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LODGING LEADERS PODCAST

Financing for New Hotel Development with Malcolm Davies

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Jon Albano: This is Lodging Leaders podcast with John Albano, Session Number 191.

Welcome to the Lodging Leaders podcast, where top performing hoteliers and hospitality industry experts share powerful insights, and actionable advice to help you grow your portfolio. And now your host, John Albano.

Jon Albano: In today's interview, we talk about financing for new hotel development, and for those that have never financed a property before, we go over some of the basics, including some rookie mistakes that you want to avoid. We talk about the types of hotels that lenders and investors are looking to get involved in right now and why. We talk about which cities and locations are most desirable for lenders and investors right now and who some of the major financing players are in the market. And, we talk about setting some realistic revenue projections so that your property can withstand a significant dip for an extended period of time.

Jon Albano: So, without further ado, please welcome Malcolm Davies of gspartners.com. Malcolm, welcome to Lodging Leaders. Thank you so much for coming on the show today.

Malcolm Davies: Thanks for having me, John.

Jon Albano: Oh, it's great to have you. Where are you calling in from, by the way?

Malcolm Davies: I am calling in from Los Angeles and actually, amtaking a trip to the Hollywood Dream Hotel to meet with one of our other clients, Oxford Capital, to talk about the Godfrey Hotel we're working on in Phoenix, Arizona.

Jon Albano: Well, fantastic. Just please don't crash your car while we're talking, all right?

Malcolm Davies: Of course.

Jon Albano: All right. Well, why don't we start out with you sharing a little bit about your background, so our listeners can get to know you.

Malcolm Davies: Sure. I'm one of the Managing Directors/Principals at George Smith Partners in Los Angeles. We've been around, in one way or the other as a firm since 1979. There are seven of us that are the Principals that I would say are the producers for originations and deal flow, representing entrepreneurial developers, really

doing institutional level deals. Our clients, by nature are entrepreneurs and generally look to hire an organization like ours to help in capitalizing their respected ventures.

Malcolm Davies: I've been a Principal at the firm for about seven years. My background before that was as a real estate developer putting together about 35 different partnerships in the 2000s. I really struggled to get through the recession. Like many folks, I learned that I was a young entrepreneurial guy, but I was also not very well capitalized to survive. I learned how to work through many challenges in that recession and about restructuring deals. I ended up getting into the hospitality sector because I was working on a project in San Diego that we actually turned from an office development to a courtyard Marriott and restructured it.

Malcolm Davies: So, that was great. We focus a lot in the hospitality sector. We recognize there are significant amounts of entrepreneurial developers and sponsors in this space. We've had a pretty good track record and run with regards to capitalizing structured deals, and what does that mean? That means we put together, not just construction or bridge or permanent financing, but we will work with sponsors and helping them in things like mezzanine financing or stretch financing facilities as well as joint venture equity placements and financing those elements as well. So, that's a little bit of the background.

Jon Albano: Awesome. So, let's start with some of the basics here, right? Because I don't want to make any assumptions here. So, for those that have never financed a property, how much do they need to have down? How much do they leverage? That kind of stuff.

Malcolm Davies: Sure. I think it goes across the board depending on risk profile and asset class per se in the hospitality space. So, for example, on select service and limited service, we will find that lenders will stretch a little bit further on leverage. For example, we did a Hilton Garden Inn in Davis, California, in the earlier part of this year where we financed 85% of the total project. It was a reposition of an old boutique hotel. Given the leverage, that pricing was higher than a project I'm doing in Portland where Bank of America is the lender at 65% leverage.

Malcolm Davies: So, you'll find yourselves in a range depending on your risk profile and leverage. I would say you're never going to put anything less than 15% as a down payment, in residential terms, upwards to 45% depending on the sponsorships' risk profile. For lower leverage deals, we've done a number of 55% levered facilities for clients as well.

