Stuck with the bill:

CMBS financing's incompatibility with an unpredictable world

As hotel revenues evaporated, owners were forced into protection mode. For most, loan forbearance and federal stimulus became the critical tools to stay afloat, but many CMBS sponsors were left to fend for themselves.

By Peter Laskey, Barclay Fellow

Almost one year ago, I attended NAREIM's Executive Officer Meeting in Newport Beach, California, as a Barclay Fellow. The opportunity for an MBA student like myself to converse with industry leaders was incredibly valuable for my young career. Over the course of the three-day conference, both small discussions and formal presentations were consistent in their message: lots of "dry powder," "late-inning" stage of the cycle, and "it won't be 2008 again." I am sure you might have heard similar outlooks.

I took the knowledge I learned at the conference and applied it to my previous column for the Spring 2020 issue of Dialogues: a glimpse into the current state and future trends for lodging. In short, I predicted that in 2020, the development lag would approach plateauing demand levels, resulting in a slight downtrend in RevPAR. However, I promoted the premium-brand, select-service hotel as a relatively recession-proof asset with a high upside on the back end.

My first foray into making predictions for the real estate industry did not age gracefully. Instead of my previous claim that "the days of a -16% RevPAR decline like in 2009 are long in the rearview mirror," we are faced with a "new reality" that dawned with the onset of the Covid-19 pandemic: according to CBRE,[1] US hotels had a -75% RevPAR decrease versus the prior year in Q2. Occupancy tumbled to 28.3% in the quarter, forcing the temporary closure of many assets. At the drop of a hat, hotel owners and operators were forced to go into protection mode: responsive asset management and loan forbearance became the top concern.

Fortunately, according to a recent survey by the AHLA,[2] about 90% of hotel investors who hold traditional bank debt have received relief, primarily in the

1 CBRE, US Hotel Outlook: Recovery Under Threat? July 30, 2020.
2 Ben Eisen, Hotel Owner Seeking Mortgage Relief? Not If Wall Street Owns Your Loan, *Wall Street Journal*, June 4, 2020.
3 Trepp, CMBS Special Servicing Rate Continues Upward Trend in August, September 2020.

form of three- or six-month payment deferrals. However, investors holding commercial mortgage-backed securities (CMBS) or other securitized debt have not been as lucky — they face many barriers when receiving relief.

Hotel CMBS market

Of the $550 billion US CMBS market, about $86 billion is secured by hotel or lodging assets, ranging from large, 'big box' convention hotels as 'single asset, single borrower' to smaller hotels packaged in a portfolio. Many investors are attracted to securitized debt's low-interest rate and non-recourse nature to finance new deals. However, the pandemic has shined a bright light on one major downside of CMBS loans: when a loan is packaged and sold to other investors, there is a much higher degree of difficulty in receiving any restructuring. According to the same AHLA survey, only about 20% of owners with securitized loans have received any form of relief.

During the Covid-19 era, it is common for CMBS borrowers to run into dead-ends or long delays when reaching a restructuring agreement with their servicers. CMBS loan documents are complex, and servicers claim it takes time to pare through each contract to reach an agreement. Understandably, servicing agencies were neither adequately staffed nor had any warnings of such a sudden blitz of servicing requests.

According to Trepp data,[3] the average special servicing rate for lodging was about 2% in the 12 months leading to March 2020 (see Exhibit 1). That number skyrocketed to 11.4% in April, then 16.2% in May, and continued to climb to 20.5% by June and a staggering 24.99% in August. The same rate for retail CMBS loans grew from 6.1% in April to 17.3% in August, indeed a large number and scary increase, but still a much tamer increase in servicing rate than witnessed in the lodging sector. Office, multifamily and industrial special servicing rates have consistently stayed low throughout the pandemic. Therefore, lodging and retail are responsible for the spike in the total special servicing rate: 10.04% in August versus 2.8% heading into 2020.

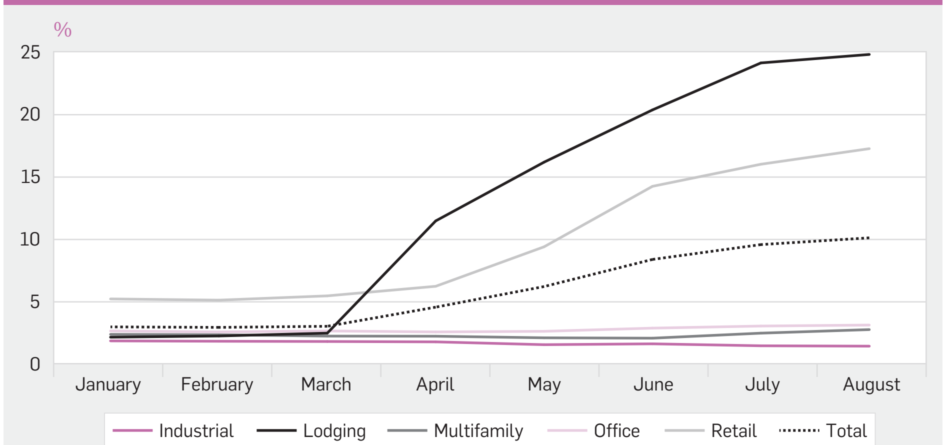
Trepp also reports that the CMBS delinquency rate for hotels spiked to 24.3% in June while retail clocked in at 18.1%. The total delinquency rate for June was 10.32%, just 2 basis points short of Trepp's all-time high of 10.34% recorded in July of 2012. Interestingly, the peak delinquency rate in the wake of the Global Financial Crisis occurred more than three years after the crash of 2009. Meanwhile, it took Covid-19 only three months to reach the same level — another sign of the incredibly unique and swift toll of the pandemic.

