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# Current Trends in Non-Performing Hotel Loan Investments

Robert Tutag
*Developers Diversified Realty*

Arjun J. Singh
*Michigan State University*

# Current Trends in Non-Performing Hotel Loan Investments

*Overview, Market Opportunities, Challenges, and Investment Strategies*

## Introduction

Based on recent estimates, outstanding commercial real estate debt in the United States is at $3.12 trillion (ULI and PwC, 2010). Of this universe, there are currently over U.S.1.5 trillion in commercial real estate (CRE) mortgages coming due over the next four years. Some industry experts estimate half of these maturing CRE loans may be "under-water" (Grinis, 2010), where the debt service is higher than the underlying market value of the asset. As such, debt buyers today are keen to acquire properties at significant discounts to their loan values- offering far greater savings than purchasing the property through traditional equity (Heschmeyer, 2010). Lenders are interesting selling loans which are not performing (when a borrow does not meet debt service) because they may want liquidity on their balance sheet, regulators or investors could force a loan sale or the lending institution may be failing and receivers sell the assets individually or collectively. According to Bruce Lowrey of RockBridge Capital, "a rolling loan gathers no loss." Thus far in the crisis, "extend and pretend" (Appendix B), where banks allow borrowers more time to repay their loans, has continued to be the resolution of choice (Barrack, 2010). Non-performing loan (NPL) pricing has, and continues to be, the largest barrier to greater NPL sale transaction volume. However, recent reports suggest that the bid-ask gap may be narrowing and increased transaction volume could materially increase in the near future (Grinis, 2010). Furthermore, as the percentage of high risk non-performing loans have increased in bank portfolios, there is an increase in the number of NPL loans available, as banks want them removed from their balance sheets.

Experts estimate that hospitality debt is at $350 billion or about 10 percent of the total Commercial Real Estate loans outstanding. The weak operating and economic fundamentals since 2008 have increased the pressure on several hotels to meet their debt service obligations. As such, many of these loans are in various stages of distress. In some cases loans are coming due and borrowers do not have the ability to refinance these loans. In several cases, banks have failed to further extend or restructure loans and the negative equity has made it prudent for the borrower to hand over the keys to the lender, colloquially known in the industry as "Jingle mail." (Appendix B) In a growing number of cases, where the borrower has not paid its scheduled payment for 60-90 days banks and special servicers have initiated foreclosure proceedings to take back the hotel asset. A case in point was the 258 room W hotel in San Diego, owned by Sunstone Hotel Investors, a REIT. Debt for the hotel was part of a CMBS pool ($60 Million), originated in 2007. By 2010 the hotel could not pay debt service and hotel was worth less than the loan. As a result Sunstone Investors returned the hotel to the lender. In fact Sunstone turned over a total of 11 hotels to their lender Mass Mutual in 2010. As a result of this strategic decision, Sunstone reduced its debt burden from $434 million due to mature in 2011 to $180 million with maturities through 2014. From the company's perspective this decision has improved their credit profile, debt maturity schedule, portfolio quality and made cash available to take advantage of opportunistic investments for growth, (Commercial Real Estate, 2010).

In other cases these loans are already a part of lender's increasing pile of REO (Real Estate Owned) assets (Appendix B). In the hospitality industry hotel distress started as early as 2008. Real Capital Analytics, which tracks distressed real estate assets, noted that as of June 2009, there were over 1000 troubled hotel assets worth $15.7 billion, (Higgins, 2009). In California, for example, a survey conducted by the Atlas Group revealed that in the 4th quarter of 2010, 465 California hotels were in default or had been foreclosed on (Atlas Hospitality Group, 2010). Many of these defaulted loans trace their origins to the boom times between 2005-2007, when capital was available and loan underwriting standards were lax. Several of these loans were pooled into Commercial Mortgage Backed Securities (CMBS). These loans started to unravel in 2008-2009, beginning with delinquency and graduating to foreclosed status. While in the early stages most of these properties were unbranded, limited service in nature, later they started to include branded properties in prime locations (Walsh, 2009). As a response to these potential opportunities several investment funds, REITS, and overseas buyers have emerged in the past year with a specific focus of investing in non-performing hotel debt and equity. These are similar in nature to the opportunity funds which emerged in the early 1990's and may be defined as "a source of capital that has a contrarian investment focus on under-performing properties and loans" (Carlson, 1997). A case in point, Colony Capital in partnership with Cogsville Group won a bid on US$1.85 billion of distressed commercial real estate loans which were auctioned by the Federal Deposit Insurance Corporation (FDIC) in the summer of 2010, (Turner, 2010). Table 2 outlines an illustrative list of distressed investment transactions in the past two years which were opportunistic in nature.

## Purpose and Significance of Study

This study is designed as a primer to create a baseline understanding of trends in non-performing commercial real estate loans and specifically hotel loans. The study will seek to define non-performing commercial real estate loans, understand the historical economic and regulatory factors that created conditions for non performance describe and identify the current participant buyers and sellers, for non-performing loans and analyze several investment strategies to opportunistically invest in non-performing commercial real estate loans, with an emphasis on hotel debt. The timeliness of study is its primary contribution as it would document the players, processes and investment strategies during this unique and less understood period in the real estate investment cycle.

## Methodology

This study will primarily rely on an extensive review of secondary sources to include historic and current literature, company reports, white papers, books and conference proceedings. In addition, the research will supplement this information with a structured survey and phone interviews with experts knowledgeable about the non-performing hotel loan market (Table 1).

## Economic and Regulatory Causes of Commercial Real Estate (CRE) Distress

To fully understand today's CRE NPL investment market, it is important to study and analyze previous real estate cycles to gain the necessary perspective. The 1974 passage of the Employee Retirement Income Security Act (ERISA) required pension funds to have enough capital on-hand to fund future pension benefit liabilities promised by the fund. ERISA's implicit sponsorship of Modern Portfolio Theory, a financial theory supporting broad diversification across asset classes, led fund managers to look for new asset classes to allocate capital. Real estate was a natural progression to consider outside of traditional stocks and bonds. During this time, pension fund contributions ballooned as the baby-boomer generation was thrust into the labor force. As a result, institutional capital made its first major entrée into commercial property investment (Geltner, 2001).

In 1982, the Reagan administration passed a real estate tax-cut incentive that furthered the inflation protection/institutional allocation derived demand for real estate investment. The tax change allowed increased depreciation and pass-through to ordinary income of losses experienced through CRE investments. Of equal importance, deregulation of the savings and loans industry allowed S&L's to invest in CRE mortgages for the first time. The tax incentives and new source of capital combined to continue the boom in CRE valuations until the mid-1980's (Geltner, 2001).