Jon Albano: Got it. Are there ever scenarios where someone else meets some of that? You're talking about a 15% minimum, is there any way to reduce that amount where you maybe get a 5% from some other sources as well? So, you're really only coming out of pocket 10.

Malcolm Davies: Exactly. So, I'll give you an example. That's where equity comes into play a little bit. If a client calls us and says, "We're doing a $100 million project and we're looking to put in only, let's call it, $3 million into the deal", that's only 3% of the capital stack. I'm already thinking, okay, we need to look for an equity partner to join in the venture. In that case, we would look to maybe lever up to 65% or 70%. And then out of the $30 million or $35 million that is remaining, we would then get, call it, $27 million to $32 million from an institutional equity partner to join our client in doing that venture.

Malcolm Davies: Other elements I would say getting to 90% leverage in hospitality is a bit aggressive. I think we cap out generally without equity at about 85%. There are some circumstances where you could get to 90%. Generally, I try to recommend against over leveraging assets. And so we generally advise to try to not go higher than 85% in most circumstances.

Jon Albano: Yeah. It totally makes sense to me. I mean when I was talking to a lot of folks after the recession, the way they got themselves into trouble was being over leveraged. They couldn't withstand a dip in revenues for any kind of extended period of time. So, I get the point of that 15% minimum there. So, how do you guys add value in finding the best financing options? You talked a little bit about that right there, but can you expand on that a little bit?

Malcolm Davies: Sure. In general, financing is a place to make a market. I always try to tell clients it is not who you know; it's how you know how to get them to do the deal with the terms that are the best for you. When we go out into the market representing clients, we generally go wide. For example, just yesterday we closed a $212 million financing on a Montage and Pendry dual branded luxury lifestyle project in California. I think on this project we went to north of 250 capital sources and spent a number of years to actually put it together. We are very proud of the execution.

Malcolm Davies: You can see how hard that would be to do within, let's call it an entrepreneurial platform. We are really an off-balance sheet team that goes out and sources all of the bids from the market and tries to work through them. The goal is to identify deal champions at those organizations who buy off on the business plan. And that can take time. So, for us, we have eight folks on our team that put together an offer memorandum that is well written, concise and supported by a model. We will go out in the market and talk to everybody and put together as many proposals as we can for whatever the project might be.

Malcolm Davies: Generally, there are a lot of different nuances along the way. However, the best part about it is the gratification of being able to successfully capitalize projects for our clients. Now, of course we're not free, but we do not charge any upfront fees of any sort. We're only paid on success. So, clients with overhead and things that they have to manage don't have to worry about paying us unless we get the project capitalized. At that point, there is more willingness to pay our fee because

we've been successful and our clients are now generating fees, revenues, and profit, and the like.

Malcolm Davies: And that's generally how it works. It's a little bit simplistic. There's a lot more to it, but it's fun. It's a lot of work, but nothing is greater than, for example, closing our project yesterday on behalf of a great client of ours, Robert Green Company. So, that's a little bit of the story.

Jon Albano: That's awesome. All right, so what are your thoughts on EB-5 funding?

Malcolm Davies: We were the first ever group to finance the four star offering within the Montage platform called the Pendry. It's the Pendry in San Diego, and, for that project, we used $49.5 million of EB-5. It was very successful and a great execution. On that project, we actually utilized Colony and Ares as the initial lenders and then refinanced that capital stack out with Mack out of New York along with some EB-5. EB-5 was great for that project.

Malcolm Davies: Another one of our clients is a group called BPM up in Portland. We very recently financed their Radisson Blu project in the Disneyland submarket of Anaheim. They were successful in utilizing EB-5 on a project of theirs up in Portland, a Radisson Red project, and we may utilize the EB-5 from the Red project on a new project they are doing up in Portland. I think EB-5 is a great capital source. However, I think the world knows that the number of opportunities for these green card holders is limited and that they face a long wait process, which has caused a slowdown in the EB-5 financing space.

