant is responsible for all costs, as in a pure net lease, and is also charged with completing all capital improvements. The purchase agreements were contingent free, requiring the buyer to purchase the property at the end of the lease. In both cases, a portion of the lease payment is credited to principle and a cash payment is also credited to the purchase price at the signing of the lease. In order to calculate the principle reduction, the lease payment was amortized over a 20 year term at a current interest rate. We are currently representing another owner and are in negotiations to complete a very similar transaction for his hotel.

Much time has been dedicated to identifying older hotels, especially exterior corridor properties and large two-story properties, which are in great locations. The value of the land for these properties is usually greater than the hotels. Recognizing the numerous hotels that will be coming out of the market over the next few years, we have developed relationships with some quality retail developers in New England. Currently, four different sites have been identified where there is either an agreement in place or negotiations in process. One of these potential transactions actually calls for partial demolition, allowing the hotel operator to reduce the number of rooms available and therefore making the hotel more viable. Another scenario in a market with high barriers to entry calls for a hotel to be demolished to make way for a new modern franchised hotel.

The on-going marketing of a closed 250-room property in Merrimack, New Hampshire has generated a great deal of interest. It is a perfect alternative use property and has been in negotiations to convert the facility to residential or assisted living. Many properties such as this are ideal for such conversions, as well as student housing.

Another strategy which combined a new first mortgage from a lender, a partial installment sale, and a tax deferred exchange into a credit tenant property helped us complete one of our largest transactions. The buyer benefited since this structure required less cash equity, and the seller now receives a monthly income from the installment sale and cash from a post closing refinance of his credit tenant properties.

A dedicated and experienced hospitality real estate broker has the ability to oversee a sale to completion, and will ensure the highest possible net sale proceeds for the seller. We are in a difficult economic and financial environment but hospitality property sales will continue to take place as buyers are becoming increasingly aware that small business, including hotel ownership, is a key driving source to improving today's economy.

Earle Wason, CCIM, author of "Hospitality Real Estate: Navigating Flexible Transaction Structures" is president and owner of Wason Associates Hospitality Real Estate Brokerage Group.

Wason has brokered more than 150 hospitality transactions over the past 15 years and has fostered excellent relationships within the Northeast hotel industry. Earle has devoted a significant portion of his career to the commercial real estate industry and has held the CCIM designation since 1985. Earle can be reached at 603-539-5545 or via email earle@earlewason.com.

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