The continued boom in CRE valuations combined with tax incentives that did not always align the investor's investment value with underlying property fundamentals, contributed to one of the largest construction booms in history. The Federal Deposit Insurance Corporation (FDIC) insurance and its related moral hazard gave incentive to the inexperienced Savings and Loan institutions (S&L's) to finance much of the new construction; which they did. The Tax Reform Act of 1986 reversed the CRE tax-benefits passed by the Reagan Administration and destroyed tax-driven demand for CRE. Additionally, tighter monetary policy stabilized the Consumer Price Index (CPI) and hampered real estate's appeal as an inflationary hedge. These two factors combined with the extreme overbuilding in the space market and resulted in an erosion of CRE asset market valuations. An economic recession and stock market drop in 1990 finally caused the already weakened commercial property market to suffer catastrophic losses. CRE asset-valuations fell 40-50 percent peak to trough from 1989-1992 (Geltner, 2001). This devaluation was the largest the industry had experienced since the Great Depression (Geltner, 2001). Commercial real estate loan balances, which were underwritten with high loan-to-value ratios by thrift institutions, exceeded the value of the property. Thus commercial real estate developers and owners found themselves in a negative equity position, and chose to exercise their "put option" by defaulting on their mortgages. The savings and loan crisis had begun.

Congress responded to the S&L crisis by passing the Financial Institutions Recovery, Reform, and Enforcement Act of 1989 (FIRREA). FIRREA set up the Resolution Trust Corporation (RTC), a government corporation, with the goal of selling large number of non-performing commercial real estate mortgages held by failed S&L institutions taken over by regulators after January 1, 1989. The RTC liquidated failed thrift's CRE loan portfolios through direct bulk sales, bulk sales via auction, and mortgage securitizations. In regard to mortgage securitization, FIRREA created the incentive to financially engineer CMBS by imposing risk-adjusted capital requirements on financial institutions; this innovation would then allow them to hold assets in securitized form rather than as whole loans. Non-performing Loan (NPL) bulk-sales employed extensive equity partnerships with private sector investment funds to allow for RTC participation in the NPL investment's upside. The private sector partner would acquire a partial interest in a pool of assets, controlling the management and sale of assets in the pool, and would have a fiduciary responsibility to distribute profits back to the

RTC reflective of the RTC's retained interest in the pool. Private sector general partners were selected based on price bid as a percentage of the derived-investment value (an estimate of liquidation value based on a valuation formula developed by the RTC). The highest qualified bidder in a competitive auction won. Government financing to facilitate the deal was handled in two ways. In RTC S-Series and Multiple Investor Fund (MIF) Partnerships, the RTC offered up to 79% direct seller financing from the RTC. On the other hand, RTC N-Series Partnerships were leveraged by issuing CMBS, the proceeds of which went to the RTC. Seller financing or CMBS debt service had the first claim on any NPL pool cash flows. After first claim debt service was paid, residual cash flows were divided between the private sector investment fund and the RTC pursuant to their respective equity ownership. Overall, the RTC disposed of $394 billion of assets from 747 banks between 1989 and 1995 according to an FDIC published report in 2000 (Bloomberg, 2009).

Real estate opportunity funds were created to take advantage of the RTC loan and property sales. The first opportunity fund created to capitalize on RTC NPL debt liquidation was Colony Capital I. Colony's founder, Tom Barrack, recognized the enormous opportunity through his successful experience purchasing distressed CRE debt from the government's first good bank-bad bank structured bail-out, American Savings. Colony I was organized with a finite life with a goal of midterm extraordinary gain rather than long-term residual growth. Other industry leaders followed suit with massive success. Overall, average internal rates of return on opportunistic CRE NPL funds from 1991 to 1995 were 70% with average finite life of 18 months (Conwell). By 1995 most of the NPL problems in the U.S. had been resolved. However, no one in the CRE industry forgot the great success enjoyed by practitioners skilled in recognizing and realizing opportunities in CRE NPL's (Haas, 2006).

The unprecedented expansion of the REIT industry and the development of the Commercial Mortgage Backed Securities (CMBS) industry resultant from the FIRREA regulations and the S&L crisis contributed to relative stability and growth in CRE valuations until around 2007. Low interest rates and a regulatory environment that encouraged easy credit led to an enormous asset price bubble to form in housing prices. The bubble eventually burst and exposed extensive fraud, counterparty risks, and over leveraging throughout the financial sector as a whole. During the unprecedented rise in residential home prices, new securitization innovations led to lax underwriting standards in commercial real estate as well. Commercial real estate rental increase projections were estimated at levels that, in hind-sight, were completely unjustifiable and unsustainable. Real estate professionals and building owners always assumed a steady growth model at either the Consumer's Price Index for the area or a flat 3% increase in yearly rental rates. They did not however, realize that because of their high Loan to Value Ratios, any corrections in the rental market due to outside economic factors such as a housing valuation bubble or the forced bankruptcies of large auto manufacturers to name a few, would create not only a decrease in rents but also vacancies thus perpetuating the decline of CRE values. On new acquisition transactions, capitalization rate contraction was so severe that cap-rates were, in some cases, only basis points above the risk-free interest rate. Eventually, values began to reflect the true space market fundamentals, (*it is interesting to note that on an inflation adjusted basis, there has been virtually no rental rate growth across any product type since 1994* (Barrrak, 2010), and greatly increased risk in the market. Increased CRE leverage and expanded exit valuations dried up and underwriters responded with decreased Loan-to-value ratios across every product type. Thus, greatly reduced value and insufficient capital has rendered CRE owners unable to refinance their maturing debt obligations. This problem has been exponentially multiplied by the massive amount of CRE loans for 2005 vintage with five-year balloon provisions. The resultant CRE NPL fall-out is a large part of the current economic crisis and experts predict it will continue or expand going forward (Levy, 2010).

**Individual Borrower Default: Decision Framework**

There are several stages that a CRE loan goes through to reach non-performing status. Inasmuch as many commercial mortgages contain an exculpatory clause (the only thing a lender can take in the event of default is property pledged as collateral), a type of borrower's put option exists for commercial property owners with such non-recourse mortgages encumbering their property. Put options allow the option holder the right without obligation to sell a specified asset at a specified price (Geltner, 2001). When analyzing the quasi put-option inherent in non-recourse lending, it is evident that the underlying asset is the collateral property. Because the borrower has the ability to default on the loan, this effectively allows the borrower the ability to sell the property back to the lender at a price equal to the value of the outstanding loan balance (Ciochetti,1998). Through default, the borrower is thought to "put" the property back to the lender and rid himself of the book value liability of outstanding loan balance (Geltner, 2001). High loan-to-value rates on vintage 2005-2006 originated commercial real estate loans combined with the subsequent destruction of CRE values has created an enormous proportion of outstanding loans meeting this criteria. Such borrowers may be thought to be in a position of "negative-equity". Default suddenly makes sense for a borrower whenever the net present value (NPV) of the property's future expected cash flows is less than the outstanding balance on the loan. Consequently, some of commercial real estate borrowers have chosen to exercise this quasi "put" option. In the hotel industry the most recent example is of Sunstone Hotel Investors that handed back 11 of their hotel properties to the lender, MassMutual in 2010. At the time of the strategic decision last year, market value of the portfolio was about $173 million, and it launched a schedule of giving back hotels that had become worth less than what was owed on them during the downturn. According to their Chief Financial Officer, this was a value creating strategic decision as it benefited the company's credit profile, debt maturity schedule, and overall portfolio quality and allowed them to position for new acquisitions. The restructured position reduced Sunstone's debt maturities through 2014 to $180 million as compared to $432 million in 2009 (Commercial Real Estate Direct.com, 2010).