Malcolm Davies: I think if it's done well with a reputable sponsor on a reputable project, it's a great source of capital. However, we do not count on it for what we do. Frankly, we aren't really EB-5 capital raisers. Other folks will do that on behalf of their clients and the regional centers that they hire and work with. However, we'll work in tandem because we're providing the financing around them. But, in general, I don't know if it's going to be as much of a utilized source going forward.

Malcolm Davies: We did a great execution on a Hyatt House and Hyatt Place at LAX late last year. They had $35 million of EB-5 in that project. But today, we're not counting on our sponsors to be able to capitalize their venture or anything below the financing with EB-5. If they are successful, that's great, but we cannot underwrite it because in reality, you have to use market fundamentals, not necessarily the ability to bring in EB-5 to refinance the capital we brought in.

Jon Albano: Got it. All right, so what are some rookie mistakes that you see clients make?

Malcolm Davies: I think the number one most important thing a hotel sponsor should do is bring in a capital advisor as early as possible. Don't spend money, time and effort on something without having somebody that can actually give you some guidance about how the market is pricing, on leverage and what expected returns should be on the equity side while you're working on that project.

Malcolm Davies: I've had numerous circumstances where a developer will come to me or an owner will come to me and ask me about financing something. And they've spent $1 million or $2 million already on the project and we will give them guidance that may not be perfect for what they've tried to accomplish. Why? Because the market is different than what they perceive. I think that is the number one mistake that most folks make in this space. Hopefully, from this podcast, the best advice I can give to anyone is be able to call someone early.

Malcolm Davies: It's fine that the project is a long way away. We don't mind when a client calls us or a potential client calls us and says, "Hey, we're not going to be able to close this for 18 or 24 months," for example. It's okay. We'd rather have the ability to have that conversation early and help guide that project along the way. That's something we're really keen on. Some capital advisors don't want to get involved until later because it's part of the pipeline.

Malcolm Davies: We actually enjoy working with clients on deals that take long periods of time. I think it's the developer in me that knows that it takes a long time to put things together. We'll work on a project that maybe is only 60 days. But I have many times worked on a project, like I mentioned, for two years. And so, that to me is the best advice I think I can give folks.

Jon Albano: Got it. Getting some advice early on rather than trying to un-ring the bell halfway down the journey, right?

Malcolm Davies: Exactly.

Jon Albano: Got it. All right, so what are some realistic revenue projections that can withstand a significant dip for an extended period of time? We talked a little bit about that before. We have another presidential election coming up in a year and a half now. We're about 10 years since the last recession, right? So we're kind of due. So, anything we can do to kind of help people be a little bit more proactive in protecting themselves will be great.

Malcolm Davies: Sure. Leverage is number one. Number two is pricing and ability to service debt. Imagine if your rate doubled from a rate of 4% to 8% or 9%. You can imagine your ability to sustain yourself through issues that are challenging from both top line and bottom in your hotel. And so, for us it's important to recognize that you can service that debt and have a great amount of debt coverage. Lenders are always looking at a metric called debt yield, not just debt coverage, and not just loan to value, and not just loan to cost.

Malcolm Davies: Debt yield is really in an inverse relationship of the cap rate. So, if you're buying a property and you're looking at the cap rate, a lender's looking at their basis and saying that what is our debt yield versus that exit cap rate potential? And so, a lender will look at it and say, okay, what is my debt yield based on EBITDA after reserves? And they'll say, "Okay, I'm at a 12 debt yield on the basis of my financing." Or when you're a sponsor looking at that thing, I'm at a 12 or 13 or 14.

Malcolm Davies: That's okay. You can also start looking at something and say, I'm at a nine debt yield. I want to make sure I can protect myself and the financing on a project to cover that debt service. What I recommend when a project is actually completed and you're stabilizing, is to choose between non-recourse versus recourse. We're a big non-recourse capital advisory firm. However, there are certain circumstances where recourse might be beneficial in that it drives down the rate so that you can service the debt easier.

Malcolm Davies: And so, some clients think, and rightly so, that lower priced recourse debt is better and less risky than nonrecourse debt, which carries a higher interest rate.

