THE TENTH ANNUAL
2012 HOSPITALITY LAW CONFERENCE
FOCUSING ON LEGAL, SAFETY & SECURITY SOLUTIONS
FEBRUARY 8-10, 2012 • HOUSTON, TEXAS
PRESENTED BY HOSPITALITYLAWYER.COM

Nuts and Bolts of Deal Structuring

Investment Analysis and How to Structure Equity

Presenters

- Steven Lerner is President & CEO of Redstone Companies Real Estate, LLC and oversees all real estate acquisitions, development and growth opportunities
- Serves on the Board of Directors of Green Bancorp, Inc. and of Harris County Improvement District #1 (Uptown Houston District)
- Graduated with honors from the University of Texas and with honors from the University of Texas School of Law, where he was a member of The Texas Law Review. Prior to joining Redstone, Mr. Lerner was a partner at the law firm now known as Schlanger, Silver, Barg and Paine, L.L.P.

- Ms. Hallem is a partner in the Real Estate and Land Use Group of the law firm of Manatt, Phelps & Phillips, LLP, and chair of its Hospitality Group
- Ms. Hallem has been involved in structuring and documenting loans and joint venture agreements for more than 25 years
- Over the last 2 years, Ms. Hallem has been involved in structuring and documenting agreements totaling more than a billion dollars in asset value.

Introduction

- Past deals had simple structures
  - Equity + Debt
    - Borrower tried to maximize debt
    - At maturity debt was refinanced at par or at increased debt level with equity pulled out
  - In the 80's, Texas thrift institutions in many cases lent 100% (or more) of the asset value
  - Market crashed, S&L crisis happened, resulting in years of workouts
  - Borrowers and lenders tightened standards and became more conservative of the total financing for a deal

Introduction

- In mid-2000s, financing deals became more complicated
  - More debt options for borrowers
    - CMBS
    - Mezzanine debt
    - Traditional lenders
  - Borrowers/equity became more sophisticated, and deals became more complicated
    - Private equity and JV structures became prevalent, bringing institutional sophistication to deal structures

Introduction

- In current economic climate, the advantages and disadvantages of complicated structures have become very apparent
  - Primary advantage is availability of more outside capital/less sponsor equity; however,
  - Restructuring a deal may take longer
  - Uncertainty around which decisions servicers/special servicers can make
  - Vague or no legal precedent in some cases with multiple debt holders/bond holders
  - Complex intercreditor agreements with multiple layers of debt

Introduction

- Todays deal structures depend highly upon the quality of the asset
  - Good properties attract an abundance of capital, though at a price.
  - Bad properties continue to be starved for new capital
  - Capital flow and pricing is highly dependent on what asset class is in favor with the lenders

Deal Structures

- Deal structures are dependent on the type of deal involved, which tend to break down into a few key categories:
  - Straight refinancing on existing properties
  - Recapitalizations (better known as 'this is what you call it when you cannot do a straight refinancing')
  - Acquisitions
  - Some combination of any of the above
  - New development (yes, there is some of this still going on!)

Deal Structures- Refi

<u>Refinancing</u>

- Most straightforward deal structure
- Only possible if there is enough (1) value and (2) cash flow in the asset to support a refinancing
  - If value or cash flow is lacking, borrower may have to invest more equity to lower debt amount
  - If underwriting standards have tightened, such as in the hospitality industry, even “healthy” assets may not be able to be refinanced

Deal Structures - Recap

Recapitalizations

- Recapitalizations are a popular route today, and the term encompasses many different structures
- Recapitalizations can involve adding new equity OR adding new debt to the investment
- Recapitalizations are necessary when
  - additional capital is needed to avoid losing the existing equity as a result of a default on the existing debt,
  - additional capital is needed for renovation or other significant capital expenditures,
  - additional capital is needed simply to pay down/pay off/refinance existing senior or mezzanine debt,

Deal Structures - Recap

- Recaps can also be completed when an owner desires to monetize a portion of the equity investment while still retaining an ownership stake in the asset
- Many recapitalizations involve some level of distress
  - Asset may no longer support debt service
  - Asset may not be able to be refinanced at current level
  - Asset may need capital investment

Example - Recap

Recapitalization Example

Original Acquisition Price & Appraised Value - $100,000,000

Senior Debt (70%)	$70,000,000 – 5 years I/O loan
Equity (30%)	$30,000,000
Primary Equity Investor (90%)	$27,000,000
Sponsor Equity (10%)	$ 3,000,000

- At loan maturity – Appraised Value is $90,000,000
- Senior Lender willing to renew only at 65% of appraised value, or $58,500,000
- “Equity Gap” of $11,500,000

Example - Recap

Potential Solutions

1. Original Primary Equity Investor and Sponsor Equity each put up their respective shares of the Equity Gap.

2. Sponsor Equity has no ability to fund additional capital; Original Primary Equity Investor is willing to fund the Equity Gap
   - Partners must review governing document (LLC or LP Agreement) to view obligations of parties under this scenario
     - If document provides an obligation to fund, then the document is followed unless parties negotiate something different

Example - Recap

- If there is no firm obligation to fund, typically there is a consequence if one party funds and the other does not.
  - dilution
  - forfeiture of interest
- If there is no agreement or if a party cannot/will not live up to its obligations, then the parties may negotiate who funds and how