## Performing and Non-Performing Loans

The process begins when the property owner chooses, or is forced, to miss a scheduled monthly payment. After missing a single or in some cases subsequent monthly payments, the loan is classified as "delinquent" and depending on the terms of the note could be in "default". The borrower typically still has plenty of room to negotiate and make-up the initial payment. However, once the loan has gone past due by 60 days, or two scheduled payments, servicing functions are transferred from the master servicer/sub-servicer, who is charged with monitoring the distribution of interest and principal payments, and handling routine services such as bookkeeping and collecting payments, to a special servicer who is charged with deciding the most effective manner to workout the loan. These strategies could consist of modification, curing the delinquency, foreclosing on the property, or selling the note/mortgage. It is also important to note that at this stage in the default process, the loan is classified as a non-performing commercial real estate loan. Appendix B has identified several new terms related to distressed debt which have become part of the new lexicon in real estate.

**Motivations for Lenders to Sell Non-Performing Loans**

In unforced hold-sell banking asset management decisions, it only makes sense to sell a NPL if the sale proceeds would be higher than the new present value of the net cash inflows from the loan (Appendix A). Banks consider all costs of staff, costs of execution proceedings, additional capital expenditure required to sell the collateral asset, and all other costs associated with working out the NPL versus the total discounted realizable value of principal repayment at maturity combined with all discounted interest payment cash flows. If costs exceed the NPV of all discounted cash flows associated with the mortgage, then holding onto the loan represents a negative NPV decision; the loan should be sold in such a case. Investment managers operating under opportunity fund structures typically employ highly specialized professionals experienced in executing all workout responsibilities and tasks in the most efficient and cost effective manner. This difference in total cost of workout between the banking institution and private investment funds often provide the motivation necessary to facilitate a transaction. Banks typically focus far more on nominal values of their assets due to accounting, capital regulatory, and pressure to meet earnings rather than in net present value. On the other hand, NPL investors focus on the present value that each individual loan within the portfolio can bring to the investment portfolio and the firm's clients. Moreover, NPL purchasers are not engaged in relationship-banking with the debtor. Therefore, any concerns about damaging a relationship by harshly enforcing all provisions of the loan and extracting as much as value as possible from the debtor will not likely result in decreased future earning potential. NPL loan divestment also allows banks to lower their ratio of risk assets and improve their capital regulatory ratios to comply with Basel II risk-based capital regulatory requirements. Speaking on a distressed loan panel at the America's Lodging Investment Summit, Mr. Joel Hiser, Principal at Horwath HTL, stated that regulators are not pressuring banks to sell the loans as was the case in the previous cycle of the early 1990s. In this case the banks have a lot more leeway because the loans are so distressed, (ALIS conference, January, 2011). Table 2 has identified some high profile non-performing hotel loan transactions.

## Investors in Distressed Commercial Real Estate Debt

A typical pattern of commercial real estate investments during a downturn has been the emergence of alternate sources of financing when traditional, risk averse, sources of capital are scarce. A type of market participant that invests in either distressed assets or debt securities has been known as a "contrarian," "opportunity" or "vulture," investor. As such, these investors which are generally organized as funds acquire under-performing hotel properties (or other forms of real estate) and loans, with the purpose of turning around the investments through repositioning, restructuring, or updating, and then waiting for the market to improve before disposing the investment. Many of these funds started in 1990 when the Resolution Trust Corporation was disposing of the real estate assets of failed S&Ls. The majority of the early acquisitions of these funds were during the period from 1990–1992, generally considered to be the bottom of the real estate cycle, (Singh, 1999).

As noted previously in this article, current underperforming and non performing loans have created  climate conducive for opportunistic investment in commercial real estate debt, as such several opportunity funds started to emerge in 2008. Of the $85 billion tracked in real estate investment fund raising in 2008, 58.6 percent were opportunistic, (Anderson, Cascioli, et al, 2009). Among these funds, the five largest were: The Blackstone Group, Morgan Stanley Real Estate, Goldman Sachs, Colony Capital and Beacon Capital Partners, (Shilling and Wurtzebach, 2010). Acquisition Funds with a specific interest in Hospitality distressed investments have also emerged and are outlined in Table 3 of this article.

In addition, hedge funds are most likely to invest in distressed debt. These funds are largely unregulated and organized as limited liability companies or partnerships for the express purpose of investing. The light nature of regulatory oversight gives them a competitive advantage in alternative investments such as distressed debt, (Eisenberg, 2007). As seen in the current cycle Hedge funds typically invest, “when default rates are high, recovery rates are low or when spreads are significantly wide…” (Chen, Gonzalez, et al, 2008). In the opinion of Scott Tross, an expert on foreclosure law, hedge funds are the largest buyers of distressed debt as they demand a high return, which distressed debt has the potential to deliver, (Bergsman, 2006).

A recent research article evaluated the return expectation of value added and opportunistic investments. Typically, these investments target a wide range of commercial properties involve a high degree of risk and potential for value creation. The goal of value added real estate funds is to achieve a 12-18 percent return, while opportunistic funds look to generate returns in excess of 18 percent IRR, with a much shorter investment horizon. Typically, these funds have a high degree of leverage, which along with market timing and cheap debt are the primary return drivers, (Shilling and Wurtzebach, 2010). In a related study, (Sterling, Fridson and Kong, 2009), the authors studied the comparable returns of distressed bonds rated double-B with an index of distressed bond investments. The results indicated that distressed double-B sample generated a return of 54.38% compared to a negative (-17.42%) return for the distressed index in a bear market. The investment implications for distressed debt manager in the present market, characterized with rising default rates, is that investment in double-B distressed segment has the potential for driving portfolio returns.

**Investor Motivations**

The NPL investor's motivations may be long-term, short-term, or anywhere in between. The investor may purchase the loans to hold until maturity after a work-out with borrower has been reached; or they may be attempting to capitalize on a perceived mispricing in the loan and realize their investment return through immediate sale to another buyer. Interestingly, Tom Barrack of Colony Capital notes the majority of secondary market CRE debt buyers are presently focusing on yield, rather than residual value (Barrack, 2010). In Mr. Barrack's blog, he states that, "near zero interest rates and bank borrowings are fueling leveraged returns to financial buyers on fixed income instruments at values which are solely focused on some positive cash flow fortified with zero interest rate borrowings and purchasers are unfazed by maturity date shortfalls."