Jon Albano: Can you define recourse versus nonrecourse?

Malcolm Davies: Sure. So, recourse involves what we call a repayment guarantee upon a loan deficiency. A great example would be in 2008. We knew that the world was imploding and then coming to an end. Let's imagine you had a $50 million loan on a project, but you'd invested $30 million, for example. So, it was an $80 million capital stack. Let's say the asset value fell down to $40 million. If you had a non-recourse loan, you would have lost your $30 million in equity that you invested, which would hurt of course, but you would also be able to give back the keys so to speak to the lender and not have to pay what I would call the deficiency judgment.

Malcolm Davies: The difference is with recourse, you would have to pay that $10 million delta between what the loan amount and what the foreclosing lender was able to sell the property for. And in the recession, there were certainly lots of folks that had to pay that deficiency because they had recourse financing.

Malcolm Davies: So, that is a risk that many people do not want to take. I spend a lot of time making sure that we can execute on a non-recourse loan and it can feel like the pricing of a recourse loan. To me, that's an important dynamic, but there are circumstances where you want to be able to service that debt no matter what because we all recognize that properties go up in value and they go down in value, but the best way to make money in real estate, it is to make sure you don't lose your assets over time.

Malcolm Davies: That's why I think we spend a lot of time figuring out our clients' risk profile. Some clients have deep pockets, some clients don't, and we are hesitant to make sure that someone's not over leveraging their asset. Because, in the stock market, for example, it goes up and down. Well, it doesn't necessarily go to zero, right? It doesn't go below zero, hopefully. Real estate, if you go down, and you go below the value of your loan on that property, and you cannot service that debt, you might lose your assets.

Malcolm Davies: The reality is we want to make sure our clients don't lose their assets, and so we're going to spend a lot of time making sure they can service that debt. We do sensitivity analyses where we spend a lot of time exploring what ifs. What if my

food and beverage drop this far? What if my occupancy drops? What if the ADR and the comp sets dropped tremendously? How far can I sustain myself? I think it's different for every deal, but it's something we want to spend an awful lot of time on to make sure that risk is really recognized.

Jon Albano: Yeah. So, there are practical projections, not unrealistic pie in the sky projections, right?

Malcolm Davies: Absolutely.

Jon Albano: All right. So, what are the types of hotels that lenders and investors are looking to get involved in?

Malcolm Davies: I think it's different for everybody. There are all kinds of hotel types out there. There are limited select service, such as the Hilton Garden Inns, the Cambrias of the world and the Courtyard and Residence Inns. Those are really popular from a lending and investor appetite standpoint, because the reality is they don't have huge operational expenses and generally, those have been really popular, not only this cycle, but for most cycles. There also are boutique hotels in really well-located markets, where that boutique hotel doesn't have a flag, but still drives revenues. Ultimately, boutique hotels don't pay the fees to the larger hotel flags such as the Marriotts and the Hiltons of the world.

Malcolm Davies: So that's an asset class some folks like, because they think they can drive occupancy and rate no matter what because of the location. We did a deal earlier this year called Adeline in downtown Scottsdale. They are an independent, boutique hotel, and they do really well. Ultimately, they don't feel a need to be part of a larger brand in that project. Then we go into full service hotels. We just closed the Hyatt Centric in downtown Sacramento. Hyatt Centric is what I call the lowest level full service hotel, meaning that it provides all the full service amenities that you'd get at a hotel, but the operational expenses are less than a traditional full service.

Malcolm Davies: That's the Hyatts, the Hiltons, the Marriotts, those are all out there. You also have what I call the luxury lifestyle sector, which we've done a lot in. So, for example, the luxury lifestyle segment would include Proper hotels, Godfrey hotels and Pendry hotels. These are nice hotels, but they've got a really cool vibe to them and great experiential elements that certain demographics are really keying in on, making them a great sector. And then you have your luxury space. We're working on a Ritz Carlton today. Montage would be a luxury hotel, five star.

