JLL Hotels & Hospitality

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Hospitality Debt Market Commentary

Post-COVID Edition Part I

Market Overview

JLL's Investment Banking team is in the market with over $1 billion of hotel financing requests and is pleased to report that the hospitality debt markets have improved significantly over the past two months as banks, debt funds, and even CMBS lenders have selectively returned to originating hotel loans. This increase in liquidity has been coupled with material spread compression among most lender types:

Banks

Banks are generally offering the lowest cost of capital[1], with the most competitive bank pricing at spreads in the high-300s to mid-400s over LIBOR (for non-recourse financing), which is approximately 50-75 bps inside of where banks were quoting hotel loans during the summer. Banks are limiting LTVs/LTCs to 50% and lower, and in some cases are prohibiting the placement of subordinate debt behind the senior. In other cases, banks are requiring that there be a subordinate lender behind the bank mortgage with hotel ownership/operating experience, which lender effectively serves as a back-up borrower in case the hotel owner defaults on the loan. Banks are looking to 2019 performance in underwriting the loans and are focused on assets with strong pre-COVID cash-flows with debt yields in excess of 10% (on 2019 NOI). We've seen banks most active in quoting hospitality loans for acquisitions of high-quality assets with good sponsorship and sustainable demand drivers. Hotels with significant drive-to leisure demand or life sciences demand have been in favor, as have luxury urban assets. Banks are also quoting refinancings of such assets, with a preference for a moderate cash-in to achieve the best pricing. Not surprisingly, there's a limited supply of this low-cost capital, and banks are being selective in the deals that they are pursuing. Nevertheless, the return of banks to the new hotel loan origination market and the spread compression represents a tremendously positive development in the resuscitation of the hospitality debt markets.

Debt Funds

The debt funds are also ramping up their origination of hotel loans and are the deepest pool of liquidity. To put it in context, we will almost always have a debt fund bid on a hotel financing campaign, while the banks will only bid what they perceive to be the higher quality assets with better sponsorship. Debt fund pricing has also tightened in recent weeks, and we've seen a tiering of pricing into three buckets. For the "best" assets, we've seen debt fund pricing as tight as the low-to-mid-500s over LIBOR up to the low-600s over LIBOR, with leverage constraints of 60-65%. For the next tier of hotel assets, we've seen debt fund pricing in the range of 600-700 bps over LIBOR with leverage constraints in the 65-70% range. Pricing for these two tiers is at least 100 bps tighter than where many debt funds were quoting hotel deals over the summer. For a third tier of assets and for which there is the most liquidity, we're seeing pricing in the L+700-850 bps range with leverage of up to 70-75% LTV.

Given the wide disparities in debt fund pricing, the obvious question is 'how are the tiers established and what are the differentiating factors?' Generally, different debt funds are originating in each pricing tier with some overlap at the margins, and the pricing is driven by each debt funds' cost of capital. In other words, we're not typically seeing the funds that can quote in the 500s, quoting deals in the 700s (and vice versa). Also, as the pricing widens, the greater the liquidity. Assets that performed well pre-COVID (high single-digit to low double-digit debt yield to the last dollar of proposed debt based on 2019 NOI) are generally grouped into the top two tiers, as are assets that are continuing to perform reasonably well post-COVID. Assets that do not have a pre-COVID history of performance and/or were ramping up pre-COVID are more likely to fall into the second or third tier unless there are mitigating factors such as a low loan basis, strong long-term demand drivers, and strong sponsorship. Assets that are perceived to have

1) With the exception of the SASB CMBS market, which is generally only applicable to financings in excess of $200 million.

a longer recovery horizon – urban full-service and big box assets with heavy group and/or business transient demand and/or with union labor tend to fall into the second or third tiers, absent strong sponsorship, low loan basis or other mitigating factors. Assets with a value-add component or required renovation are generally falling into the third tier, unless there are mitigating factors to drive the pricing down. Despite the challenges facing many urban assets, lenders continue to gravitate to smaller, non-union city center assets with limited F&B revenues that will likely recover quickly once there is a vaccine, and we are generally seeing these assets price in the first or second tier.