Investors can also exploit economies of scale and scope if they specialize in purchasing NPL's and obtain a critical mass where cost per workout decreases materially (Schafer, 2010). Most significant to commercial real estate NPL investors is the ability to speculate on and acquire undervalued CRE at a discount. Many CRE investors have employed a "loan-to-own" strategy with enormous success by purchasing non-performing senior commercial real estate mortgages, commencing foreclosure proceedings, bidding on the property at public auction, and if successful, adding the property to its investment portfolio to pursue whatever value creation strategy that appropriately fits the investor's goals and risk-tolerance (Appendix A). The purchase of the non-performing mortgage prior to foreclosure gives investors a significant advantage in the auction process by providing the investor with superior information about the property through its position as a secured creditor. Commercial mortgages also typically contain a "lender in possession clause." This clause gives the lender automatic right of possession of the property after a borrower defaults on the loan. The "lender in possession clause" allows the lender to control the maintenance, leasing and other general property level issues leading up to the foreclosure process. This clause may allow the loan-to-own lender/investor to prevent loss of value in the property during a prolonged foreclosure process (Geltner, 2001). Most importantly, the investor can bid full face value of the allowed secured claim as opposed to a discounted purchase price during the auction proceedings, giving the senior creditor a significant advantage in the foreclosure auction (Schafer, 2007).

While most buyers today are looking to obtain access to the asset through any borrower default, others are finding attractive risk adjusted yields with an immunization strategy (Appendix A). One such group is Prudential's Capital Partner's Mezzanine Fund. Prudential will purchase non-performing hotel loans and extend the loan, modify terms such as levels of escrow collections, and work with the borrower to create a structure that will allow for attractive yield through maturity. Those with equity positions in the underlying property are also stepping up to purchase the non-performing debt. Inasmuch as equity owner/managers typically know the asset best, they are usually in a position to make the most attractive risk-adjusted offer.

High profile transactions tend to be generating the most investor interest today. Loans with unpaid balances of over $25M are seeing the most activity and investor interest. Smaller notes, with unpaid balances between $10M and $15M are typically being extended or modified, rather than sold. Large investment funds are seeking to obtain "trophy" assets that rarely come to market and have a history of strong operations in supply constrained markets (Appendix A). Table 3 has identified the major investment funds focusing on distressed hotel assets and loans.

While investor strategies and tactics associated with distressed debt vary with the individual situation, a relatively recent empirical study on the investor objectives clearly categorizes the two broad strategies adopted by investors in distressed debt. The study surveyed 364 institutional investors of which 82 invested in distressed debt, (Harner, 2008). A summary of the relevant findings from the study are outlined below.

- Survey results point to an increase in the amount of assets allocated by investors to distressed debt and a sentiment to increase investments.

- Approximately 72 percent of the respondents indicated that their investment horizon for distressed debt before liquidating was within 24 months, with about 50 percent indicating a liquidation period between 10 and 18 months.

- Based on the top three debt investment preferences, respondents identified their debt investment preferences as, senior secured bank debt (35%), high yield bonds (26%), and mezzanine loans (15.5%). Approximately 78 percent indicated that they invested in multiple tranches of debt.

- The two primary investment strategies adopted by investors in distressed debt were the use of their debt holdings to influence board and management decisions and secondly to acquire a controlling interest in the firm. More than 70 percent of the respondents noted that they try to exert influence through controlling the operational strategy of the investment. A majority of those using the debt investment to acquire a controlling interest in the firm used the "loan to own" strategy (68%).

Two other studies focused on the competitive advantage that potentially drive superior returns for opportunistic investors. These focus on specific qualities or traits of investors in distressed investments, versus investment strategies. As noted by Gilson (1995), success may be attributed to their superior quality to value firms assets based on their expertise in getting information, and industry knowledge. Furthermore, their experience gives them a competitive advantage for negotiating, bargaining and exerting their influence as "rescue capital" by discounting the purchase price. Finally, the opportunistic investor's previous experience in the arena provides them insight into the true risks of the venture and they conduct a thorough due diligence to mitigate their risk exposure. A similar argument is extended by Noe and Rebello (2003) whose research shows that a vulture's reputation for toughness allows them to limit the value distributed to other claimants. A large part of this skewed negotiating position is a result of information asymmetry on the value of the distressed debt. In this regard, the vulture's private information allows the firm to become marginal creditors which maximize their leverage in debt-purchase negotiations.

### Process of Buying and Sourcing Distressed CRE Loans from Banks

CRE NPL whole loan sales undertaken by traditional banking institutions typically follow two distinct legal structures for execution. NPLs can be transferred to a purchaser individually by assignment in what is referred to as an Asset Deal. On the other hand, NPLs can be placed in a company that is subsequently sold to the purchaser in what is referred to as a Share Deal (Schafer, 2010).

### Public Private Distressed Loan Partnerships Today

Today's CRE NPL investment market is extremely similar to the S&L era market. The FDIC has replaced the RTC as the government's representative. Meanwhile, many of the same opportunity funds that profited from the S&L crisis are among those active today. According to data compiled by Bloomberg, some NPL sales are occurring for only 22 cents on the dollar. Today's sales often include no-interest financing from the agency responsible for insuring the mortgage. However, the FDIC is attempting to avoid the criticisms of the RTC era that the government allowed assets to go for valuations far below their inherent investment worth (Keehner, 2010). It is doing so by keeping up to 50% stakes in the loan portfolios and demanding as much as 70% of loan sale gains (Bloomberg). Innovative partnership structures are helping the FDIC obtain its goal of compensating taxpayers for the risk they take on. For example, a recent deal involving the sale of a company holding $4.5 billion of non-performing commercial real estate loans, originally held by failed Chicago lender Corus Bankshares Inc. to an investment fund led by Starwood Capital, required Starwood to agree to an "equity kicker" with the FDIC (Table 2). In this transaction, the equity kicker will increase the FDIC's stake in the deal from 60 percent to 70 percent if the Starwood led investment fund makes back twice its initial invested capital, Starwood is then required to pay the FDIC a 25% internal rate of return in addition to whatever return they are already entitled to (Keehner, 2010). At the property level, an example of value creation through FDIC leverage is the Carlos Ott-designed Artech condominium "loan-to-own" acquisition in Aventura, Florida. In order to facilitate higher sale prices of condo units, the FDIC pledged up to $1 billion in working capital to help the Starwood investment fund complete construction and sell the units at a price favorable to the FDIC-Starwood partnership (Keehner, 2010).