Fortunately, unlike the virus itself, the delinquency rate hit 'terminal velocity' in July — meaning that if borrowers have not requested relief in April through June, they probably never will. If this theory proves true, the month-over-month increase in delinquency should diminish as time goes on. In fact, after its peak in June, the delinquency rate decreased 78 basis points in July and another 58 basis points in August after a large chunk of loans were 'cured' by way of maturity extension or reserve relief. However, the delinquency rate is expected to increase again in Q3 after the temporary relief window closes.

Searching for relief

Due to the nature of their loans, CMBS borrowers have struggled to find relief. Unfortunately, their headaches do not stop there: CMBS loan structures also prohibit borrowers from taking on any 'additional indebtedness' without approval from their servicer. Borrowers who take on unapproved debt are massively penalized, including the possibility of the loan becoming fully recourse. Therefore, most federal programs designed to keep businesses open during the pandemic lockdowns,

Exhibit 1: CMBS special servicing rate by sector



Source: Trepp. Data as of September 3, 2020.

[4] Asian American Hotel Owners Association, Hotel Owners Call for Additional Congressional Action to Stave Off Catastrophic Collapse of Hospitality Industry, July 23, 2020.
[5] CBRE, US Hotel Outlook: Recovery Under Threat? July 30, 2020.
[6] Jay Singh, Plateauing US Passenger Numbers Show Evidence of Choppy Recovery, *Simple Flying*, July 28, 2020.
[7] Peter Grant, Cash Pours Into Distressed Real Estate Funds as Investors Aim to Play Offense, *Wall Street Journal*, April 21, 2020.

such as the Payment Protection Program (PPP) rolled out in April, were out of reach for CMBS borrowers; taking on these federal loans could breach their contracts. Even if their servicers do approve additional debt like the PPP, the added complexity and red tape for borrowers desperately searching for cash inflows may be too high a hurdle to clear.

There is a silver lining that might backstop some of the borrower's losses. As previously mentioned, many servicers were not prepared for the influx of servicing requests and therefore may be reluctant to foreclose on assets. From the servicer's perspective, the sponsors are still best suited to continue to manage the asset, as courts are clogged and appraisals are difficult. Foreclosure seems to be the last resort for servicers, especially for well-capitalized and name-brand sponsors. The foreclosure process might be prohibitively difficult to the already overwhelmed servicers, and some borrowers might squeak with a few missed payments while cash is low.

With an industry back on its heels and in dire need of support, lobby groups such as the AHLA and the Asian American Hotel Owners Association, which represent about 55,000 of the nation's hotels, have stepped up their lobbying efforts. On July 23, 2020, the AHLA penned a letter to lawmakers to "establish a CMBS market relief fund, with a specific focus on the hotel industry." In this letter, the AHLA warned that "pervasive default and foreclosure on hotel CMBS debt would be disastrous for the commercial real estate market at large, as well as the holders of that debt, including pension plans and other investors."[4] Thus far, federal resources have supported mainly agency and multifamily CMBS distressed debt.

For those investors who did receive deferrals, the three- or six-month forbearance period will quickly recede, and unfortunately, it will not take the virus with it. While the deferrals are crucial to maintain liquidity and keep people employed, the US's uncontrolled Covid-19 spread means it is more and more likely that six months is not long enough of a runway to get most hotels back to profitability. When these deferrals expire in about Q4 of this year, travel demand will still be severely depressed; Q3 and Q4 skew heavily toward group and convention business, which will surely be near nonexistent. As with all things Covid-19, it is too early to tell how agreeable banks will be in their restructuring come winter, but it will likely be less than the 90% of bank debt holders who received relief the first go-around.

(New) Outlook for hotels

So, what does this mean for the near future of hotels? Indeed, it is a different world than my prior prediction made in February of a slight downturn. After a predicted -52.8% RevPAR decrease in 2020, CBRE forecasts[5] that US hotel revenues will not fully recover until 2024.

The United States' lack of control of the Covid-19 viral spread through the summer, as compared to other countries with high testing rates, has undoubtedly hampered our recovery. According to Transportation Security Administration (TSA) data,[6] week-over-week air travelers decreased in late July, generally peak summer travel season, after consistent favorable green shoots since mid-April. Better control of the spread is necessary for economic recovery. Domestically, travelers will not gain the confidence to travel until they feel safe, and inbound international travel will be restricted until we can prove that the US's Covid-19 spread is under control.

Surely this will not be the death blow to the lodging industry. While cultural changes due to Covid-related work-from-home policies could cause irreversible damage to the business and convention sectors, many Americans like myself are longing to travel again. With all the dry powder sitting on the sidelines from the eight-year expansion, many investors are gearing up for a surge of 'Covid discount' lodging assets to become available. While the transaction market is currently pretty quiet, banks might be forced to sell off the loans when loan forbearance expires in Q4. We have already witnessed many funds raised specifically for distressed assets and non-performing debt.[7]

Alas, hotel investors encumbered with CMBS debt have endured the long road, and they are not anywhere close to being out of the woods. The AHLA is correct when they say that such a massive surge in hotel delinquency will haunt the entire CRE industry, not just lodging. And while we should put more resources towards helping these assets stay afloat, the lesson is clear: our world has become increasingly unpredictable, and rigid financing options, like CMBS, have been exposed in their instrumentality in an already unpredictable sector. ◆

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