Malcolm Davies: In all of these sectors, you have different profiles of investors and lenders. For example, we've done a lot of business with the likes of Starwood, Accor, 3650 REIT and Mosaic. These are what I would call debt fund lenders in the market that are looking to do large loans on really great projects. You'll find that appetite is tremendous in that space. Not to mention Bank of the Ozarks or Bank of America and the like, which will also be very active in that space.

Malcolm Davies: If you go into the limited service and select service space, you're going to find lenders like Lowe Enterprises and Stone Hill. They are great in that space, but they're not interested in doing anything in the full service or luxury space. So, I think in general, less risk and limited service space, maybe the yield isn't as great, but the risk is reduced so it's more like hitting a double. When you go up to the luxury lifestyle and luxury space, you need to have deep pockets, because you have huge operational expenses, but you can absolutely hit home runs in that asset class as well.

Malcolm Davies: I hope that gives a little bit of an indication. In general, the profile of the lenders might be different, but it's part of our job to make sure that we identify the right lender and the right investors for the right projects and the right sponsors.

Jon Albano: Now, do you find it hard to get funding for truly independent properties? I've heard a lot of folks say that they've gone the route of soft brands just because having that brand affiliation, it makes it a lot easier to get funding.

Malcolm Davies: No question. For example, we just closed a Marriott Autograph, and we're closing a Hyatt Unbound and a Hilton Curio. These are the soft brands that are out there. They provide that feeling of staying at a hotel that's got unique character to it, but also the backing of a reservation system that drives traffic. People are willing to figure that dynamic out and pay that extra freight so to speak, but they are de-risking themselves in the fact of not having to use the online travel agencies to book. And so, they look at that and say, okay, that's a better scenario for us rather than somebody who does that boutique or lifestyle that isn't brand affiliated.

Malcolm Davies: Again, each appetite of the folks that are looking at this have different perspectives. Our job is to match a capital source with their business plan and guide them along the way. Again, also understanding risk. I would say that the sector has grown tremendously and obviously we've seen that growth and we've worked tremendously to be in that space. We are starting to see new projects coming on line that are tapestries, that are just launching in the world that weren't there 18 months ago.

Malcolm Davies: So, it's really interesting. Again, I think that's the middle ground between being purely independent and obviously being let's just say a traditional Marriott, for example.

Jon Albano: Got it. All right. So, Malcolm, what cities and locations are most desirable for lenders? Investors right now?

Malcolm Davies: As you can imagine, we're a West Coast-centric firm, based in Los Angeles. So I'm going to probably talk more about West Coast than I am about East Coast. So, to all the East Coast listeners, I apologize. The reality is we have been able to recognize the growth of our downtown core markets. For example, we have been extremely active in downtown San Diego, Los Angeles, San Francisco, Portland, Salt Lake City, Denver, and Phoenix. These are places where you're starting to find

the traveler is looking for a greater experience with lots of things that they can walk to, restaurants, art museum and the like, around the hotels that they stay at.

Malcolm Davies: That is a trend in place and investors and lenders have said, the profile there is a great place for us to be. Another related element is universities. I think universities have had a tremendous amount of growth. Lenders and investors have recognized that these communities have been underserved in a number of ways. So, we've been active, for example, in Davis doing three hotels. You would sit there and say, "Wow, that's a lot of hotels," but it was a very underserved market.

Malcolm Davies: Another example, we did that Hyatt Centric in Sacramento. That was a market that probably was not overly active over the years, and we've seen now the Kimpton has just opened, the Centric is open and a number of other hotels are opening. In San Diego for example, we just did the Moxie which is a more millennial branded hotel. And that hotel is small square footage, 180 square feet on average per room. But, because it's in an urban environment, people aren't spending as much time in the room than they might be. The rates can go down, but you can put more room keys in that same box.