The FDIC alone sold about 3,500 commercial real estate loans with a book value of more than $6.1 billion last year; combined with other agency loan sales, the total amount for 2009 was $10 billion. However, as of April 14, 2010, over $8 billion in total loan sales have been completed for 2010 (Heschmeyer, 2010). The FDIC has arranged over $850 million in interest-free government financing to support these 2010 deals. Much like the RTC priority of claims structuring, private equity buyers cannot keep any profits from loan sales or restructuring until the FDIC's interest-free financing has been repaid in full. FDIC interest-free financing has received some criticism by members of government and academia for artificially increasing prices by as much as 20% leaving the FDIC's core responsibility, the insurance of depositor's accounts in national banks, threatened. Linus Wilson, a finance professor at University of Louisiana stated that the FDIC could take significant losses if private equity fund managers cannot recover as much of the NPLs as they expect. Wilson suggests that a better structure would eliminate the government's stake completely and provide no agency seller financing. He reasons that this would protect the FDIC's core responsibilities and allow the agency to collect cash much more quickly (Keehner, 2010). FDIC Chairwoman Sheila Blair defended the interest-free financing stating that it is necessary to help pricing move to an equilibrium level that clears the market. FDIC spokesman Andrew Gray affirmed that the agency seller financing is made on a deal-by-deal basis and will not necessarily continue if conditions within the market change favorable going forward (Keehner, 2010).

## Distressed Loan Acquisition Due Diligence

Extensive due diligence on behalf of investment buyers is absolutely necessary for an investment fund to achieve success in a CRE NPL purchase. In addition to thorough examination of the loan itself and the underlying property serving as collateral, investment buyers must engage in a thorough legal review of all applicable loan documents and the servicing records. The buyer should research the public record to confirm that all filings and recordings have been properly recorded in order to ensure the priority of the noteholder's security position. According to distressed real estate attorney Charles Weiss, buyers should: "(1) review the required payment terms, including the timing and amounts of required payments and whether any party with assets other than the primary real estate collateral is liable for payments through a payment guaranty; (2) verify the purported collateral for the loan and that the collateral is properly granted to the loan holder; and (3) thoroughly review all remedy exercise provisions to ensure that they are complete, unambiguous, and adequate in scope, and that they are effective and enforceable under applicable state law to achieve their intended purposes. For instance, for properties in states providing for non-judicial foreclosure, the Buyer should ensure that all requirements necessary for a non-judicial foreclosure are complied with, since judicial foreclosures are typically far more expensive and lengthy (Weiss, 2010)."

Investment buyers should also review "carve-out guaranties found in the mortgage. A carve-out guaranty, also known as a "bad-boy" guaranty (Appendix B), exists in a non-recourse commercial real estate mortgage to trigger full recourse against the borrower in cases of fraud, declaring bankruptcy, misapplication of funds, transfers of the mortgaged property, other egregious behaviors (Falby, 2010). Reviewing the carve-out provision helps ensure that sufficient incentive exists to prevent such behaviors detrimental to the value of the collateral property and therefore the loan. Verifying that all material documents were executed properly, notarized, and witnessed is also essential. Investment buyers should evaluate the background, financial position, track record, and credibility of the borrower to determine the likelihood of their performance under a restructuring or their cooperation in giving back the collateral. A buyer's declaration of bankruptcy or commencement of adversarial litigation would also destroy the loan value and significantly increase investment buyer costs. The probability of this happening should be evaluated. Investment buyers should review the history of the loan and read all available correspondence between the borrower and the note holder. The investment buyer should be on the lookout for any acts that might give rise to a borrower's argument that certain requirements or covenants of the mortgage document/note had been waived expressly or implied by informal written agreement, course of dealing, or oral agreement. For example, a note holder's failure to exercise remedies in response to continual, material defaults by the borrower or accepting partial payments and deficient performance on non-monetary obligations could constitute a case that modification of the loan occurred.  The buyer should also be looking for any evidence that would show the likelihood of the borrower taking action against the lender for any lender liability claim. Examples of lender liability claims include, not giving required notices before exercising remedies, acting in bad faith, taking a commanding role in the borrower's business to its ultimate detriment, or negligently administering the loan.  Consequences of lender liability claims can be very punitive.  While this article focuses primarily on senior non-performing mortgage investment, it is important to note that lower security interest NPL purchasers must engage in the same due diligence, perhaps to an even greater extent.

Distressed mezzanine loan buyers must fully analyze the relative collateral positions, duties and rights of all other lenders applicable under intercreditor agreements. Moreover, if a mezzanine buyer takes ownership of the borrowing entity's corporate stock (or whatever collateral pledged in the mezzanine agreement), then the buyer becomes subject to all contractual and tort-based liabilities of the owning entity. Therefore the buyer should review and analyze all entity level, in addition to property level, information available.  One positive attribute to subordinated CRE NPL investment such as mezzanine loans, is that mezzanine debt foreclosure is governed by the Uniform Commercial Code, rather than a judicial sale.  This greatly reduces the time it takes for the investment holder of the NPL to obtain the collateral.  Mezzanine foreclosures typically take as little as three to four weeks.  Senior CRE NPL foreclosure usually requires at least six weeks and can sometimes take six months or longer.  No matter where the opportunistic CRE NPL investor chooses to acquire along the security-interest spectrum, extensive due diligence is critical to a successful deal and an attractive risk-adjusted return (Weiss, 2010).

### Issues Specific to Distressed Hospitality Loan Acquisition

One of the largest impediments to increased distressed hotel loan sales is the industry's reliance on management agreements. Hotel management agreements (HMAs) spell out the relationship between the hotel management company and hotel owner. Of particular importance to hospitality debt purchasers are the provisions in the Subordination, Non-Disturbance, and Attornment Agreement (SNDA). Ensuring that the hotel management agreement is subordinate to the mortgagee's claim is essential to prudent debt acquisition and hedging the purchaser's risk. Most hotel loans contain a non-disturbance provision with the hotel management company. Lenders usually agree not to disturb the management company's control/quiet enjoyment of the hotel, and not to terminate the hotel management agreement executed by the owner (Butler, 2008). Thus far, such non-disturbance agreements have withstood judicial scrutiny despite numerous challenges (Barrack, 2010). The Non-Disturbance clause of the SNDA causes few issues while the loan is performing. However, when the loan goes into default, the clause can severely affect flexibility and asset value (Butler, 2008). Special servicers or banks looking to foreclose or sell hospitality loans may face further losses by not being able to deliver the asset free and clear of a management contract (Barrack, 2010). Eighty percent of distressed hotel debt or equity buyers over the past 20 years were either branded hotel management companies or a joint venture of a capital source with a branded hotel management company (Butler, 2008). Clearly, asset values are greatly affected when the largest purchaser (strategic buyers), do not have the right to terminate a competitor's management contract and substitute their own (Appendix A).