3. The parties cannot/ will not fund the necessary equity and look to new equity to provide the needed capital.

Example - Recap

- Key issue is value of original equity
  - What is value of original equity?
  - Is it wiped out?
- Common theme exists that the new capital (the "New Capital") has priority
  - preferential return PLUS a return of capital prior to the old capital receiving anything
  - original equity sometimes keeps ownership "share" pari passu but is simply subordinated to New Capital; however,
  - original equity may also be diluted 125 – 150% or more
  - New Capital, in some cases, becomes the General Partner and earns a promoted interest as part of the waterfall

Example - Recap

- No standard formula for these types of transactions
  - outcome is highly dependent on the current and potential performance of the asset and therefore the range of potential outcomes
  - Low end: existing equity is wiped out
  - Middle: existing equity receives hope certificate (piece of promoted interest, if any exists)
  - High: counted as pari passu with new equity
    - Only in limited circumstances where values and performance are good, but new equity is still necessary for refi or to invest needed cap ex

Example - Recap

New Waterfall Examples

- The following slides depict some commonly seen examples of how returns are preferenced and allocated in recapitalizations
- These are merely representative; actual structures vary greatly and may be based upon
  - return requirements of New Equity
  - desirability and predicted performance of the investment
  - the value proposition of the Original Equity
    - management capabilities/continuity
    - important relationships
    - important historical knowledge

Example - Recap

Example A- Basic Waterfall

Senior Debt	$58,500,000
New Equity	$11,500,000

Capital Distributions:

1. 10-15% preferred return on New Equity
2. Return of capital for New Equity
3. 50% to New Equity; 50% to Original Equity

Example - Recap

Example B- Two Tier Waterfall

Senior Debt	$58,500,000
New Equity	$11,500,000

Capital Distributions:

1. 10-15% preferred return on New Equity
2. Return of capital for New Equity Capital
3. 75% to New Equity; 25% to Original Equity until New Equity receives a specified IRR [16% - 20%]; then
4. 50% to New Equity; 50% to Original Equity

Example - Recap

Example C- Waterfall with "Hope Certificate"

Senior Debt	$58,500,000
New Equity Injection	$11,500,000
New Equity	$9,200,000
Original Primary Equity	$2,300,000
Original Sponsor Equity	$0

Capital Distributions:

1. New Equity Injection receives 10-15% preferred return
2. Return of capital for New Equity Injection; thereafter
3. 50% to New Equity; 50% to Original Primary Equity until a specified IRR, then
4. 50% to New Equity, 45% to Original Primary Equity, 5% to Original Sponsor Equity (effectively a "hope certificate" to Original Sponsor Equity).

Deal Structures - Acquisitions

Acquisitions

- What has changed the most about acquisitions is the deal sourcing
- Fewer deals on the market
  - Some are in “extend and pretend”
  - Some are just “stuck” in restructuring
  - Some notes have been sold to new owners who are either happy with note yield or have not restructured/ foreclosed
- Increased number of acquisitions are done through note or REO sales from lenders

Deal Structures - Acquisitions

- “Normal” investment sales activity has begun to increase for all property types, including hospitality, as debt returns to the market and interest rates remain favorable
  - As expected, desirability and volume of investment sales is highly correlated with banking industry’s appetite for product type.
    - Hotels are somewhere on the continuum between multifamily (most desirable) and single family residential land (least desirable)

Deal Structures - Acquisitions

- Acquisitions structures in the new economy are generally the same, with key differences being:
  - Lower LTVs (50-75% generally)
  - Fewer non- recourse loans
  - Difficult to get funding for future loan proceeds, such as for capital expenditure requirements
    - Forces equity to find alternative financing sources for large capital requirements

Deal Structures - Other

Combinations

- New equity sources have been stepping in as mezzanine debt
  - Can be short term (bridge debt/high yield) or longer term (traditional mezzanine financing)
  - Some new equity sources are "loan to own"
    - If borrower defaults on the senior note, mezzanine can cure
    - mezzanine debt holder may have a perceived advantage in acquiring the note from senior lender
  - Some new equity simply desires equity like returns for a perceived lower risk

Deal Structures - Other

- Note purchases, performing or non-performing
  - Note holder can either foreclose or restructure if debt is in default
  - Note holder can get good return if note is purchased at discount
- Partial acquisitions
  - Equity can “buy into” an asset that has little or no need for a recapitalization
    - Generally only high quality assets with good value/cash flow
    - Allows owner to monetize some of the investment today and still maintain some ownership
    - New equity gets to put capital to work

Deal Structures - Development

New Development

- The ability to develop new product is highly correlated with banks ability/willingness to lend construction capital
- Lenders will often require substantial guarantees in conjunction with construction loans
- Very little construction debt available for speculative development projects outside of multifamily
- Brands have stepped in with creative solutions
  - Key money
  - Loan Guarantees (whole or partial)
  - Mezzanine debt programs
- In areas of high demand, owners/developers may approach local demand generators to “pre-sell” or guarantee a certain number of room nights for a certain number of years (like pre-leasing)

Session Evaluation

Scan or Visit TheHLC.co