Malcolm Davies: That's part of the element. I do think that a lender is going to sit there and say, "Okay, I'm in a tertiary market. What are my demand drivers? Are there businesses around here that need business travelers? Is it a resort level market where there's going to be a lot of leisure travel?" For example, our Montage and Pendry project in La Quinta is obviously going to capture a lot of leisure travel. Our Radisson Blu at Disneyland, that's an 85% occupied market today, not a lot of four star product that's in that market.

Malcolm Davies: So, that's why that deal made a lot of sense. There are different things to focus on really, where does that demand come from? What is your group and leisure percentage differential? To me, that's another element that is important to recognize. Lenders and investors will look at tertiary markets a little more discerningly due to liquidity concerns, but in the larger markets, we're seeing a lot of appetite. I will say people aren't talking about supply, right? So, you look at certain markets and say how many keys can this market sustain?

Malcolm Davies: And you start to look at the traffic counts at the airport. One of the things we've been doing is looking at growth trajectories. How many businesses have moved here? How big is this city going to get? I have a phrase we use for markets that we call secondary. I call them, "Emerging Primary Markets". Places like Salt Lake City, Portland, or Sacramento are perceived as secondary markets. Why are they emerging primary? Because lots of jobs are being created and the quality of life in these markets is attractive. You've seen a lot of hospitality provide new offerings that probably hadn't been there previously. Those are some of the areas I would say that are of interest to investors and lenders.

Jon Albano: Yeah, that's great stuff. So, we didn't even talk about pricing here. I don't want to have you disclose too much over the podcast here, but can you give a range of if someone wanted to bring George Smith Partners on board as an advisor in the process early on, picking up your advice from early on, you start that process or what kind of numbers are they talking? I'm assuming that the model is a percentage of the total amount funded?

Malcolm Davies: If we're doing highly levered non-recourse construction financing, we're generally about 1%. The permanent loans that are maybe less complicated, pricing can come down from there. If we're doing some sub-debt, which is mezzanine financing and/or joint venture equity financing, the range of pricing goes up a little bit, because obviously it's a little more complicated. The one thing I always tell clients is if you think you can do this yourself, I absolutely am the first person to say, "Go ahead and do that." So, on less complicated deals that certainly can happen.

Malcolm Davies: I tell folks that, for the fees we charge, generally the value we create needs to be four to five times our fee. What does that mean? Well, let's just imagine if our fee was $200,000 on a project, I want to be able to create a way for the sponsor to make $800,000 to $1 million more by hiring us than they would have if they just went and did something direct. The value has to be there for us to be hired.

Malcolm Davies: And that's why you're going to find us in the space where we're doing transitional real estate, opportunistic real estate, places where people can make real returns. I'm the first to tell somebody, "Hey, this is something I think you can just go down to your local community bank, your local relationship bank and be able to execute on." Because I think, at the end of the day, we're not in the business of trying to earn something that we don't think is a value.

Jon Albano: Got It. Yeah, that makes sense. So, what's the best way for the listeners to connect with you?

Malcolm Davies: If you have interest in anything that we've talked about today, you can reach me at 310-867-2938. Our offices are right smack dab in the middle of Century City in Los Angeles, right on Avenue of the Stars and Constellation. Next time you guys are in Los Angeles, please feel free to give us a ring and stop by. You can also email me at mdavies@gspartners.com. Feel free to ping me on anything that you've heard today and hopefully we can help anybody out in any way.

Jon Albano: Awesome. And I'll make sure I link to that stuff in the show notes for you. Well, Malcolm, I've really enjoyed talking with you today. This is really great stuff. Thanks so much. I wish you well.

Malcolm Davies: Thanks John. Take care.

Jon Albano: All right. Well, I hope you enjoyed that interview with Malcolm Davis of gspartners.com. This is session number 191 and you can find the show notes,

resources, links, and comments section for this episode at lodginleaders.com/191. I'd like to thank today's sponsor, Revinate. I featured revenue back in episode number 142, so invited their co founder and CEO, Marc Heyneker back on the show to tell us a little bit about the company.

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