LEGAL BRIEFING – Banking & Finance

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Hotel Financing in the era of COVID - 19

It is no secret that the hotel industry has been heavily affected by the global COVID-19. The COVID-19 outbreak has presented unprecedented circumstances before the fragile tourism and hospitality industry. Travel restrictions, border closures, quarantine requirements and the cancellation of large events have placed extreme challenges on tourism and hospitality sectors and the hotel market has been operating at an all-time low.

The closure of hotels and the resultant loss of income led inevitably to defaults of debt finance terms in facility agreements. The nature of these defaults largely fell into two categories: economic defaults (e.g. non-payment of debt repayments when due and/or a breach of financial covenants) and non-economic defaults (e.g. a breach of non-financial undertakings, such as cessation of business undertakings).

Borrowers have so far largely engaged in a constructive dialogue with their lenders to obtain temporary waivers of loan covenant defaults arising on their latest interest payment dates. Lenders were mostly quick to provide temporary waivers pending greater visibility on the extent of the anticipated distress in the sector.

However, such "time out waivers" do not act as a blanket waiver for any further distress which may occur, and have been provided under the condition that borrowers will continue to make their quarterly interest payments. These waivers were designed to provide a short amount of "breathing room" for borrowers while the full extent of the pandemic's impact was assessed.

As the scale of the pandemic unfolded and resulted in a closure of hotels, it became clear that obtaining a quarter-by-quarter waiver would not be sufficient. Instead, it was clear that longer-term waivers and loan amendments would be needed to allow borrowers to focus their efforts on ramping up their operations over the next months.

To deal with such issues arising from the COVID-19 pandemic in a more permanent way, hospitality industry participants have been forced to revisit the terms of their existing financing, brand management and franchise agreements and to engage in discussions with other stakeholders to build a path forward.

Most borrowers will already have considered and/or implemented the following:

1. Amendments of any existing loans. Such option requires reviewing the terms of their credit agreements to consider whether there are any existing covenants in respect of which the borrowers should seek waivers from their lenders. Such covenants include: (i) continuous operating covenants; (ii) financial covenant requirements, including regular testing and reporting of compliance with such financial covenants; or (iii) requirements to make regular payments into a furniture, fixtures and equipment (FF&E) reserve fund, or to make property improvement plan (PIP) renovations as required by a hotel brand;
2. Entering into standstill agreements with respect to financial covenant/payment defaults in order to preserve cash to meet necessary expenditures;
3. Taking out new loans to refinance the existing ones; and
4. Reaching out to other lenders with whom they have existing relations.

Some other key matters that borrowers shall consider during the negotiation with lenders are:

<u>A. Hotel management / Franchise agreements</u>

Many hotel owners have been engaging with their brand manager or franchisor to discuss how they can provide assistance to hotel owners in navigating the COVID-19 pandemic. Brand managers and franchisors may be able to offer relief. Relief can come in the form of:

- fee relief,
- deferred cycle renovations,
- waived required funding of FF&E reserves,
- suspended brand standards/initiatives,
- suspended brand standard audits,
- usage of FF&E or PIP reserve funds, or management fee accruals.

<u>B. Construction</u>

Borrowers have been engaging with contractors in order to design a project strategy demonstrating how work may be able to continue during the lockdown period, therefore minimizing delay to the project and limiting significant cost increases.

C. Leases

Depending on the nature of the real property interest involved, borrowers will want to ensure that the ground lease is kept in good standing or ensure that an acceptable deferral of rental payments is negotiated with the ground landlord, with the consent of the lender.

Creative Solutions May Be Needed

Given that the pandemic is an extraordinary event resulting in an uncertain market environment, to-date many lenders have been inclined to work with their borrower clients on finding a solution going forward.

Lenders will want to understand the borrowers' strategy during these unprecedented times, including how the owner's business is able to adapt to the current climate, as well as focusing on how debt will be serviced once this period of disruption has come to an end.

It is helpful for borrowers to present their lenders with their immediate plans to preserve cash flow—by seeking deferrals of taxes or rent, for example—together with their plan for navigating the next 18 to 24 months and attempting to re-attain some significant percentage of their pre-COVID-19 levels of performance. This information will assist lenders in deciding whether a waiver should be granted and, if so, the period of time that would be appropriate for such waiver.

Lenders can choose to approve or deny these requests, of course.

In circumstances where waivers have not been agreed or are terminated early, lenders with loans secured on hotels will have a range of options available to them. These are typical in commercial real estate loan structures, and include (subject to the exact terms of the finance documents):

- the ability to accelerate the loan and demand immediate payment of all amounts due, likely charging "default interest" in addition to the usual interest payable;
- the ability to commence enforcement action, whether by way of seeking to obtain control of the corporate structure which owns the hotel or by way of direct recourse against the hotel itself;
- the ability to terminate the existing contracts under which the hotel is managed and to appoint a replacement operator or manager of the hotel;
- the ability to sell the loan to a third-party, who would then have the rights mentioned above.

Whilst many lenders are taking a supportive and pragmatic approach to the challenges that lay ahead, some of the more opportunistic lenders may view the current crisis as an opportunity to acquire assets at a low value.

A number of European jurisdictions are introducing legislation to protect companies from insolvency proceedings during the pandemic and it is likely that other jurisdictions will consider similar protections. European governments have also put in place substantial emergency funding packages to help businesses with their cashflow requirements during the COVID-19 pandemic. These include deferral or waiver of taxes, furloughing of employees, cash grants, loans to businesses and other aid.

Looking to the future

It is becoming increasingly clear that securing new debt financing for a refinancing or an acquisition as we emerge from the crisis is likely to be significantly more difficult for a period of time. Margins for new debt are likely to increase, at least in the short term, and there will be fewer lenders actively looking for new financing opportunities. Many lenders will need to review all of the loans in their existing portfolio to ensure that the financing arrangements are still viable.

According to Savills, as banks retreat, private credit is likely to be the most prevalent form of lending in post-crisis situations as a result of reduced bank lending and lower risk appetite. Therefore, we can expect more debt funds to be raised in the upcoming year to support transactions and take advantage of distressed assets as lenders start to take a harder line in 2021. This is reflected by new fundraising where private debt fundraising has already been at an all-time high in the lead up to 2020 – since 2015, $12bn of private debt has been raised for funds investing or lending in real estate globally (Source: Preqin).

With precedent established from the global financial crisis of 2008, we expect these debt funds to replace the role of bank lenders in the hospitality market for at least the next 18 to 24 months while banks focus on the damage to their own balance sheets with respect to the asset class. Banks will particularly struggle to underwrite hotel loans given the lack of historical operating performance from this year, as hotels will be unable to prove that they can maintain appropriate debt yields and coverage ratios. In keeping with this more cautious approach to hospitality lending, it is likely that banks will continue to lend at reduced leverage levels for the near future (for loans that they do issue), at around 50–55% LTV.

Banks should take all information into account when making decisions about how to work with borrowers. While reduced or deferred payments and debt restructuring are far from ideal, drawing too hard a line during times of financial difficulty for borrowers and economic uncertainty overall could result in losing a valuable relationship. Borrowers who genuinely want to bounce back are great assets compared to unoccupied real estate.