## Liquidity in Today's Marketplace

Some of the world's largest commercial real estate brokerage houses are experiencing a boom in business related to the flood of CRE NPL assets entering the market. Cushman & Wakefield, Colliers International, and CB Richard Ellis have all established in-house asset recovery groups to work though the distressed debt (and property) expected to enter the market (Fleming, 2010). Troubled assets flowing into the asset recovery group accounted for over a third of Colliers International's 2009 deal flow. So far in 2010, CB Richard Ellis has been tasked with selling over $5 billion in non-performing CRE debt. Brokerage companies are aggressively recruiting professionals with experience working through the Savings and Loans crisis. Brokerage firms note that in the RTC era, the federal government was much more concerned with quick resolution of troubled assets than they were with price. In today's environment, the federal government and financial institutions have remembered the huge profits made by RTC opportunity fund investors and are remaining much more steadfast in trying to hold onto non-performing loans to workout in-house, rather than by selling them. New banking regulations set forth in the FDIC's "Policy Statement on Prudent Commercial Real Estate Loan Workouts" exempt banks from mark-to-market write-downs on previously "impairment-required" categories of CRE debt where residual value is significantly diminished (Barrack, 2010). "Doubtful assets" are defined by the FDIC as, "an asset that has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable (FDIC)." Such doubtful assets were previously required to be marked-to-market under the previously subscribed to policy statement, "Review and Classification of Commercial Real Estate Loans (June, 1993, FDIC)." Regulations that permit banks to not recognize problem CRE loans significantly diminishes transaction volume within the asset class and prevents natural economic forces from cleaning out the market and restoring liquidity to global financial markets (Appendix A). Spencer Levy of CB Richard Ellis states that, "banks and special servicers have the ability to hold on longer to non-performing loans this time than in the early 90s, and they're going to (Fleming, 2010)." However debate in the brokerage community will rigorously continue as to if, and when, major non-performing commercial real estate loan capitulation by American financial institutions will occur (Fleming, 2010).

## Methods of Sale

For regulated institutions, the motivation as to how loan sales are carried out is somewhat self-preservation. The institution needs to be able to demonstrate to regulators that they are broadly marketing their assets to the highest bidder. This is severely limiting direct sales to specific buyers. On the other hand, non-regulated institutions and CMBS Special servicers focus on maximizing total value (net of marketing/closing costs). These groups are more inclined to engage in direct sales with select buyers. To accommodate the enormous demand for CRE NPLs and the bank's need for professional marketing, some loan sale advisors resorted to technology to improve the availability of information and create a more efficient auction process for investors. The Carlton Group, a global real estate investment bank, recently launched CEX Mobile, an internet based auction program that allows potential property bidders to access due diligence information and make bids for loans using their Blackberrys or iPhones. According to Carlton Chairman Howard Michaels, Carlton is currently selling $2 billion in CRE NPLs and REO assets. Bidders are requiring 24/7 access from their handhelds. Collateral information, servicing files, and loan documents are all available for download through the CEX program (Kalette, 2010). Other debt auction websites such as DebtX have seen significant traffic and volume. Traditional marketed sales through Requests for Proposal continue to be effective, but are gradually being replaced with technological innovations (Appendix A). The commercial real estate industry clearly has adapted their business model with resounding flexibility, speed, and execution.

## Conclusion

With most, if not all, sectors of commercial real estate property investment showing deteriorating fundamentals and a significant lack of financing interest, the market for distressed commercial real estate backed debt is burgeoning. According to Bruce Lowrey of RockBridge Capital, "loose monetary policy has pushed rates down to near zero and allowed borrowers with floating rate loans to meet debt service, those with fixed rate debt or balloons maturing may not fare as well". Conditions today in the CRE debt markets are extremely similar to the RTC era. It is not surprising that many of the RTC era's leading investors are thriving today. Sourcing, negotiating, and closing attractive, non-performing commercial real estate loans is extremely difficult and requires connections, credibility, and a large investment capital base. However, there is the potential to earn very attractive risk-adjusted returns by sophisticated commercial real estate investors with the experience, knowledge, risk-appetite, tenacity, and determination to work through the enormous construction, performance, and litigation issues surrounding the underlying properties.

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Robert Tutag, is a Fund Management Analyst at the Developers Diversified Realty. Arjun J. Singh, Ph.D. is an Associate Professor in the School of Hospitality Business, Michigan State University.

**Table 1**

**Participants in Phone Survey Interviews and Industry Resources**

| NAME | TITLE | AFFILIATION | INTERVIEW DATE |
|---|---|---|---|
| Mark Bratt | Executive Vice President and Chief Investment Officer | Developers Diversified Realty Corporation | November 27, 2010 |
| Angelo Stambules | SVP Mortgage Banking | Marriott International, Inc. | December 7, 2010 |
| Bruce Lowrey | Managing Director | RockBridge Capital, LLC | January 11, 2011 |
| Joel Hiser | Principal | Horwath HTL | January, 2011 |
| Adam McGaughy | Vice President | Jones Lang LaSalle Hotels | January, 2011 |
| Richard Conti | President | The Plasencia Group | November, 2011 |