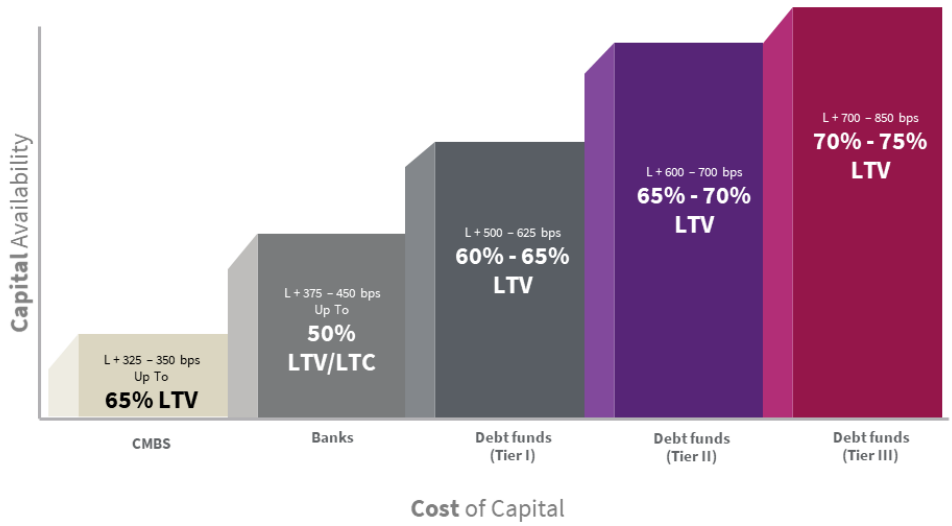
CMBS

The CMBS market is also showing signs life for hospitality as a large private equity sponsor recently closed a "single asset single borrower" (SASB) refinancing of portfolio of well-performing economy extended stay assets. The $265 million loan was sized to 63% LTV and a 14.7% trailing twelve-month debt yield, with pricing in the mid-300s over LIBOR. This financing and the re-opening of the SASB CMBS market is a meaningful step forward, as this market has been a primary source of low cost, high leverage financing for large hotel transactions (typically $200 million of proceeds or greater). The recovery of this market will be a key factor in the re-opening of the investment sales market for large hotel/portfolio transactions and M&A activity.

In the near term, we do not expect the re-opening of the SASB market to materially affect the refinancing market because the spreads on most hotel loans previously financed in the SASB market are lower than current SASB spreads. In addition, we expect that special servicers on existing SASB financed hotels will work with their borrowers to extend the loans and waive covenants, which will limit the need for these borrowers to refinance in near-term. Also, the depth of investor demand for new issue SASB paper is unclear, so there's a question as to how much supply of new hotel loans the SASB market can absorb.

Unfortunately, the small loan CMBS conduit market remains largely closed to new hotel financings. Many conduit hotel loans that were originated pre-COVID remain on bank balance sheets, and the banks have only recently started to securitize these loans. We expect that the reopening of the CMBS conduit market will be a gradual process that will accelerate once there is greater clarity around the course of the virus and property operating fundamentals.

Summary of Current Debt Markets



Construction Loans

The construction lending markets continue to be the most constrained. Given the uncertainty around the timing for a recovery and the abundance of opportunities to finance existing assets at relatively wide spreads, lender appetite for new construction loans is low and the spreads are wide. To the extent that deals are getting done, loan sizing and pricing is very bespoke, with each deal being underwritten based on the particulars of the project, market and sponsorship. Based on conversations with lenders, banks are generally limiting construction leverage to 50% or lower, with spreads in the 400s over LIBOR and with repayment guarantees of 50% or greater, and completion guaranties. Debt funds are generally limiting leverage to 60% with spreads in the high single digits over LIBOR, and may also require a partial repayment guaranty, in addition to a completion guaranty. From an underwriting perspective, today is arguably the best time to originate a construction loan because the debt service will be capitalized for 18-24 months, enabling a lender to hopscotch the remaining pre-vaccine period and the early post-vaccine period. Newly constructed assets will be opening into what we expect to be a very strong recovery with the newest, state-of-the-art product designed with post-COVID sensibilities. For these reasons, we are confident that as the uncertainty around COVID dissipates there will be an appetite among lenders to originate construction loans on high-quality assets in high barrier-to-entry markets with great sponsorship.