**Table 2**
**Recent Non Performing Hotel Loan Investments**

| Seller | Buyer | Transaction Summary | Investment Strategy |
|---|---|---|---|
| Hilton Lenders | Blackstone Group | In 2010, bought $3.8 Billion of Hilton Debt. Paid cash $800 million buy $1.8 billion debt and converted balance to preferred equity. | Debt restructuring and purchase of its own debt at a discount. Reducing debt load while the economy recovers. |
| FDIC | Colony Capital and Cogsville Group | US$1.85 billion of distressed commercial real estate loans auctioned by the Federal Deposit Insurance Corporation, | Public-Private Distressed REO Sale Partnership. Opportunistic investment strategy. |
| FDIC | Pending | FDIC looking to sell $385 Million worth of hotel mortgages collateralized by 45 hotels held by failed Georgia based Silverton Bank | Public-Private Distressed REO Sale Partnership. |
| Columbia Sussex | Blackstone Group | October 2010. Discounted purchase of junior mezzanine debt for $300 million on 14 upscale hotels owned by Columbia Sussex. The face value of the Mezzanine debt was $500 Million. Blackstone had sold these hotels to Columbia Sussex for $1.3 Billion in 2006. | Loan to Own opportunistic investment strategy. |
| Wachovia Corp | Blackstone Group | Purchase at a significant (undisclosed) discount to face value of senior mezzanine debt from Wachovia for $320 million. The debt is backed by 27 hotels owned by Highland Hospitality, a hotel REIT. The total debt load for Highland Hospitality is $1.7 Billion. | Loan to Own opportunistic investment strategy. |
| Morgan Stanley Real Estate Fund V | Investor Group: CNL-AB by hedge fund Paulson & Co | February, 2011, an agreement between Investor Group and Morgan Stanley Real Estate Fund V to take control of CNL through a foreclosure proceeding. The transaction includes 8 very large resorts. The transaction exchanged their $600 million of CNL's corporate mezzanine debt for the company's equity. The properties were immediately put into chapter 11 bankruptcy protection to stave off senior secured lender claims. | Foreclosure sale and debt restructuring under bankruptcy protection. This includes a debt to equity swap and negotiations with current lenders Investors hope to capitalize on the upside potential of the iconic properties in the portfolio, when they eventually sell. |
| FDIC | Investor Group: Northwest Investments managed by Starwood Capital | Investor group paid $554 Million for asset of failed Corus Bank. The assets consist of over 100 loan and Real estate owned assets. FDIC will have a 60 percent ownership of Northwest investments which will manage and turn around the non performing assets. In addition FDIC will provide a zero interest $1 billion working capital loan to complete projects in the loan portfolio | Public-Private Distressed Sale Partnership. The investor group purchased the assets at approximately a 60% discount and expect to monetize their investment by turning around the distressed assets. |
| Extended Stay America | Investment Group: Centerbridge, Paulson & Co and Blackstone | Purchased Extended Stay America in a bankruptcy auction for $3.93 billion in 2010. | Bankruptcy auction sale, and repositioning for eventual sale. |
| Six Flags Inc: Amusement Parks | Lenders: Hedgefund Silver Point Capital, Beach Point Capital, Fidelity, JP Morgan Chase | Just ahead of bankruptcy filing in the summer of 2010, Six Flags reached a prenegotiated reorganization plan with lenders to exchange its debt for 92 percent equity in the new company after it emerges from bankruptcy | Debt to Equity Swap |

**Source: Author**

## Table 3

## Hotel Acquisition Funds: Distressed Asset Focus

| COMPANY | NAME OF FUND | EQUITY SIZE | TARGET |
|---|---|---|---|
| Blackstone Group Backstonegroup.com | Blackstone Real Estate Partners IV | US $10.6 billion | hotels, global |
| Brightside Acquisitions Group Danielldevelopment.com | Brightside's Global Opportunity Fund | US $700 million | Unfinished or distressed hotels; highly motivated sellers; REIT-quality Luxury, Upper Upscale, Upscale, Midscale with F&B, Midscale w/o F&B |
| Colony Capital Colonyfinancial.com | Colony Financial Inc. | US $308.25M market cap (3/1/2011) | acquiring, originating, investing in, financing and managing a diversified portfolio of real estate-related debt investments, with a primary focus on commercial mortgage loans (which may be performing, sub-performing or non-performing loans), |
| Colony Capital Colonyinc.com | Colony Distressed Credit Fund | US $1 billion | Performing products from financial institutions selling at distressed prices, including CMBS and first mortgages |
| Concord Hospitality Enterprises Concordhotels.com | | US $300 million | Distressed hotels and debt |
| DLJ Real Estate Capital Partners | DLJ Real Estate Capital Partners IV | US $200 million | Repositioning, distressed debt, development |
| Equity Global Investments LLC Equityinternational.com | Zell Credit Opportunities Fund LP | US $625 million | Distressed securities backed by assets |
| Geolo Capital Geolo.com | | US $150 million | Distressed hospitality assets in 3.5, 4-star category. |
| KABR Group/Capstone Realty | KABR Capstone Distressed Debt Fund | Distressed mortgages, mostly hotels | |
| Lone Star Funds Lonestarfunds.com | Loan Star Real Estate Fund II | US $10 billion target | Distressed commercial real estate and commercial mortgage backed securities |
| Macfarlan Capital Partners Macfarlan.com | Macfarlan Special Situations Fund I | US $300 million target | Distressed properties, high-end hotels |
| NextBridge Capital Nextbridgegroup.com | | US 100 million | Repositioning, distressed debt, development (unfinished/motivated seller) |
| RockBridge Capital Rockbridgecapital.com | RockBridge Hospitality Fund IV LP | US $160 million | Hotels with total transaction capitalization between US $10million and US$50 million |
| Starwood Property Trust Starwoodpropertytrust.com | | US $830 million IPO target | Distressed debt opportunities |

**Source: www.Hotel NewsNow.com**

## Appendix A

## Survey Questions and Summary Responses

1) How would you describe the investment market for non-performing hotel loans today?

   The market for distressed hotel loans is crowded with a large number of well-capitalized investment funds pursuing limited opportunities. Regulator's reluctance to force institutions to sell has significantly decreased available investment opportunities.

2) What major barriers exist today that are restricting non-performing hotel loan transaction volume?

   Regulators are cognizant of the heavy criticism they received resulting from the massive profits realized by distressed loan buyers in the RTC-era. As such, they have significantly relaxed requirements for banks to sell their distressed assets. Extend-and-pretend continues to be the resolution of choice. This allows banks to defer recognizing the losses in hopes that the asset's value returns to acceptable underwriting levels.

3) Who are the most active sellers of non-performing hotel loans in the market today? What are the primary motivations of those sellers?

   The FDIC and non-regulated financial institutions are the most active sellers of non-performing hotel loans in the market today. In unforced hold-sell decisions for non-regulated institutions, it is accretive to sell whenever the net present value (NPV) of the sale proceeds would be higher than the present value of the net cash inflows from the loan.

4) Who are the top buyers of non-performing hotel loans? Briefly describe the acquisition requirements and investment motivation for these buyers.

   Private-equity funds remain the largest buyers of non-performing hotel loans. Many of the same groups from the RTC-era are hoping to repeat their success during the most-recent cycle. The largest investment funds are seeking to obtain "trophy" assets that rarely come to market and have a history of strong operations in supply constrained markets.

5) What strategies are most common among each top buyer group to unlock value from the investment (loan-to-own, discounted payoffs, loan modification, etc.)?

   Most buyers are looking to obtain access to the asset through any borrower default. The loan-to-own strategy is by far the most common in the market today. However, distressed CRE owners remain active in discounted payoffs on their own loans. Yield buyers who seek to modify purchased loans are also prominent.

6) Briefly describe the most common processes of buying and sourcing debt today (Auction, Direct Sales, Marketed Sales).

Auction Sales: The selling party will arrange with a brokerage such as the Carlton Group to arrange an auction with pre-screened buyers. This is by far the most expensive option. The highest, qualified bidder will prevail. Technology and web-based auction platforms are beginning to take a much more significant role.

Direct Sales: The selling party will reach out to a select, credited buyer to assess interest. Interested parties with respond to the selling party with an Letter of Intent (LOI) and discussions will proceed from there.

Marketed Sale: Requests for Proposals (RFP) will be sent to a group of accredited buyers. While this process remains effective, it is gradually being replaced with technological innovations.

7) How does today's non-performing hotel loan investment market differ from the RTC era?

Regulators are not pressuring banks to sell distressed assets. This has significantly decreased loan sale volume. Allowing banks to hold the assets has deferred losses and allowed troubled institutions more time to shore up their balance sheets.

8) What impact do hotel management and franchise agreements have on non-performing hotel loan values?

Hotel management agreements (HMAs) with SNDA provisions preventing termination usually have a negative impact on loan pricing. The presence of a "comfort letter", which restricts the franchisor from terminating the agreement upon foreclosure, will usually have a positive impact on loan pricing. This letter ensures that the property will remain stable. Of course, the impact of HMAs and franchise agreements will vary on a case-by-case basis driven primarily by the investment buyer's motivations.

9) From a legal perspective, what is unique to non-performing hotel loan that must be addressed in the due diligence process compared to other non-performing commercial real estate debt?

Analyzing the hotel management agreements (HMA's) associated with the underlying property is of utmost importance. The mortgagee's ability to terminate a management contract could be limited by provisions in the SNDA. Given the fact that most distressed hotel debt buyers have been branded hotel companies, this could seriously diminish the pool of potential buyers and have a negative impact on pricing.

# Appendix B
# Lexicon of Distressed Debt Terms

| TERM | DEFINITION |
|---|---|
| B Note | A non-securitized (outside of REMIC Trust) subordinate loan secured by a mortgage. |
| Bad Boy Carve-out | A risk or source of liability for which a borrower's principals may assume personal liability under a Carve-out Guaranty. |
| Bid-Out | A strategy where multiple foreclosure bidders agree to let one of them acquire the collateral with a low bid, then resell it at a second auction just within the group, with the increase in price being split among the multiple bidders. Often a crime. |
| Bow-Tie Loan | Modification of an existing loan in distress, deferring interest that accrues above a pre-determined interest rate. A Bow-Tie Loan rolls any deferred interest due into the loan principal. |
| Carve-out Guaranty | A guaranty of certain risks for which a lender refuses to look solely to the collateral. Also sometimes a contingent full guaranty of the loan, to discourage the borrower from doing certain bad things (e.g., a voluntary or collusive bankruptcy). These matters are all "carved out" from the otherwise nonrecourse nature of the loan, giving the lender access to the other assets of the guarantor(s). Of little value, unless signed by a Warm Body. See also Bad Boy Carve-out. |
| Cash Sweep (or Cash Trap) | Procedure in which excess cash (beyond operating costs and debt service) goes into a lender-controlled account. Often activated by the borrower's failure to meet a financial test and accompanied by a Lockbox. |
| Chilling a Sale | Actions taken at a foreclosure sale to suppress bidding, so a favored bidder can buy below market. See also Bid-out. |
| Controlling Class | The most subordinate ("First Loss") Certificate holder in a REMIC pool. Appoints or terminates the special servicer and has approval rights over key decisions. |
| Deep Pocket | A person with extensive cash or immediately marketable securities. |
| Deep Pocket and Short Arms | A person with extensive cash or immediately marketable securities who is also very good at not using that cash or those immediately marketable securities. |
| Dialing for Dollars | Looking for a lender and trying to negotiate the best deal. |
| Doctors and Dentists | Many small investors in a real estate deal and potential plaintiffs if the deal goes bad. Often team up with lawyers who don't follow their own advice. |
| Extend and Pretend | Extending a loan because as long as the loan isn't due, the lender doesn't have to report a loss. |
| Hair | Complexities, issues, and history about a particular property that create problems, delays, and extra legal fees for the closing or workout of a transaction. |
| Haircut | A reduction of the amount of a loan or the value of an equity investment for valuation or capital purposes. |
| Hope Certificate | A subordinated position (created in a Workout) that may become valuable if the world changes in a more positive way than it has changed from mid-2007 to early 2009. |
| Jingle Mail | When a borrower mails the keys to the property back to the lender (an informal deed in lieu of foreclosure). |
| Lockbox | Arrangement by which property income goes directly to a particular bank account (subject to a lender security interest) to be applied in accordance with agreed priorities for distribution of cash. Formally called cash management. |

| TERM | DEFINITION |
|---|---|
| Marry Up | A lender's sale of an REO property by packaging it with some other property to increase the appeal to buyers. |
| Mod | Modification of an existing loan agreement. |
| Neutron Loan | A loan that destroys the borrower by forcing a sale of the property, while leaving the property itself intact. |
| NPV Positive | Anything that will increase the "Net Present Value" of a loan |
| Overrun (or Cost Over-run) | Amount by which the actual cost exceeds the originally budgeted, estimated, original, or targeted cost of a construction project. |
| REMIC | Real Estate Mortgage Investment Conduit. A non-taxable entity created to hold a pool of mortgages. |
| REO | "Real Estate Owned" or "Other Real Estate Owned" – a category of assets on a bank's balance sheet, reserved for real estate that the bank has acquired through foreclosure or a deed in lieu of foreclosure. |
| A Rolling Loan Gathers No Loss | Rolling back the maturity date of a loan defers recognition of loss. |
| See-Through Building | A finished building that does not yet have any tenant improvements or occupants and is typically in distress (or about to be). Popularized in the 1980s by Texas developers that had friendly S&L lenders. |
| Shill | A fake bidder at an auction, whose role is simply to increase the bids, with an understanding that the seller won't really require the Shill to buy if the Shill is the highest bidder. |
| Snatch Dirt | Resolution of a defaulted loan where the collateral is transferred to the lender, often through a bankruptcy. |
| Snorkeling | Negotiating, structuring, and closing transactions that relate to mortgages that are Under Water. |
| Temporary Liquidity Problem | Common explanation for financial stresses that precede a default. |
| Tranche Warfare | Disputes among the bond holders of various classes of interest in a REMIC trust. |
| Under Water | A loan whose amount exceeds the value of its collateral. |
| Warm Body | A creditworthy individual, as opposed to the borrower or a borrower-related entity that might sign a guaranty but has no real assets beyond the collateral itself. See also Deep Pocket. |
| Workout | The negotiated resolution of a troubled loan, typically but not necessarily allowing the borrower to retain the collateral, subject to the debt, for some period. |
| Yank a Bank | A clause in a loan agreement allowing the lender that administers a syndicated loan to buy out the interest of a syndicate member who does not behave, such as by disapproving a Workout that the rest of the group favors. Usually the pricing formula makes a Yank a Bank clause not very useful. |
| Zombie Building | A building that has a far off debt maturity date, but since the building is so far under water, neither the owner nor the lender will spend cash on new or renewal deals, and, therefore, building vacancy is increasing. The building appears alive but is dead. |

**Source:** http://www.1stservicesolutions.com/reference_materials.html