Loan Structure

The post-COVID hospitality financing landscape has ushered in several new structural features. Specifically, we are seeing lenders require 6-12 months of interest reserves, even if an asset is cash flow positive. In the SASB CMBS deal previously mentioned, the lender required a 12-month interest reserve to be capitalized at closing, even though the portfolio had in excess of a 14% debt yield on trailing twelve-month NOI. To the extent that operating losses are projected, lenders will also require an operating shortfall reserve for several months or longer, with an obligation to replenish the reserve if the account dips below a threshold. Depending on the leverage constraints, lenders may gross up the loan amount to include the reserves, so long as the total debt does not exceed the prescribed max LTV/LTC of the loan to cost (asset value plus closing costs and capex, but excluding the reserves in the total capitalization calculation). Many lenders are also requiring carry guarantees that are recourse to the sponsor for any debt service and operating expense shortfalls. We expect these structures to remain in place until there's an improvement in operating fundamentals and there's an increase in debt market liquidity/competition to drive a relaxing of these requirements.

The Backstory & the Road to Recovery

The reopening of the hotel debt markets has been precipitated by several factors:

- Nascent Investment Sales Market: Although not many deals have closed post-COVID, there are an increasing number of asset sales and recapitalizations that are driving the need for new financing and are inducing lenders back into the space. These trades are also establishing a pricing benchmark for hospitality assets, which the markets/lenders have so desperately needed since the start of the crisis.
- Abundance of Debt Capital: Debt funds are raising record amounts of capital to take advantage of the real estate market recovery, and the need to deploy this capital is resulting in new loan originations.
- Credit Trifecta:
    - » Lower Asset Values: Recent hotel investment sales are generally establishing values at a 10-20% discount to pre-COVID valuation and these lower, reset values are attractive to lenders.
    - » Lower Leverage: Many lenders have lowered their maximum leverage constraints by 5 to 10 points depending on lender type, resulting in more attractive attachment points in the capital structure for lenders.
    - » Higher Pricing: Even with the recent tightening in pricing, hotel loan pricing is significantly wider than pre-COVID levels and is also at a substantial premium to debt pricing for other CRE asset classes. Specifically, bank loan pricing is at least 200 bps wider than pre-COVID, while debt fund pricing is at least 250-300 bps wider. Pricing for hospitality loans is also at least 200 to 300 bps wider than pricing for other in-favor CRE asset types. This risk premium is drawing more lenders into the space and will be a key driver of spread tightening as operating fundamentals improve.

In our opinion the recovery of the hospitality debt markets will be led by the debt funds, which are best situated to provide the risk capital (in the debt stack) to underwrite the hospitality market recovery. We anticipate that debt fund lending in the short- and medium-term will make up for the withdrawal of many banks from the sector, much like in the period following the Global Financial Crisis when banks were sidelined from new origination due to impaired balance sheets, and the debt funds stepped in to fill the void. Today, bank balance sheets are relatively healthy, but the impairment that does exist is concentrated in hospitality and retail, causing some banks to withdraw from the space, thus creating an opportunity for the debt funds. Even for the banks that are active, many will be challenged to underwrite hospitality because their standard underwriting metric of a 10%+ historical debt yield may not exist on many assets for 18-24 months. In the absence of strong historical operating performance, banks will likely keep leverage levels in the 50-60% range (compared to 65% LTV pre-crisis, and will be very mindful of loan-per-key relative to the cyclical low asset valuations).

Although banks may be less active in new hotel loan originations, they will be an integral part of the hotel debt market recovery as providers of “repo” financing, credit facilities and loan-on-loan financing for the debt funds. Banks’ willingness to provide this financing at higher advance rates and at attractive spreads will be a key component in reducing the cost of debt fund capital for hotel loans.

Conclusion

While the past seven months have certainly been among the most historically challenging periods for hospitality, the JLL Hotel Investment Banking team remains optimistic that the debt markets are on the road to recovery. On the day of the election and come what may, our optimism is supported by the increase in liquidity and the meaningful spread compression that we've witnessed in a short period of time. Despite this optimism, let us be clear that the markets continue to be affected by uneven liquidity and significant spread disparities among lenders. In fact, it's not uncommon for us to see spread disparities of 150bps or greater on a bid matrix for the same level of proceeds in a financing campaign. As you consider your financing options, JLL's Hotel Investment Banking team stands ready to assist in navigating today's unique financing environment.

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